



# PRINCIPLES OF ACCOUNTING

Needles ■ Powers ■ Crosson ■ 12e

# Principles of Accounting

TWELFTH EDITION

Belverd E. Needles, Jr., Ph.D., C.P.A., C.M.A.  
DePaul University

Marian Powers, Ph.D.  
Northwestern University

Susan V. Crosson, M.S. Accounting, C.P.A.  
Emory University



Australia • Brazil • Japan • Korea • Mexico • Singapore • Spain • United Kingdom • United States

This is an electronic version of the print textbook. Due to electronic rights restrictions, some third party content may be suppressed. Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. The publisher reserves the right to remove content from this title at any time if subsequent rights restrictions require it. For valuable information on pricing, previous editions, changes to current editions, and alternate formats, please visit [www.cengage.com/highered](http://www.cengage.com/highered) to search by ISBN#, author, title, or keyword for materials in your areas of interest.

**Principles of Accounting, 12e****Belverd Needles, Marian Powers, Susan Crosson**

Senior Vice President, LRS/Acquisitions &  
Solutions Planning: Jack W. Calhoun

Editorial Director, Business & Economics:  
Erin Joyner

Editor-in-Chief: Rob Dewey

Executive Editor: Sharon Oblinger

Development Editor: Krista Kellman

Editorial Assistant: A.J. Smiley

Sr. Brand Manager: Kristen Hurd

Sr. Market Development Manager:  
Natalie Livingston

Sr. Marketing Communications Manager:  
Sarah Greber

Marketing Coordinator: Eileen Corcoran

Sr. Content Project Manager: Tim Bailey

Media Editor: Lysa Kosins

Manufacturing Planner: Doug Wilke

Production Service: Cenveo Publisher Services

Sr. Art Director: Stacy Jenkins Shirley

Internal and Cover Designer: Craig Ramsdell

Cover Image: © Martin Marraud/Getty Images

Rights Acquisition Director: Audrey Pettengill

© 2014, 2011 South-Western, Cengage Learning

ALL RIGHTS RESERVED. No part of this work covered by the copyright herein may be reproduced, transmitted, stored, or used in any form or by any means graphic, electronic, or mechanical, including but not limited to photocopying, recording, scanning, digitizing, taping, web distribution, information networks, or information storage and retrieval systems, except as permitted under Section 107 or 108 of the 1976 United States Copyright Act, without the prior written permission of the publisher.

For product information and technology assistance, contact us at  
**Cengage Learning Customer & Sales Support, 1-800-354-9706**

For permission to use material from this text or product,  
submit all requests online at **www.cengage.com/permissions**

Further permissions questions can be emailed to  
**permissionrequest@cengage.com**

**ExamView®** is a registered trademark of eInstruction Corp.

The financial statements are included for illustrative and education purposes only. Nothing herein should be construed as financial advice.

Except where otherwise noted, all content in this title is © Cengage Learning.

Library of Congress Control Number: 2012950474

ISBN-13: 978-1-133-62698-5

ISBN-10: 1-133-62698-X

**South-Western**

5191 Natorp Boulevard

Mason, OH 45040

USA

Cengage Learning is a leading provider of customized learning solutions with office locations around the globe, including Singapore, the United Kingdom, Australia, Mexico, Brazil, and Japan. Locate your local office at: **www.cengage.com/global**

Cengage Learning products are represented in Canada by Nelson Education, Ltd.

For your course and learning solutions, visit **www.cengage.com**  
Purchase any of our products at your local college store or at our preferred online store **www.cengagebrain.com**



# BRIEF CONTENTS

	<b>1</b>	<b>Accounting Principles and the Financial Statements</b>	<b>1</b>
	<b>2</b>	<b>Analyzing and Recording Business Transactions</b>	<b>39</b>
	<b>3</b>	<b>Adjusting the Accounts</b>	<b>85</b>
	<b>4</b>	<b>Completing the Accounting Cycle</b>	<b>131</b>
	<b>5</b>	<b>Foundations of Financial Reporting and the Classified Balance Sheet</b>	<b>169</b>
	<b>6</b>	<b>Accounting for Merchandising Operations</b>	<b>205</b>
SUPPLEMENT TO CHAPTER	<b>6</b>	<b>Special-Purpose Journals</b>	<b>249</b>
	<b>7</b>	<b>Inventories</b>	<b>263</b>
	<b>8</b>	<b>Cash and Internal Control</b>	<b>301</b>
	<b>9</b>	<b>Receivables</b>	<b>335</b>
	<b>10</b>	<b>Long-Term Assets</b>	<b>367</b>
	<b>11</b>	<b>Current Liabilities and Fair Value Accounting</b>	<b>409</b>
	<b>12</b>	<b>Accounting for Partnerships</b>	<b>451</b>
	<b>13</b>	<b>Accounting for Corporations</b>	<b>491</b>
	<b>14</b>	<b>Long-Term Liabilities</b>	<b>545</b>
	<b>15</b>	<b>The Statement of Cash Flows</b>	<b>601</b>
SUPPLEMENT TO CHAPTER	<b>15</b>	<b>The Direct Method of Preparing the Statement of Cash Flows</b>	<b>649</b>
	<b>16</b>	<b>Financial Statement Analysis</b>	<b>659</b>
SUPPLEMENT TO CHAPTER	<b>16</b>	<b>How to Read an Annual Report</b>	<b>715</b>
	<b>17</b>	<b>Managerial Accounting and Cost Concepts</b>	<b>759</b>
	<b>18</b>	<b>Costing Systems: Job Order Costing</b>	<b>803</b>
	<b>19</b>	<b>Costing Systems: Process Costing</b>	<b>843</b>
	<b>20</b>	<b>Valued-Based Systems: Activity-Based Costing and Lean Accounting</b>	<b>881</b>
	<b>21</b>	<b>Cost-Volume-Profit Analysis</b>	<b>921</b>
	<b>22</b>	<b>The Budgeting Process</b>	<b>957</b>
	<b>23</b>	<b>Flexible Budgets and Performance Analysis</b>	<b>1005</b>
	<b>24</b>	<b>Standard Costing and Variance Analysis</b>	<b>1047</b>
	<b>25</b>	<b>Short-Run Decision Analysis and Capital Budgeting</b>	<b>1089</b>
APPENDIX	<b>A</b>	<b>Investments</b>	<b>1131</b>
APPENDIX	<b>B</b>	<b>Present Value Tables</b>	<b>1147</b>
		<b>Endnotes</b>	<b>1155</b>
		<b>Glossary</b>	<b>1159</b>
		<b>Company Name Index</b>	<b>1176</b>
		<b>Subject Index</b>	<b>1178</b>

# CONTENTS

CHAPTER 1	<b>Accounting Principles and the Financial Statements</b>	1
	<b>BUSINESS INSIGHT KEEP-FIT CENTER</b> 1	
	<b>Concepts Underlying Accounting Measurement</b> 2	
	Financial and Managerial Accounting 2	
	Accounting Measurement 3	
	Forms of Business Organization 4	
	<b>Concepts Underlying Financial Position</b> 6	
	Assets 6	
	Liabilities 6	
	Owner's Equity 7	
	<b>Financial Statements</b> 8	
	Income Statement 8	
	Statement of Owner's Equity 8	
	Balance Sheet 8	
	Statement of Cash Flows 10	
	Relationships Among the Financial Statements 11	
	<b>Generally Accepted Accounting Principles</b> 12	
	GAAP and the Independent CPA's Report 12	
	Organizations That Issue Accounting Standards 13	
	Other Organizations That Influence GAAP 13	
	Professional Conduct 14	
	<b>Decision Makers: The Users of Accounting Information</b> 15	
	Management 15	
	Users with a Direct Financial Interest 15	
	Users with an Indirect Financial Interest 16	
	Governmental and Not-for-Profit Organizations 16	
	Business Goals and Activities 17	
	Financial Analysis 18	
	<b>Ethical Financial Reporting</b> 19	
	<b>TRILEVEL PROBLEM</b> 20	
	CHAPTER REVIEW 22	
	CHAPTER ASSIGNMENTS 24	
CHAPTER 2	<b>Analyzing and Recording Business Transactions</b>	39
	<b>BUSINESS INSIGHT PAWS AND HOOFS CLINIC</b> 39	
	<b>Concepts Underlying Business Transactions</b> 40	
	Recognition 40	
	Valuation 40	
	Classification 41	
	<b>Double-Entry System</b> 42	
	Accounts 42	
	Chart of Accounts 42	
	The T Account 44	
	Rules of Double-Entry Accounting 44	
	Normal Balance 45	
	Owner's Equity Accounts 45	
	The Accounting Cycle 46	
	<b>Business Transaction Analysis</b> 47	
	Summary of Transactions 54	
	<b>The Trial Balance</b> 56	
	Preparation and Use of a Trial Balance 56	
	Finding Trial Balance Errors 57	
	<b>Recording and Posting Transactions</b> 58	
	General Journal 58	
	General Ledger 59	
	Some Notes on Presentation 60	
	<b>Ethical Financial Reporting and Business Transactions</b> 62	
	Recognition 62	
	<b>Cash Flows and the Timing of Transactions</b> 63	
	<b>TRILEVEL PROBLEM</b> 65	
	CHAPTER REVIEW 68	
	CHAPTER ASSIGNMENTS 69	

---

**CHAPTER 3 Adjusting the Accounts 85**
**BUSINESS INSIGHT RELIABLE ANSWERING SERVICE 85**
**Concepts Underlying Income Measurement 86**

Net Income 86

Income Measurement Assumptions 87

**Concepts Underlying Accrual Accounting 88**

Recognizing Revenues 88

Recognizing Expenses 89

**The Adjustment Process 90**

Type 1 Adjustment: Allocating Recorded Costs (Deferred Expenses) 91

Type 2 Adjustment: Recognizing Unrecorded Expenses (Accrued Expenses) 94

Type 3 Adjustment: Allocating Recorded, Unearned Revenues (Deferred Revenues) 96

Type 4 Adjustment: Recognizing Unrecorded, Earned Revenues (Accrued Revenues) 97

A Note About Business Transactions 98

**Using the Adjusted Trial Balance to Prepare Financial Statements 99**
**Adjusting Entries and the Financial Statements 101**
**Net Income: Ethical Measurement and Cash Flows 102**

Ethical Considerations for Business 102

Using Accrual-Based Information to Make Management Decisions 103

**TRILEVEL PROBLEM 104**

CHAPTER REVIEW 108

CHAPTER ASSIGNMENTS 110

---

**CHAPTER 4 Completing the Accounting Cycle 131**
**BUSINESS INSIGHT SPEEDY MOVERS 131**
**Concepts Underlying Closing Entries 132**

Closing Entries 132

**Preparing Closing Entries 134**

Step 1: Closing the Credit Balances 135

Step 2: Closing the Debit Balances 136

Step 3: Closing the Income Summary Account Balance 138

Step 4: Closing the Withdrawals Account Balance 139

The Accounts After Closing 140

**Reversing Entries: An Optional First Step 141**
**The Work Sheet: An Accountant's Tool 143**

Preparing the Work Sheet 143

**Closing Entries and the Financial Statements 146**
**The Importance of the Work Sheet and Closing Entries for Managers 148**

Using the Work Sheet 148

**TRILEVEL PROBLEM 149**

CHAPTER REVIEW 151

CHAPTER ASSIGNMENTS 152

---

**CHAPTER 5 Foundations of Financial Reporting and the Classified Balance Sheet 169**
**BUSINESS INSIGHT SURF-WITH-PARK COMPANY 169**
**Concepts Underlying Financial Reporting 170**

Objective of Financial Reporting 170

Qualitative Characteristics of Accounting Information 171

Accounting Conventions 172

Ethical Financial Reporting 174

**Classified Balance Sheet 175**

Assets 175

Liabilities 177

Owner's Equity 178

Overview of Classified Balance Sheet Accounts 179

**Using Classified Financial Statements 180**

Evaluation of Liquidity 180

Evaluation of Profitability 181

**TRILEVEL PROBLEM 188**

CHAPTER REVIEW 191

CHAPTER ASSIGNMENTS 192

---

**CHAPTER 6 Accounting for Merchandising Operations 205**

**BUSINESS INSIGHT MINK COMPANY** 205

**Concepts Underlying Merchandising Accounting** 206

**Forms of the Income Statement** 208

Multistep Income Statement 208

Single-Step Income Statement 211

**Terms of Sale** 212

Sales and Purchases Discounts 212

Transportation Costs 213

Terms of Debit and Credit Card Sales 214

**Perpetual Inventory System** 215

Purchases of Merchandise 215

Sales of Merchandise 217

**Periodic Inventory System** 221

Purchases of Merchandise 222

Sales of Merchandise 224

**Merchandising Transactions and the Financial Statements** 227

**The Operating Cycle and Foreign Business Transactions** 228

Operating Cycle 228

Foreign Business Transactions 229

**TRILEVEL PROBLEM** 231

CHAPTER REVIEW 234

CHAPTER ASSIGNMENTS 235

---

**SUPPLEMENT TO CHAPTER 6: SPECIAL-PURPOSE JOURNALS 249**

**Sales Journal** 249

**Purchases Journal** 252

**Cash Receipts Journal** 254

**Cash Payments Journal** 257

**General Journal** 259

CHAPTER ASSIGNMENTS 260

---

**CHAPTER 7 Inventories 263**

**BUSINESS INSIGHT GRABS COMPANY** 263

**Concepts Underlying Inventory Accounting** 264

Accrual Accounting and Valuation of Inventories 264

Goods Flow and Cost Flows 265

Conservatism and the Lower-of-Cost-or-Market (LCM) Rule 265

Disclosure of Inventory Methods 266

Summary of Inventory Decisions 266

**Inventory Cost Under the Periodic Inventory System** 268

Specific Identification Method 268

Average-Cost Method 269

First-In, First-Out (FIFO) Method 269

Last-In, First-Out (LIFO) Method 270

Summary of Inventory Costing Methods 271

**Impact of Inventory Decisions** 272

Effects on the Financial Statements 272

Effects on Income Taxes 273

Effects on Cash Flows 273

**Inventory Cost Under the Perpetual Inventory System** 274

Specific Identification Method 274

Average-Cost Method 275

FIFO Method 275

LIFO Method 276

Summary of Inventory Costing Methods 276

**Valuing Inventory by Estimation** 277

Retail Method 277

Gross Profit Method 278

**Inventory and the Financial Statements** 278

**Management Issues Related to Inventory** 280

Evaluating the Level of Inventory 280

Inventory Management 281

Effects of Inventory Misstatements on Income Measurement 282

**TRILEVEL PROBLEM** 284

CHAPTER REVIEW 287

CHAPTER ASSIGNMENTS 288

---

**CHAPTER 8 Cash and Internal Control 301**

**BUSINESS INSIGHT SUNG'S GRILL** 301

**Concepts Underlying Internal Control** 302

The Need for Internal Controls 302

Components of Internal Control 303

Control Activities 303

Internal Control and Achieving Control Objectives 304

Limitations on Internal Control 305

**Internal Control over Merchandising Transactions** 306

Control of Cash Receipts 307

Control of Purchases and Cash Disbursements 307

**Cash Equivalents and Cash Control** 311

Cash Equivalents 311

Cash Control Methods 312

**Petty Cash Funds** 314

Establishing the Petty Cash Fund 314

Making Disbursements from the Petty Cash Fund 315

Reimbursing the Petty Cash Fund 315

**Internal Control and the Financial Statements** 317

**Management Issues Related to Internal Control** 318

Management's Responsibility for Internal Control 318

Independent Accountant's Audit of Internal Control 318

**TRILEVEL PROBLEM** 319

**CHAPTER REVIEW** 320

**CHAPTER ASSIGNMENTS** 322

---

**CHAPTER 9 Receivables 335**

**BUSINESS INSIGHT SMART COMPUTER COMPANY** 335

**Concepts Underlying Notes and Accounts Receivable** 336

Accounts Receivable 336

Notes Receivable 337

The Allowance Method: Using Accrual Accounting to Value Receivables 338

Disclosure of Receivables 339

**Uncollectible Accounts** 340

Percentage of Net Sales Method 340

Accounts Receivable Aging Method 341

Comparison of the Two Methods 343

Writing Off Uncollectible Accounts 344

**Common Calculations for Notes Receivable** 345

Maturity Date 346

Duration of a Note 346

Interest 346

Maturity Value 347

Accrued Interest 347

Dishonored Note 347

**Receivables and the Financial Statements** 348

**Evaluating the Level of Accounts Receivable and Ethical Ramifications** 349

Receivables Turnover 349

Days' Sales Uncollected 350

Financing Receivables 350

Ethics and Estimates in Accounting for Receivables 352

**TRILEVEL PROBLEM** 353

**CHAPTER REVIEW** 355

**CHAPTER ASSIGNMENTS** 356

## CHAPTER 10

**Long-Term Assets**

367

**BUSINESS INSIGHT NEIGHBORHOOD CARRIERS** 367**Concepts Underlying Long-Term Assets** 368

Classification, Accrual Accounting, and Disclosure of Long-Term Assets 368

Valuation and Disclosure of Long-Term Assets 369

Recognition of the Acquisition Cost of Long-Term Assets 370

**Acquisition Cost of Property, Plant, and Equipment** 372

Specific Applications of Determining the Acquisition Cost of Property, Plant, and Equipment 372

**Depreciation** 374

Factors in Computing Depreciation 375

Methods of Computing Depreciation 375

Special Issues in Determining Depreciation 379

**Disposal of Depreciable Assets** 380

Discarded Plant Assets 380

Plant Assets Sold for Cash 381

Exchanges of Plant Assets 383

**Natural Resources** 384

Depletion 384

Depreciation of Plant Assets Related to Natural Resources 385

Development and Exploration Costs in the Oil and Gas Industry 385

**Intangible Assets** 386

Research and Development Costs 389

Computer Software Costs 389

Goodwill 390

Long-Term Assets and the Financial Statements 390

**Management Decisions Relating to Long-Term Assets** 392

Acquiring and Financing Long-Term Assets 392

Ethics in Acquiring and Financing Long-Term Assets 393

**TRILEVEL PROBLEM** 394

CHAPTER REVIEW 396

CHAPTER ASSIGNMENTS 398

## CHAPTER 11

**Current Liabilities and Fair Value Accounting**

409

**BUSINESS INSIGHT TERESA'S FITNESS CENTER** 409**Concepts Underlying Current Liabilities** 410

Recognition 410

Valuation 410

Classification 410

Disclosure 411

**Common Types of Current Liabilities** 412

Definitely Determinable Liabilities 412

Estimated Liabilities 420

**Contingent Liabilities and Commitments** 424**Valuation Approaches to Fair Value Accounting** 425

Interest, the Time Value of Money, and Future Value 426

Present Value 427

Present Value of an Ordinary Annuity 429

**Applications Using Present Value** 430

Valuing an Asset at Present Value 431

Present Value of a Deferred Payment 431

Other Applications 432

Current Liabilities and the Financial Statements 432

**Business Issues Related to Current Liabilities** 433

Working Capital and the Current Ratio 433

Evaluating Accounts Payable 433

**TRILEVEL PROBLEM** 436

CHAPTER REVIEW 438

CHAPTER ASSIGNMENTS 439

## CHAPTER 12

**Accounting for Partnerships**

451

**BUSINESS INSIGHT ANKIN AND KENT****PARTNERSHIP** 451**Concepts Underlying Partnerships** 452

Characteristics of Partnerships 452

Advantages and Disadvantages of Partnerships  
Summarized 453

Advantages of Partnerships 453

Disadvantages of Partnerships 453

**Accounting for Partners' Equity** 454**Distribution of Partnership Income and  
Losses** 455

Stated Ratios 456

Capital Balance Ratios 456

Salaries, Interest, and Stated Ratios 458

**Dissolution of a Partnership** 461

Admission of a New Partner 461

Withdrawal of a Partner 465

Death of a Partner 467

**Liquidation of a Partnership** 467

Gain on Sale of Assets 468

Loss on Sale of Assets 470

The Balance Sheet and Partner's Equity 472

**Alternate Forms of Partnership-Type  
Entities** 474

Limited Partnerships and Joint Ventures 474

Limited Partnerships 474

Joint Ventures 474

Companies That Look Like Partnerships 475

**TRILEVEL PROBLEM** 476

CHAPTER REVIEW 478

CHAPTER ASSIGNMENTS 480

## CHAPTER 13

**Accounting for Corporations**

491

**BUSINESS INSIGHT VIETCHA, INC.** 491**Concepts Underlying the Corporate  
Form of Business** 492

The Corporate Form of Business 492

Advantages and Disadvantages of  
Incorporation 493

Equity Financing 494

**Components of Stockholders'  
Equity** 496

Characteristics of Preferred Stock 498

**Issuance of Common Stock** 500

Accounting for Par Value Stock 501

No-Par Stock 502

Issuance of Stock for Noncash Assets 503

**Accounting for Treasury Stock** 505

Purchase of Treasury Stock 505

Sale of Treasury Stock 506

Retirement of Treasury Stock 508

**Accounting for Cash Dividends** 510**Stock Dividends and Stock Splits** 513

Stock Dividends 513

Stock Splits 515

**The Statement of Stockholders' Equity and  
Book Value per Share** 516

Statement of Stockholders' Equity 516

Book Value per Share 518

Stockholders' Equity and the Financial  
Statements 518**Evaluating Dividend Policies, Company  
Performance, and Stock Options** 520

Dividend Yield 520

Return on Equity 520

Price-Earnings Ratio 521

Cash Flow Information 522

Stock Options as Compensation 522

**TRILEVEL PROBLEM** 523

CHAPTER REVIEW 525

CHAPTER ASSIGNMENTS 527



CHAPTER 14	<b>Long-Term Liabilities</b>	545
	<b>BUSINESS INSIGHT SWAN MANUFACTURING COMPANY</b> 545	
	<b>Concepts Underlying Long-Term Liabilities</b> 546	
	Recognition 546	
	Valuation 546	
	Classification 546	
	Disclosure 546	
	Types of Long-Term Debt 546	
	<b>The Nature of Bonds</b> 549	
	Bond Issue: Prices and Interest Rates 549	
	Characteristics of Bonds 550	
	<b>Accounting for the Issuance of Bonds</b> 551	
	<b>Bonds Issued at Face Value</b> 551	
	<b>Bonds Issued at a Discount</b> 552	
	<b>Bonds Issued at a Premium</b> 554	
	Bond Issue Costs 554	
	<b>Using Present Value to Value a Bond</b> 555	
	<b>Amortization of Bond Discounts and Premiums</b> 557	
	Amortizing a Bond Discount 557	
	Amortizing a Bond Premium 562	
	<b>Retirement and Conversion of Bonds</b> 566	
	Retirement of Bonds 566	
	Conversion of Bonds 567	
	<b>Other Bonds Payable Issues</b> 568	
	Sale of Bonds Between Interest Dates 568	
	Year-End Accrual of Bond Interest Expense 570	
	<b>Long-Term Leases</b> 572	
	<b>Pension Liabilities</b> 576	
	<b>Long-Term Liabilities and the Financial Statements</b> 576	
	<b>Management Issues Related to Long-Term Debt Financing</b> 578	
	<b>Evaluating the Decision to Issue Long-Term Debt</b> 578	
	Evaluating Long-Term Debt 579	
	Interest Coverage Ratio 580	
	Cash Flow Information 581	
	<b>TRILEVEL PROBLEM</b> 581	
	<b>CHAPTER REVIEW</b> 584	
	<b>CHAPTER ASSIGNMENTS</b> 586	

CHAPTER 15	<b>The Statement of Cash Flows</b>	601
	<b>BUSINESS INSIGHT DELIGA CORPORATION</b> 601	
	<b>Concepts Underlying the Statement of Cash Flows</b> 602	
	Relevance of the Statement of Cash Flows 602	
	Classification of Cash Flows 603	
	Required Disclosure of Noncash Investing and Financing Transactions 605	
	Alternate Presentations of Operating Activities 605	
	<b>Step One: Determining Cash Flows from Operating Activities</b> 607	
	Depreciation, Amortization, and Depletion 609	
	Gains and Losses 610	
	Changes in Current Assets 610	
	Changes in Current Liabilities 611	
	Schedule of Cash Flows from Operating Activities 613	
	<b>Step Two: Determining Cash Flows from Investing Activities</b> 614	
	Investments 615	
	Plant Assets 615	
	<b>Step Three: Determining Cash Flows from Financing Activities</b> 618	
	Bonds Payable 618	
	Common Stock 618	
	Retained Earnings 619	
	Treasury Stock 619	
	<b>Step Four: Preparing the Statement of Cash Flows</b> 620	
	<b>Cash Flows and the Financial Statements</b> 621	
	<b>Analyzing Cash Flows</b> 622	
	Cash Flow Ratios 622	
	Free Cash Flow 624	
	Asking the Right Questions About the Statement of Cash Flows 625	
	Ethical Considerations in Analyzing the Statement of Cash Flows 626	
	<b>TRILEVEL PROBLEM</b> 627	
	<b>CHAPTER REVIEW</b> 631	
	<b>CHAPTER ASSIGNMENTS</b> 632	

---

**SUPPLEMENT TO CHAPTER 15: THE DIRECT METHOD OF PREPARING THE STATEMENT OF CASH FLOWS** 649

<b>Determining Cash Flows from Operating Activities</b> 649	Cash Payments for Operating Expenses 651
Cash Receipts from Sales 650	Cash Payments for Interest 652
Cash Receipts from Interest and Dividends 650	Cash Payments for Income Taxes 652
Cash Payments for Purchases 650	<b>Compiling the Statement of Cash Flows</b> 652



CHAPTER 16	<b>Financial Statement Analysis</b>	659
	<b>BUSINESS INSIGHT MEDICAL INVESTMENTS</b> 659	
	<b>Concepts Underlying Financial Performance Measurement</b> 660	
	Standards of Comparison 661	
	Sources of Information 662	
	<b>Tools and Techniques of Financial Analysis</b> 664	
	Horizontal Analysis 664	
	Trend Analysis 666	
	Vertical Analysis 667	
	Financial Ratio Analysis 670	
	<b>Comprehensive Illustration of Financial Ratio Analysis</b> 670	
	Evaluating Profitability and Total Asset Management 671	
	Evaluating Liquidity 673	
	Evaluating Financial Risk 675	
	Evaluating Operating Asset Management 677	
	Supplemental Financial Ratios for Assessing Operating Asset Management and Liquidity 679	
	Evaluating Market Strength with Financial Ratios 680	
	<b>Financial Statement Analysis and Performance Assessment</b> 681	
	<b>Evaluating Quality of Earnings</b> 683	
	Accounting Methods 683	
	Accounting Estimates 684	
	One-Time Items 685	
	Management Compensation 687	
	<b>TRILEVEL PROBLEM</b> 688	
	CHAPTER REVIEW 693	
	CHAPTER ASSIGNMENTS 694	

---

SUPPLEMENT TO CHAPTER 16: HOW TO READ AN ANNUAL REPORT	715
--	-----

<b>The Components of an Annual Report</b> 715	Statements of Management's Responsibilities 722
Letter to the Shareholders 715	Auditors' Reports 722
Financial Highlights 715	<b>Excerpts from CVS Caremark Corporation's 2011 Annual Report</b> 725
Description of the Company 716	<b>Excerpts from Southwest Airlines Co.'s 2011 Annual Report</b> 747
Management's Discussion and Analysis 716	
Financial Statements 716	
Notes to the Financial Statements 720	

---

CHAPTER 17	<b>Managerial Accounting and Cost Concepts</b>	759
------------	--	-----

<b>BUSINESS INSIGHT CHOICE CANDY COMPANY</b> 759	Income Statement and Accounting for Inventories 771
<b>The Role of Managerial Accounting</b> 760	Statement of Cost of Goods Manufactured 773
Managerial Accounting and Financial Accounting: A Comparison 760	Cost of Goods Sold and a Manufacturer's Income Statement 774
<b>Concepts Underlying Costs</b> 761	<b>Measurement of Product Costs</b> 775
Cost Recognition 761	Computing Product Unit Cost 775
Cost Measurement 762	Product Cost Measurement Methods 775
Financial Reporting 763	Computing Service Unit Cost 776
Cost Behavior 764	<b>Managerial Accounting and the Management Process</b> 777
Value-Adding versus Non-Value-Adding Costs 765	Evaluating 779
<b>Inventory Accounts in Manufacturing Organizations</b> 766	Communicating 779
Document Flows and Cost Flows Through the Inventory Accounts 766	<b>Standards of Ethical Conduct</b> 780
The Manufacturing Cost Flow 768	<b>TRILEVEL PROBLEM</b> 782
<b>Financial Statements and the Reporting of Costs</b> 771	CHAPTER REVIEW 785
	CHAPTER ASSIGNMENTS 787

---

**CHAPTER 18 Costing Systems: Job Order Costing 803**

**BUSINESS INSIGHT CUSTOM GOLF CARTS, INC.** 803

**Concepts Underlying Product Costing Systems** 804

Job Order and Process Costing Systems 804

**Job Order Costing in a Manufacturing Company** 805

Materials 805

Labor 807

Overhead 808

Completed Units 809

Sold Units 809

**A Job Order Cost Card and the Computation of Unit Cost** 810

A Manufacturer's Job Order Cost Card 810

Computation of Unit Cost 810

Job Order Costing in a Service Organization 811

**Cost Allocation** 813

Allocating the Costs of Overhead 814

Actual Cost of Goods Sold or Cost of Sales 815

Allocating Overhead: The Traditional Approach 817

Allocating Overhead: The ABC Approach 817

**Product Unit Cost Information and the Management Process** 818

Planning 818

Performing 818

Evaluating 818

Communicating 818

Supporting the Management Process 819

**TRILEVEL PROBLEM** 820

**CHAPTER REVIEW** 823

**CHAPTER ASSIGNMENTS** 825

---

**CHAPTER 19 Costing Systems: Process Costing 843**

**BUSINESS INSIGHT MILK PRODUCTS COMPANY** 843

**Concepts Underlying the Process Costing System** 844

**Patterns of Product Flows and Cost Flow Methods** 845

Cost Flows Through the Work in Process Inventory Accounts 846

**Computing Equivalent Production** 846

Equivalent Production for Direct Materials 847

Equivalent Production for Conversion Costs 848

Summary of Equivalent Production 848

**Preparing a Process Cost Report Using the FIFO Costing Method** 849

Accounting for Units 851

Accounting for Costs 852

Assigning Costs 852

Process Costing for Two or More Production Departments 854

**Preparing a Process Cost Report Using the Average Costing Method** 856

Accounting for Units 856

Accounting for Costs 857

Assigning Costs 858

**The Management Process and the Process Costing System** 861

**TRILEVEL PROBLEM** 862

**CHAPTER REVIEW** 865

**CHAPTER ASSIGNMENTS** 867

<b>CHAPTER 20</b>	<b>Valued-Based Systems: Activity-Based Costing and Lean Accounting</b>	<b>881</b>
	<b>BUSINESS INSIGHT BEAN BAG CONVERTIBLES, INC.</b> 881 <b>Concepts Underlying Value-Based Systems</b> 882 Value Chain Analysis 882 Supply Chains 882 Using Information from Value Chains and Supply Chains 883 Process Value Analysis 883 Value-Adding and Non-Value-Adding Activities 883 <b>Activity-Based Management</b> 885 Activity-Based Costing 885 The Cost Hierarchy and the Bill of Activities 885 <b>The New Operating Environment and Lean Operations</b> 889 Just-In-Time (JIT) 889 Continuous Improvement of the Work Environment 891 Accounting for Product Costs in a JIT Operating Environment 891 <b>Backflush Costing</b> 892 Cost Flows in Traditional and Backflush Costing 893 <b>Management Tools for Continuous Improvement</b> 896 Total Quality Management 896 Theory of Constraints 896 Comparison of ABM and Lean Operations 896 <b>TRILEVEL PROBLEM</b> 899 CHAPTER REVIEW 902 CHAPTER ASSIGNMENTS 903	
<b>CHAPTER 21</b>	<b>Cost-Volume-Profit Analysis</b>	<b>921</b>
	<b>BUSINESS INSIGHT MY MEDIA PLACE</b> 921 <b>Concepts Underlying Cost Behavior</b> 922 Cost Behavior 922 <b>Mixed Costs and the Contribution Margin Income Statement</b> 927 The Scatter Diagram Method 927 The High-Low Method 928 Statistical Methods 929 The Engineering Method 929 Contribution Margin Income Statements 929 <b>Cost-Volume-Profit Analysis</b> 931 <b>Breakeven Analysis</b> 931 Using an Equation to Determine the Breakeven Point 932 The Breakeven Point for Multiple Products 933 <b>Using CVP Analysis to Plan Future Sales, Costs, and Profits</b> 936 Assumptions Underlying CVP Analysis 936 Applying CVP to Target Profits 936 <b>TRILEVEL PROBLEM</b> 940 CHAPTER REVIEW 942 CHAPTER ASSIGNMENTS 944	
<b>CHAPTER 22</b>	<b>The Budgeting Process</b>	<b>957</b>
	<b>BUSINESS INSIGHT FRAMECRAFT COMPANY</b> 957 <b>Concepts Underlying the Budgeting Process</b> 958 The Master Budget 958 <b>Preparation of a Master Budget</b> 960 Budget Procedures 962 <b>Operating Budgets</b> 962 The Sales Budget 962 The Production Budget 963 The Direct Materials Purchases Budget 964 The Direct Labor Budget 966 The Overhead Budget 966 The Selling and Administrative Expenses Budget 967 The Cost of Goods Manufactured Budget 968 <b>Financial Budgets</b> 970 The Budgeted Income Statement 970 The Capital Expenditures Budget 971 The Cash Budget 971 The Budgeted Balance Sheet 974 <b>Budgeting and the Management Process</b> 976 Advantages of Budgeting 976 Budgeting and Goals 976 Budgeting Basics 977 <b>TRILEVEL PROBLEM</b> 979 CHAPTER REVIEW 981 CHAPTER ASSIGNMENTS 983	

---

**CHAPTER 23 Flexible Budgets and Performance Analysis 1005**
**BUSINESS INSIGHT WINTER WONDERLAND****RESORT 1005****Concepts Underlying Performance Analysis 1006**

What to Measure, How to Measure 1006

Types of Responsibility Centers 1007

Organizational Structure and Performance Reports 1009

**Performance Evaluation of Cost Centers and Profit Centers 1011**

Flexible Budgets and Performance Analysis 1011

Evaluating Cost Center Performance Using Flexible Budgeting 1012

Evaluating Profit Center Performance Using Variable Costing 1012

**Performance Evaluation of Investment Centers 1014**

Return on Investment 1014

Residual Income 1016

Economic Value Added 1017

**Performance Measurement 1018**

Organizational Goals and the Balanced Scorecard 1018

Performance Evaluation and the Management Process 1021

**Performance Incentives and Goals 1022**

Linking Goals, Performance Objectives, Measures, and Performance Targets 1022

Performance-Based Pay 1022

The Coordination of Goals 1022

**TRILEVEL PROBLEM 1024**

CHAPTER REVIEW 1027

CHAPTER ASSIGNMENTS 1029

---

**CHAPTER 24 Standard Costing and Variance Analysis 1047**
**BUSINESS INSIGHT ICU, INC. 1047****Concepts Underlying Standard Costing 1048****Variance Analysis 1049**

Computing Standard Costs 1049

Standard Direct Materials Cost 1049

Standard Direct Labor Cost 1050

Standard Overhead Cost 1050

Total Standard Unit Cost 1051

The Role of Flexible Budgets in Variance Analysis 1051

Using Variance Analysis to Control Costs 1053

**Computing and Analyzing Direct Materials Variances 1054**

Computing Total Direct Materials Cost Variance 1054

Business Application 1056

**Computing and Analyzing Direct Labor Variances 1057**

Computing Total Direct Labor Cost Variance 1057

Business Application 1059

**Computing and Analyzing Overhead Variances 1060**

Computing Total Overhead Cost Variance 1060

Business Application 1065

**Using Cost Variances to Evaluate Managers' Performance 1067****TRILEVEL PROBLEM 1069**

CHAPTER REVIEW 1075

CHAPTER ASSIGNMENTS 1076

CHAPTER 25	<b>Short-Run Decision Analysis and Capital Budgeting</b>	1089
	<p><b>BUSINESS INSIGHT HOME STATE BANK</b> 1089</p> <p><b>Concepts Underlying Decision Analysis</b> 1090</p> <p>Concepts Underlying Incremental Analysis 1090</p> <p><b>Incremental Analysis for Outsourcing Decisions</b> 1093</p> <p>Outsourcing Analysis 1093</p> <p><b>Incremental Analysis for Special Order Decisions</b> 1094</p> <p>Special Order Analysis: Price and Relevant Cost Comparison 1095</p> <p>Special Order Analysis: Minimum Bid Price for Special Order 1096</p> <p><b>Incremental Analysis for Segment Profitability Decisions</b> 1096</p> <p>Segment Profitability Analysis 1096</p> <p><b>Incremental Analysis for Sales Mix Decisions</b> 1098</p> <p>Sales Mix Analysis 1099</p> <p><b>Incremental Analysis for Sell-or-Process-Further Decisions</b> 1101</p> <p>Sell-or-Process-Further Analysis 1101</p> <p><b>Analyzing Capital Investments</b> 1102</p> <p>Capital Budgeting Process 1103</p> <p>The Minimum Rate of Return on Investment 1104</p> <p>Capital Budgeting Analysis Measures and Methods 1104</p> <p>Other Methods of Capital Investment Analysis 1106</p> <p><b>TRILEVEL PROBLEM</b> 1111</p> <p>CHAPTER REVIEW 1113</p> <p>CHAPTER ASSIGNMENTS 1115</p>	

APPENDIX A	<b>Investments</b>	1131
------------	--------------------	------

APPENDIX B	<b>Present Value Tables</b>	1147
------------	-----------------------------	------

Endnotes 1155
Glossary 1159
Company Name Index 1176
Subject Index 1178



## LATEST RESEARCH ON STUDENT LEARNING

### We talked to over 150 instructors and discovered that current textbooks did not effectively:

- Help students logically process information
- Build on what students already know in a carefully guided sequence
- Reinforce core accounting concepts throughout the chapters
- Help students see how the pieces of accounting fit together

The Needles/Powers/Crosson series addresses these challenges by creating a better solution for you. This includes new features and a brand new structure for enhanced learning.

**We have worked hard to create a textbook  
that mirrors the way you learn!**



© Martin Marraud/Getty Images

## A LOGICAL METHODOLOGY TO BUILDING KNOWLEDGE: THE THREE SECTION APPROACH

Needles/Powers/Crosson continuously evolves to meet the needs of today's learner. As a result of our research, the chapters in Needles/Powers/Crosson have been organized into a **Three Section Approach**, which helps students more easily digest the content.

### ThreeSection APPROACH

- 1 The first section is **Concepts** and focuses on the overarching accounting concepts that require consistent reiteration throughout the course.
- 2 With a clear understanding of the concepts, you can proceed to the second section, **Accounting Applications**. Here, you can practice the application of accounting procedures with features like “Apply It!” and a new transaction analysis model, which breaks down the transaction in a simple, visual format.
- 3 Finally, move to section three, **Business Applications**. This section illustrates how the concepts and procedures are used to make business decisions. Real company examples are used throughout the chapter to show the relevance of accounting.

**“I think this new chapter structure would be much easier for students to read and comprehend.”**

**Shannon Ogden**

Black River Technical College

### TriLevel PROBLEM

TriLevel Problems within CengageNOW mirror the Three Section Approach and connect the sections—Concepts, Accounting Applications, and Business Applications. In this way, the problems teach you to think holistically about an accounting issue.



## Breaking Down the Three Section Approach

# SECTION 1: CONCEPTS

In Section 1, students experience the **Concepts** related to each chapter. In this case, *concepts* are the overarching accounting concepts that need to be reinforced throughout the accounting course, such as revenue recognition, the matching rule, valuation, classification, and disclosure.

Every chapter's Section 1 reinforces these key concepts so that once students understand the concepts, they can apply them to every aspect of the accounting system—from measuring to processing to communicating information about a business. This is a clear and logical way to present accounting.

## SECTION 1

## CONCEPTS

### CONCEPTS

- Accrual accounting (matching principle)
- Valuation
- Disclosure

### RELEVANT LEARNING OBJECTIVE

**LO 1** Define receivables, and explain the allowance method for valuation of receivables as an application of accrual accounting.

## **LO 1** Concepts Underlying Notes and Accounts Receivable

The most common receivables are *accounts receivable* and *notes receivable*. The *allowance method* is used to apply *accrual accounting* to the *valuation* of accounts receivable. Proper *disclosure* in the financial statements and the notes to them is important for users of the statements to interpret them.

### **Accounts Receivable**

**Accounts receivable** are short-term financial assets that arise from sales on credit and are often called **trade credit**. Terms of trade credit usually range from 5 to 60 days, depending on industry practice, and may allow customers to pay in installments. Credit sales or loans not made in the ordinary course of business, such as those made to employees, officers, or owners, should appear separately under asset titles like Receivables from Employees. Exhibit 1 shows the level of accounts receivable in selected industries.

**“It does a very good job in explaining each concept and reinforcing each one by giving specific examples.”**

**Paul Jajairam**  
Bronx Community College

## SECTION 2: ACCOUNTING APPLICATIONS

In Section 2, students learn the accounting procedures and the technical **application** of concepts. Students can apply the fundamental concepts they have already learned in Section 1. Section 2 includes things like recording business transactions and creating financial statements in financial chapters, and then building budgets and creating schedules and reports in the managerial chapters.

### SECTION 2

### ACCOUNTING APPLICATIONS

#### ACCOUNTING APPLICATIONS

- Estimate uncollectible accounts and uncollectible accounts expense using
  - Percentage of net sales method
  - Accounts receivable aging method
- Write off uncollectible accounts
- Make common calculations for notes receivable

#### RELEVANT LEARNING OBJECTIVES

**LO 2** Apply the allowance method of accounting for uncollectible accounts.

**LO 3** Make common calculations for Notes Receivable

### **LO 2** Uncollectible Accounts

The allowance account is necessary because the specific uncollectible accounts will not be identified until later. It is not like another contra account, Accumulated Depreciation, whose purpose is to show how much of the plant and equipment cost has been allocated as an expense to previous periods.

If management takes an optimistic view and projects a small loss from uncollectible accounts, the resulting net accounts receivable will be larger than if management takes a pessimistic view. The net income will also be larger under the optimistic view because the estimated expense will be smaller. The company's accountant makes an estimate based on past experience and current economic conditions. For example, losses from uncollectible accounts are normally expected to be greater in a recession than during a period of economic growth. The final decision on the amount of the expense will depend on objective information, such as the accountant's analyses, and on certain qualitative factors, such as how investors, bankers, creditors, and others view the performance of the debtor company. Regardless of the qualitative considerations, the estimated losses from uncollectible accounts should be realistic.

Two common methods of estimating uncollectible accounts expense are the percentage of net sales method and the accounts receivable aging method.

### **Percentage of Net Sales Method**

The basis for the **percentage of net sales method** is the amount of this year's *net sales* that will not be collected. The answer determines the amount of uncollectible accounts expense for the year.

#### **Uncollectible Accounts: The Percentage of Net Sales Method**

**Transaction** The following balances represent Varta Company's ending figures for 2014:

**"Section 2 walks through the accounting procedures very well. I like the use of a visual plus the narrative to explain the procedures."**

**Gerald Childs**

Waukesha County Technical College

## SECTION 3: BUSINESS APPLICATIONS

With a solid foundation of the fundamental accounting concepts as well as how to apply these concepts when performing accounting procedures, students are now ready for Section 3: **Business Applications**. This section teaches students how accounting information is used to make business decisions. Included here are topics like using ratios to evaluate a company's performance.

### SECTION 3

### BUSINESS APPLICATIONS

#### BUSINESS APPLICATIONS

- Receivables turnover
- Days' sales uncollected
- Financing receivables
  - Factoring of accounts receivable
  - Securitization of accounts receivable
  - Discounting of accounts receivable
- Ethics

#### RELEVANT LEARNING OBJECTIVE

- LO 4** Show how to evaluate the level of receivables, and identify alternative means of financing receivables.

### **LO 4** Evaluating the Level of Accounts Receivable and Ethical Ramifications

Receivables are an important asset for any company that sells on credit. For them, it is critical to manage the level of receivables. Two common measures of the effect of a company's credit policies are *receivables turnover* and *days' sales uncollected*. Further, many companies manage their receivables by using various means to finance them. Finally, the judgments in estimating uncollectible accounts are a temptation for unethical behavior.

#### Receivables Turnover

The **receivables turnover** shows how many times, on average, a company turned its receivables into cash during a period. It reflects the relative size of a company's accounts receivable and the success of its credit and collection policies. It may also be affected by external factors, such as seasonal conditions and interest rates.

The receivables turnover is computed by dividing net sales by the average accounts receivable (net of allowances). Theoretically, the numerator should be net credit sales; but since the amount of net credit sales is rarely available in public reports, investors use total net sales. Using data from **Nike's** annual report, we can compute the company's receivables turnover in 2011 as follows (dollar amounts are in millions).

#### RATIO

#### Receivables Turnover: How Many Times Did the Company Collect Its Accounts Receivable During an Accounting Period?

$$\begin{aligned} \text{Receivables Turnover} &= \frac{\text{Net Sales}}{\text{Average Accounts Receivable}} \\ &= \frac{\$20,962}{(\$3,138 + \$2,650)/2} = \frac{\$20,962}{\$2,894} = 7.2 \text{ times}^* \end{aligned}$$

\* Rounded

**"This is a nice and useful touch to help students tie everything together. The theory can be dry at times, so this recap helps engage the students' attention again."**

**Dennis Mullen**  
City College of San Francisco

# EXAMPLES, ACTIVITIES, AND PRACTICE



## Business Perspective

### A Whirlwind Inventory Turnover—How Does Dell Do It?

**Dell Computer Corporation** turns its inventory over every 10 days. How can it do this when other computer companies have inventory on hand for 60 days or even longer? Technology and good inventory management are a big part of the answer. Dell's speed from order to delivery sets the standard for the computer industry. Consider that a computer ordered by 9 A.M. can be delivered the next day by 9 P.M. How can Dell do this when it does not start ordering components and assembling computers until a customer places an order? First, Dell's suppliers keep components warehoused just minutes from Dell's factories, making efficient, just-in-time operations possible. Dell also saves time by sending an e-mail message for some finished products to a shipper, such as **United Parcel Service**, and the shipper picks up the product from a supplier and schedules it to arrive with the PC. In addition to contributing to a high inventory turnover, this practice saves Dell in freight costs. Dell is showing the world how to run a business in the cyber age by selling more than \$39 million worth of computers a day on its website.\*

## Business Perspective

Throughout the chapter, **Business Perspective** features keep students engaged by providing real business context and examples from well-known companies including **Google, CVS, Boeing, Ford Motor Company, Microsoft, L.L. Bean, and The Walt Disney Company.**

## BUSINESS INSIGHT

### Sung's Grill

Sung's Grill is a popular neighborhood restaurant. Its business has increased substantially over the past year, and Emma Sung, the restaurant's owner, has had to hire more cashiers, waiters, and kitchen help. She has become concerned about possible theft of cash and food inventory, and she is looking for ways to prevent it. She is also concerned about whether the restaurant's sales and other transactions are being recorded properly. She is particularly concerned about the accuracy of the restaurant's financial statements, because she is considering applying for a bank loan so that she can open a second restaurant. To obtain a loan, she will have to present Sung's Grill's financial statements to the bank.

- 1. CONCEPT** ▶ Why is each of the five components of internal control important to the faithful representation of a company's operations in its financial statements?
- 2. ACCOUNTING APPLICATION** ▶ How can Sung's Grill maintain control over its cash?
- 3. BUSINESS APPLICATION** ▶ How can Sung's Grill's bank and other users of its financial statements be confident that the restaurant has an adequate system of internal control?

## TriLevel Problem



Sung's Grill

The beginning of this chapter focused on Emma Sung, the owner of Sung's Grill, who was looking for ways to ensure that the restaurant's assets were protected and that all its transactions were recorded properly. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

**Section 1: Concepts**  
Why is each of the five components of internal control important to the faithful representation of a company's operations in its financial statements?

**Section 2: Accounting Applications**  
How can Sung's Grill maintain control over its cash?

In order to have better control over cash, Emma Sung has established several rules for cashiers. Match each of the internal controls with the control activities that follow. (Hint: Some may have more than one answer.)

## Business Insight and TriLevel Problem ▲

Each chapter opens with a **Business Insight** that shows how a small company would use accounting information to make decisions. The Business Insight poses three questions—each of which will be answered in one of the three sections of the chapter. At the end of each chapter, a **NEW TriLevel Problem** revisits the Business Insight company to tie the three sections together.

## Apply It! and Try It! ▶

**Apply It!** activities throughout the chapter illustrate and solve a short exercise and then reference end-of-chapter assignments where students can go to **Try It!** This provides students with an example to reference as they are working to complete homework, making getting started less intimidating.

## APPLY IT!

Assume that on December 1, 2014, a company receives a 90-day, 8 percent, \$5,000 note and that the company prepares financial statements monthly.

1. What is the maturity date of the note?
2. How much interest will be earned on the note if it is paid when due?
3. What is the maturity value of the note?
4. If the company's fiscal year ends on December 31, describe the adjusting entry that would be made, including the amount.
5. How much interest will be earned on this note in 2015?

## SOLUTION

1. Maturity date is March 1, 2015, determined as follows.

Days remaining in December (31 - 1)	30
Days in January	31
Days in February	28
Days in March	1
Total days	90
	—

2. Interest:  $\$5,000 \times 8/100 \times 90/365 = \$98.63^*$

3. Maturity value:  $\$5,000 + \$98.63 = \$5,098.63$

4. An adjusting entry to accrue 30 days of interest income in the amount of \$32.88\* ( $\$5,000 \times 8/100 \times 30/365$ ) would be needed.

5. Interest earned in 2015:  $\$65.75$  ( $\$98.63 - \$32.88$ )

\* Rounded

**TRY IT! SE6, SE7, SE8, E8A, E9A, E10A, E11A, E8B, E9B, E10B, E11B**

## Notes Receivable Calculations

**SE8.** On August 25, Intercontinental Company received a 90-day, 9 percent note in settlement of an account receivable in the amount of \$20,000. Determine the maturity date, amount of interest on the note, and maturity value. (Round to the nearest cent.)

## Business Transaction Model ▶

A new business transaction model for all financial accounting chapters involving transactions visually guides students step-by-step through accounting for business transactions as follows:

- Statement of the transaction
- Analysis of the effect on the accounts
- Application of double-entry accounting in T accounts
- Illustration of the journal entry (linked to the T account showing the relationships between the methods and featuring accounting equations)
- Comments that offer supporting explanations regarding the significance of the transaction (often looping back to the concepts covered in Section 1)

## Purchase of an Asset on Credit

**Transaction** On July 5, Blue Design Studio receives the office supplies ordered on July 2 and an invoice for \$5,200.

**Analysis** The journal entry to record the purchase of office supplies on credit

- ▲ increases the asset account *Office Supplies* with a debit
- ▲ increases the liability account *Accounts Payable* with a credit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity
Office Supplies			Accounts Payable			
Dr.	Cr.		Dr.	Cr.		
July 5	5,200			July 5		5,200

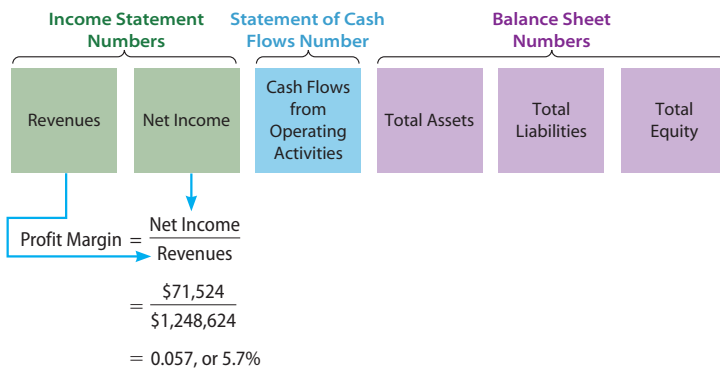
### Journal Entry

		Dr.	Cr.
July 5	Office Supplies	5,200	
	Accounts Payable		5,200

**Comment** Office supplies in this transaction are *classified* as an asset (prepaid expense) because they will not be used up in the current month and thus will benefit future periods. The credit is *classified* as Accounts Payable because there is a delay between the time of the purchase and the time of payment.

## RATIO

### Profit Margin: How Much Income Does Each Dollar of Sales Generate?



Based on Bizmin Industry Financial Report, December 2011.

## Ratio Analysis Model

A new framework for teaching how to analyze company information and make informed decisions simplifies ratio analysis as follows:

- Key question regarding company performance (which the ratio answers)
- Elements of the financial statements that are needed to compute the ratio (focusing on revenue and net income from the income statement, cash flows from operating activities from the statement of cash flows, and total assets, total liabilities, and total equity from the balance sheet)
- Formula for the ratio (which links to the related elements of the financial statements)
- Computation/example
- Graph of industry averages
- Comments that explain what the ratio means (whether it's good or bad)

## TRILEVEL PROBLEM: TYING IT ALL TOGETHER!

# TriLevel

PROBLEM

**NEW** TriLevel Problems within CengageNOW follow the same Three Section Approach the book employs by including *Concepts, Accounting Applications, and Business Applications*. The problems reinforce and apply overarching concepts while also tying the three sections together to give students a complete understanding.

**“Any time the students are engaged in the learning process and have to actively participate, I think they enhance their retention of the material. The ability to relate this to an actual company (whether real or not) allows students to see this information in practice.”**

**Chuck Smith**  
Iowa Western Community College

**Transaction Analysis**

The process of assigning business transactions to accounts is called .

One of the most important classification issues in accounting is the difference between an asset and their cost is classified as an . If the items will be used in the future, they are classified as .

Travis Services is an office cleaning company. Consider Travis Services' transactions during its first mo

(a) Received cash from Stanley Travis, in exchange for stock, \$18,680.  
 (b) Performed services for a client on account, \$6,530.  
 (c) Purchased equipment with cash, \$12,920.  
 (d) Performed services for a customer who paid cash, \$7,150.  
 (e) Purchased supplies with cash, \$3,480.

Use the following T accounts to record these transactions. You will need to record the transactions in bottom) on the debit or credit side of the T account, whichever is appropriate.

Cash	Accounts Receivable	Supplies
Equipment	Fees Earned	Common Stock

As supplies are used, Travis Services debits Supplies Expense and credits Supplies.

Stanley Travis would like to charge Supplies Expense when the supplies are purchased. He wants to

- “Great idea. By increasing expenses Travis Services income is lowered and that translates to la
- “Accounting rules dictate that purchases that are consumed in future periods be classified as a purposes.”

© Cengage Learning 2014

**96%** of instructors surveyed said that the TriLevel Problem adequately coached students through thinking about an issue.

**“The [TriLevel Problem] links procedure to the creation and use of information, and closes that loop between what students are doing and why it is useful.”**

**Andy Williams**  
Edmonds Community College

**“It reviews everything students have learned in a format they will find useful, and it links the three areas together. I love this. Each one ending with a business application.”**

**Joan Ryan**  
Clackamas Community College



# NEW CENGAGENOW FEATURES HELP STUDENTS MAKE CONNECTIONS

## NEW Blueprint Problems ▶

In CengageNOW, these problems cover primary learning objectives and help students understand the fundamental accounting concepts and their associated building blocks—not just memorize the formulas or journal entries required for a single concept. *Blueprint Problems* include rich feedback and explanations, providing students with an excellent learning resource.

**Blueprint Problem: Predetermined, overapplied, and underapplied overhead**

**The Nature of Overhead**

Recall that unit costs include direct materials, direct labor, and overhead. The costs for direct materials and direct production or sales, and some overhead costs are unknown until the end of the period or early in the next period to determine unit costs, because overhead costs are not always directly related to units produced. Therefore, the beginning of the year, and applied to production throughout the year. This requires three steps:

1. Calculate the predetermined overhead rate.
2. Apply the overhead throughout the year.
3. Reconcile the applied and actual overhead at the end of the year.

**Predetermined Overhead Rate**

The overhead costs are allocated to jobs using a common measure related to each job; this measure is called a driver and should reflect the consumption or use of the overhead costs. There are basically three types of drivers (or cost):

To calculate the predetermined overhead rate, you must first estimate the overhead costs for the year, as well as the volume of the driver.

Match the type of driver with its cause.

Driver	Cause
1. Direct labor	Select <input type="text"/>
2. Time	Select <input type="text"/>
3. Cost	Select <input type="text"/>

**Disposal of Fixed Assets**

When a fixed asset is being disposed of (sold or discarded), an entry to record depreciation will most likely be necessary before recording the disposal of the asset, since the last depreciation entry for the asset, unless the amount of time is insignificant, such as a few days.

An entry for depreciation will:

- total expenses for the same period.
- the book value of the asset.
- the gain/loss calculation for the asset disposal.

After depreciation has been recorded (if necessary), any gain or loss is calculated and then the journal entry is recorded. The purchase price was \$50,000, the residual value was determined to be \$5,000 and the useful life is 5 years. The company disposed of the asset on July 1, 2009. Depreciation of \$4,500 was recorded on that day, resulting in independent scenarios. The gain/loss calculation and journal entry to record the disposal under each scenario:

Cash received:	Scenario A	Scenario B	Scenario C	Scenario D
	\$0	\$24,750	\$27,500	\$30,000

**Scenario A: Gain/loss calculation:**

Original cost, January 1, 2007	\$50,000
Less: Accumulated depreciation (as of July 1, 2009)	22,500
Book value, July 1, 2009	\$27,500
Cash received	0
Loss on disposal of asset	\$27,500

**Asset disposal entry on July 1, 2009:**

Accumulated Depreciation—Machine	22,500	
Loss on Disposal of Asset	27,500	
Machine		50,000

© Cengage Learning 2014


## NEW Blueprint Connections ▲

*Blueprint Connections* in CengageNOW build upon concepts covered and introduced within the *Blueprint Problems*. These scenario-based exercises help reinforce students' knowledge of the concept.

## NEW Animated Activities ▶

*Animated Activities* in CengageNOW are videos that guide students through selected core topics using a realistic company example to illustrate how the concepts relate to the everyday activities of a business.

Assets	February 26, 2016	February 27, 2015
<b>Current assets</b>		
Cash and cash equivalents	\$ 1,183,587	\$ 1,096,300
Short-term investment securities	605,608	431,476
Merchandise inventories	1,968,907	1,759,703
Other current assets	315,736	276,066
Total current assets	4,073,838	3,563,545
Long-term investment securities	121,446	132,860
Property and equipment, net	1,118,297	1,119,292
Other assets	334,632	336,633
Total assets	\$ 5,646,193	\$ 5,152,130

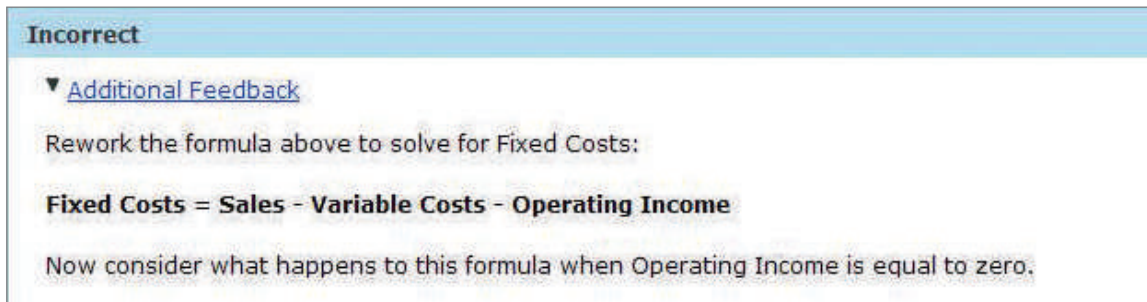


© Cengage Learning 2014

# NEW CENGAGENOW FEATURES HELP STUDENTS MAKE CONNECTIONS

## NEW Check My Work Feedback ▼

Written feedback is now available when students click on “Check My Work” in CengageNOW to provide students with valuable guidance as they work through homework items.



**Incorrect**

▼ [Additional Feedback](#)

Rework the formula above to solve for Fixed Costs:

**Fixed Costs = Sales - Variable Costs - Operating Income**

Now consider what happens to this formula when Operating Income is equal to zero.

© Cengage Learning 2014

## NEW Post-submission Feedback ▼

After students have submitted their assignments for a grade in CengageNOW, they can go back and see the correct answers to better understand where they might have gotten off track.



▼ Hide Feedback

**Incorrect**

▼ [Additional feedback](#)

a. Sales minus sales returns and allowances and minus sales discounts equals net sales.  
b. Net sales minus the cost of merchandise sold equals gross profit.  
c. Gross profit minus operating expenses minus other revenue and expenses equals net income.

▼ [Solution](#)

**Correct Response:**

 eBook

**Exercise 6-3**  
Income Statement for Merchandiser

For the fiscal year, sales were \$6,750,000, sales discounts were \$120,000, sales returns and allowances were \$90,000, and the cost of merchandise sold was \$4,000,000.

a. What was the amount of **net sales**?  
\$ 6540000

b. What was the amount of **gross profit**?  
\$ 2540000

c. If total operating expenses were \$1,200,000, could you determine net income?  
No, there could be separately reported "other income" and "other expenses" items.

© Cengage Learning 2014

## NEW Apply It Demos

These demonstration videos in CengageNOW will help students complete end-of-chapter questions from Section 2.



# ACKNOWLEDGMENTS

In developing and refining the twelfth edition of *Principles of Accounting*, we wanted to ensure that we were creating a textbook that truly reflected the way we teach accounting. To do so, we asked for feedback from over 150 professors, other professional colleagues, and students. We want to recognize those who made special contributions to our efforts in preparing this edition through their reviews, suggestions, and participation in surveys, interviews, and focus groups. We cannot begin to say how grateful we are for the feedback from the many instructors who have generously shared their responses and teaching experiences with us.

John G. Ahmad, *Northern Virginia Community College*  
Robert Almon, *South Texas College*  
Elizabeth Ammann, *Lindenwood University*  
Paul Andrew, *SUNY, Morrisville*  
Ryan Andrew, *Columbia College Chicago*  
Sidney Askew, *Borough of Manhattan Community College*  
Joe Atallah, *Irvine Valley College*  
Shele Bannon, *Queensborough Community College*  
Michael Barendse, *Grossmont College*  
Beverly R. Beatty, *Anne Arundel Community College*  
Robert Beebe, *Morrisville State College*  
Teri Bernstein, *Santa Monica College*  
Cynthia Bird, *Tidewater Community College*  
David B. Bojarsky, *California State University*  
Linda Bolduc, *Mount Wachusett Community College*  
John Bongorno, *Cuyahoga Community College*  
Anna Boulware, *St. Charles Community College*  
Amy Bourne, *Oregon State University*  
Thomas Branton, *Alvin Community College*  
Billy Brewster, *University of Texas at Arlington*  
Nina E. Brown, *Tarrant County College*  
Tracy L. Bundy, *University of Louisiana at Lafayette*  
Jacqueline Burke, *Hofstra University*  
Marc L. Butterfield, *University of Utah*  
Charles Caliendo, *University of Minnesota*  
Gerald Childs, *Waukesha County Technical College*  
James J. Chimenti, *Jamestown Community College*  
Alice Chu, *Golden West College*  
Sandra Cohen, *Columbia College*  
Lisa Cole, *Johnson County Community College*  
Debora Constable, *Georgia Perimeter College*  
Barry Cooper, *Borough of Manhattan Community College*  
Cheryl Copeland, *California State University, Fresno*  
Susan Cordes, *Johnson County Community College*

Meg Costello, *Oakland Community College*  
Richard Culp, *Ball State University*  
Sue Cunningham, *Rowan Cabarrus Community College*  
Robin D'Agati, *Palm Beach State College*  
Emmanuel Danso, *Palm Beach State College*  
Robert Derstine, *Kutztown University*  
Michael Dole, *Marquette University*  
Jap Efendi, *University of Texas at Arlington*  
Dustin Emhart, *North Georgia Technical College*  
Denise M. English, *Boise State University*  
Michael Farina, *Cerritos College*  
J. Thomas Franco, *Wayne County Community College*  
Dean Gray, *Reedley College*  
Timothy Green, *North Georgia Technical College*  
Timothy Griffin, *Hillsborough Community College*  
Teri Grimmer, *Portland Community College*  
Michael J. Gurevitz, *Montgomery College*  
Qian Hao, *Wilkes University*  
Sara Harris, *Arapahoe Community College*  
Syed Hasan, *George Mason University*  
Wendy Heltzer, *DePaul University*  
Merrily Hoffman, *San Jacinto College*  
Shanelle Hopkins, *Carroll Community College*  
David Hossain, *California State University, Los Angeles*  
Phillip Imel, *NOVA Community College, Annadale*  
ThankGod O. Imo, *Tompkins Cortland Community College*  
Paul Jajairam, *Bronx Community College*  
Gene Johnson, *Clark College*  
Howard A. Kanter, *DePaul University*  
Irene Kim, *George Washington University*  
Christopher Kinney, *Mount Wachusett Community College*  
Gordon Klein, *University of California, Los Angeles*  
Shirly A. Kleiner, *Johnson County Community College*  
Leon Korte, *University of South Dakota*

Lynn Krausse, *Bakersfield College*  
 Les Kren, *University of Wisconsin, Milwaukee*  
 Donnie Kristof-Nelson, *Edmonds Community College*  
 Christopher Kwak, *De Anza College*  
 Richard Lau, *California State University, Los Angeles*  
 Suzanne R. Laudadio, *Durham Technical Community College*  
 George Leonard, *St. Petersburg College*  
 Lydia Leporte, *Tidewater Community College*  
 Hui Lin, *DePaul University*  
 Joseph Lipari, *Montclair State*  
 Xiang Liu, *California State University, San Bernardino*  
 Angelo Luciano, *Columbia College*  
 Susan Lueders, *DePaul University*  
 Cathy Lumbattis, *Southern Illinois University*  
 Sakthi Mahenthiran, *Butler University*  
 Eileen Marutzky, *DePaul University*  
 Robert Maxwell, *College of the Canyons*  
 Mark McCarthy, *DePaul University*  
 Clarice McCoy, *Brookhaven College*  
 Terra McGhee, *University of Texas at Arlington*  
 Florence McGovern, *Bergen Community College*  
 Cheryl McKay, *Monroe County Community College*  
 John McQuilkin, *Roger Williams University*  
 Jeanette Milius, *Iowa Western Community College*  
 Jeanne K. Miller, *Cypress College*  
 Rita Mintz, *Calhoun Community College*  
 Jill Mitchell, *Northern Virginia Community College,  
Annandale*  
 Odell Moon, *Victor Valley College*  
 Kathleen Moreno, *Abraham Baldwin Agricultural College*  
 Walter Moss, *Cuyahoga Community College*  
 Dennis Mullen, *City College of San Francisco*  
 Elizabeth A. Murphy, *DePaul University*  
 Penny Nunn, *Henderson Community College*  
 Christopher O'Byrne, *Cuyamaca College*  
 Shannon Ogden, *Black River Technical College*  
 Glenn Pate, *Palm Beach State College*  
 Sy Pearlman, *California State University, Long Beach*  
 Rama Ramamurthy, *College of William & Mary*  
 Lawrence A. Roman, *Cuyahoga Community College*  
 Gregg Romans, *Ivy Tech Community College*  
 Joan Ryan, *Clackamas Community College*  
 Donna B. Sanders, *Guilford Technical Community College*  
 Regina Schultz, *Mount Wachusett Community College*  
 Jay Semmel, *Broward College*  
 Andreas Simon, *California Polytechnic State University*  
 Jaye Simpson, *Tarrant County College*  
 Alice Sineath, *Forsyth Technical Community College*  
 Kimberly Sipes, *Kentucky State University*  
 Chuck Smith, *Iowa Western Community College*  
 Robert K. Smolin, *Citrus College*  
 Jennifer Sneed, *Arkansas State University, Newport*  
 Lyle Stelter, *Dakota County Technical College*  
 Rhonda Stone, *Black River Technical College*  
 Gracelyn Stuart-Tuggle, *Palm Beach State College – Boca  
Raton*  
 Linda Tarrago, *Hillsborough Community College*  
 Steve Teeter, *Utah Valley University*  
 Don Trippeer, *SUNY Oneonta*  
 Robert Urell, *Irvine Valley College*  
 La Vonda Ramey, *Schoolcraft College*  
 Patricia Walczak, *Lansing Community College*  
 Scott Wandler, *University of New Orleans*  
 Chris Widmer, *Tidewater Community College*  
 Andy Williams, *Edmonds Community College*  
 Wanda Wong, *Chabot College*  
 Ronald Zhao, *Monmouth University*  
 Teri Zuccaro, *Clarke University*

We also wish to express deep appreciation to colleagues at DePaul University, who have been extremely supportive and encouraging.

Finally, very important to the quality of this book are our Developmental Editor, Krista Kellman; Executive Editor, Sharon Oblinger; and Senior Market Development Manager, Natalie Livingston.

## ABOUT THE AUTHORS

**Belverd E. Needles, Jr.**, received B.B.A. and M.B.A. degrees from Texas Tech University and his Ph.D. degree from the University of Illinois at Urbana-Champaign. He teaches financial accounting, managerial accounting, and auditing at DePaul University, where he is an internationally recognized expert in international accounting and education. He has published in leading journals and is the author or editor of more than 20 books and monographs. His current research relates to international financial reporting, performance measurement, and corporate governance of high-performance companies in the United States, Europe, India, and Australia. His textbooks are used throughout the world and have received many awards, including (in 2008) the McGuffey Award from the Text and Academic Authors Association. Active in many academic and professional organizations, he is immediate past Vice-President-Education of the American Accounting Association. He has received the Distinguished Alumni Award from Texas Tech University, the Illinois CPA Society Outstanding Educator Award and its Life-Time Achievement Award, the Joseph A. Silvos Faculty Award of Merit from the Federation of Schools of Accountancy, the Ledger & Quill Award of Merit, and the Ledger & Quill Teaching Excellence Award. He was named Educator of the Year by the American Institute of CPAs, Accountant of the Year for Education by the national honorary society Beta Alpha Psi, and Outstanding International Accounting Educator by the American Accounting Association. He has received the Excellence in Teaching Award from DePaul University.

**Marian Powers** received her B.S. degree from Chicago State University and her Ph.D. degree from University of Illinois at Urbana-Champaign. In addition to the Kellogg School of Management at Northwestern University, she has taught financial accounting at the University of Illinois, Chicago, and at the Lake Forest Graduate School of Management. Internationally recognized as a dynamic teacher in executive education, she specializes in teaching nonfinancial managers how to read and understand internal and external financial reports, including the impact of international financial reporting standards (IFRS). Her current research relates to international financial reporting, performance measurement, and corporate governance of high-performance companies in the United States, Europe, India, and Australia. Her research has been published in leading journals. Her textbooks, coauthored with Belverd E. Needles, Jr., are used throughout the world and have received many awards, including the Textbook Excellence Award and the McGuffey Award from the Text and Academic Authors Association. She has also coauthored three interactive multimedia software products. She currently serves on the Board of the CPA Endowment Fund of Illinois and is immediate past-chair of the Board of Governors of the Winnetka Community House. She is a member of International Association of Accounting Education and Research, and Illinois CPA Society. She has served on the Board of Directors of the Illinois CPA Society, the Educational Foundation of Women in Accounting, and both the national as well as Chicago chapters of ASWA.

**Susan V. Crosson** received her B.B.A. degree in economics and accounting from Southern Methodist University and her M.S. degree in accounting from Texas Tech University. She is currently teaching in the Goizueta Business School at Emory University in Atlanta, Georgia. Until recently, she was the Accounting Faculty Lead and Professor at Santa Fe College in Gainesville, Florida. She has also been on the faculty of the University of Florida; Washington University in St. Louis; University of Oklahoma; Johnson County Community College in Kansas; and Kansas City Kansas

Community College. She is internationally known for her YouTube accounting videos as an innovative application of pedagogical strategies. In recognition of her professional and academic activities, she was a recipient of the Outstanding Service Award from the American Accounting Association (AAA), an Institute of Management Accountants' Faculty Development Grant to blend technology into the classroom, the Florida Association of Community Colleges Professor of the Year Award for Instructional Excellence, and the University of Oklahoma's Halliburton Education Award for Excellence. Currently, she serves as President of the Teaching, Learning, and Curriculum section of the AAA. Recently she served as a Supply Chain Leader for The Commission on Accounting Higher Education, which published "*Pathways to a Profession, Charting a National Strategy for the Next Generation of Accountants*." She has also served on various committees for the AICPA, Florida Institute of CPAs, and the Florida Association of Accounting Educators.

# Principles of Accounting

TWELFTH EDITION





# CHAPTER 1

## Accounting Principles and the Financial Statements

### BUSINESS INSIGHT

#### Keep-Fit Center

On January 1, 2014, Jenny Mullin, an experienced fitness coach, started a business called Keep-Fit Center, which offers classes and private instruction in aerobics, yoga, and Pilates. By December 31, 2014, the center had generated \$375,500, and its clients were praising its excellent service. Jenny is now considering expanding the business. She would need a bank loan and, to qualify, both she and the bank would have to use various financial measures to determine the business's ability to repay the loan (i.e., its profitability and liquidity). Whether a business is small, like Keep-Fit Center, or large, like CVS, the same financial measures are used to evaluate it.

- 1. CONCEPT** ► *What is accounting, and what are the concepts that underlie it?*
- 2. ACCOUNTING APPLICATION** ► *What are three financial statements that Keep-Fit Center will need to present in a way that is useful to Jenny and to the bank?*
- 3. BUSINESS APPLICATION** ► *How do these financial statements help Jenny Mullin, as owner of Keep-Fit Center, measure progress toward the company's two main financial goals of profitability and liquidity? What additional financial statement information would be useful?*

### LEARNING OBJECTIVES

- LO 1** Define *accounting*, and explain the concepts underlying accounting measurement.
- LO 2** Define *financial position*, and state the accounting equation.
- LO 3** Identify the four basic financial statements and their interrelationships.
- LO 4** Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.
- LO 5** Identify the users of accounting information, and identify business goals, activities, and performance measures.
- LO 6** Explain the importance of ethics in financial reporting.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Accounting measurement
- Business transactions
- Money measure
- Separate entity
- Assets
- Liabilities
- Owner's equity

RELEVANT  
LEARNING OBJECTIVES

**LO 1** Define *accounting* and explain the concepts underlying accounting measurement.

**LO 2** Define *financial position*, and state the accounting equation.

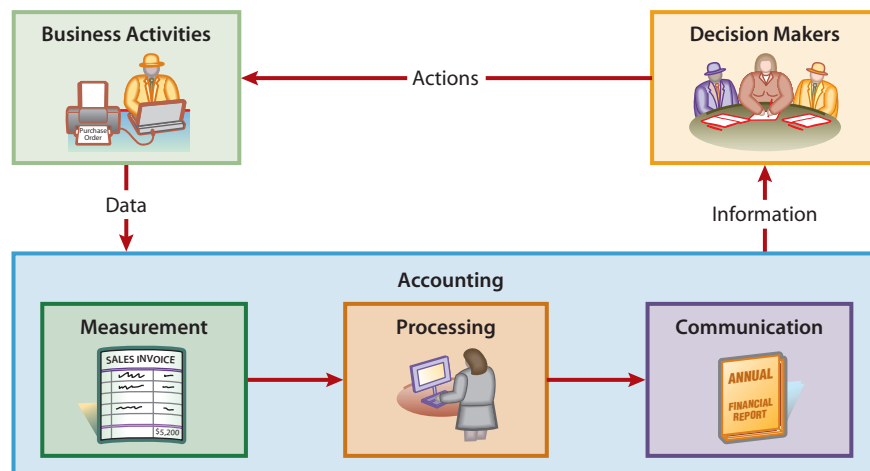
## LO 1 Concepts Underlying Accounting Measurement

**Accounting** is an information system that measures, processes, and communicates financial information about a business.<sup>1</sup> Accountants focus on the needs for financial information, whether the decision makers are inside or outside a business or other economic entity. An **economic entity** is a unit that exists independently, such as a business, hospital, or a governmental body. Accountants supply the information decision makers need to make “reasoned choices among alternative uses of scarce resources in the conduct of business and economic activities.”<sup>2</sup> As shown in Exhibit 1, accounting is a link between business activities and decision makers.

- Accounting measures business activities by recording data about them for future use.
- The data are stored until needed and then processed to become useful information.
- The information is communicated through reports to decision makers.
- Based on information from accounting, decision makers take actions that affect subsequent business activities.

In other words, data about business activities are the input to the accounting system, and useful information for decision makers is the output.

**Exhibit 1**  
Accounting as an Information System



© Cengage Learning 2014

## Financial and Managerial Accounting

Accounting's role of measuring, processing, and communicating financial information is usually divided into financial accounting and managerial accounting. Although the functions of financial accounting and managerial accounting overlap, they can be distinguished by the principal users of their information.

**Financial Accounting** *External* decision makers use **financial accounting** to evaluate how well the business has achieved its goals. These reports, called **financial statements**,



are a central feature of accounting. **CVS**, whose stock is traded on the New York Stock Exchange, sends its financial statements to its owners (called *stockholders*), its banks and other creditors, and government regulators. Financial statements report on a business's financial performance and are used extensively both inside and outside a business to evaluate its financial success.

It is important to distinguish accounting from bookkeeping and management information systems.

- **Bookkeeping** is the process of recording financial transactions and keeping financial records. It is mechanical and repetitive, yet an important part of accounting that is usually handled by computers.
- **Management information systems (MIS)** consist of the interconnected subsystems, including accounting, that provide the information needed to run a business.

**Managerial Accounting** *Internal* decision makers use information provided by **managerial accounting** about operating, investing, and financing activities. Managers and employees need information about how they have done in the past and what they can expect in the future. For example, **Gap, Inc.**, a retail clothing business, needs an operating report that tells how much was sold at each store and what costs were incurred, and it needs a budget that projects each store's sales and costs for the next year.

## Accounting Measurement

To make an *accounting measurement*, the accountant must answer four basic questions:

- What is measured?
- When should the measurement be made?
- What value should be placed on what is measured?
- How should what is measured be classified?

Accountants debate the answers to these questions constantly, and the answers change as new knowledge and practice require. But the basis of today's accounting practice rests on a number of widely accepted concepts and conventions. We begin by focusing on the first question: What is measured? We discuss the other three questions in the next chapter.

**Business Transactions** **Business transactions** are economic events that affect a business's financial position. Businesses can have hundreds or even thousands of transactions every day. These transactions are the raw material of accounting reports.

A transaction can be an exchange of value (a purchase, sale, payment, collection, or loan) between two or more parties. A transaction also can be an economic event that does not involve an exchange. Some examples of nonexchange transactions are losses from fire, flood, explosion, and theft; physical wear and tear on machinery and equipment; and the day-by-day accumulation of interest.

To be recorded, a transaction must relate directly to a business entity. Suppose a customer buys toothpaste from **CVS** but buys shampoo from a competing store because CVS is out of shampoo. The transaction in which the toothpaste was sold is entered in CVS's records. However, the purchase of the shampoo is not entered in CVS's records because, even though it indirectly affects CVS economically (by losing a sale), it does not involve a direct exchange of value between CVS and the customer.

**Money Measure** All business transactions are recorded in terms of money. This concept is called **money measure**. Of course, nonfinancial information may also be recorded, but a business's transactions and activities are measured through the recording of monetary amounts. Money is the only factor common to all business transactions, and thus it is the only unit of measure capable of producing financial data that can be compared. The monetary unit a business uses depends on the country in which the business resides. For example, in the United States, the basic unit of money is the dollar. In China, it is the yuan; in Japan, the yen; in the European Union (EU), the

euro; and in the United Kingdom, the pound. In international transactions, exchange rates must be used to translate from one currency to another. An **exchange rate** is the value of one currency in terms of another. For example, a British person purchasing goods from a U.S. company like **CVS** and paying in U.S. dollars must exchange British pounds for U.S. dollars before making payment. In effect, currencies are goods that can be bought and sold.

Exhibit 2 illustrates the exchange rates for several currencies in dollars. It shows the exchange rate for British pounds as \$1.59 per pound on a particular date. Like the prices of many goods, currency prices change daily according to supply and demand. For example, a year and a half earlier, the exchange rate for British pounds was \$1.63.

### Exhibit 2 Examples of Foreign Exchange Rates

Country	Price in \$U.S.	Country	Price in \$U.S.
Australia (dollar)	1.07	Hong Kong (dollar)	0.13
Brazil (real)	0.58	Japan (yen)	0.012
Britain (pound)	1.59	Mexico (peso)	0.08
Canada (dollar)	1.00	Russia (ruble)	0.03
European Union (euro)	1.32	Singapore (dollar)	0.79

Source: *The Wall Street Journal*, February 18, 2012.

**STUDY NOTE:** For accounting purposes, a business is always separate and distinct from its owners, creditors, and customers.

**Separate Entity** For accounting purposes, a business organization is a **separate entity**, distinct not only from its creditors and customers but also from its owners. It should have its own set of financial records, and its records and reports should refer only to its own affairs.

For example, Just Because Flowers Company should have a bank account separate from the account of Molly Dar, the owner. Molly Dar may own a home, a car, and other property, and she may have personal debts; but these are not the resources or debts of Just Because Flowers. Molly Dar may own another business, say a stationery shop. If she does, she should have a completely separate set of records for each business.

## Forms of Business Organization

The three basic forms of business organization recognized as separate entities are the sole proprietorship, the partnership, and the corporation.

**Sole Proprietorship** A **sole proprietorship** is a business owned by one person.\* The owner takes all the profits or losses of the business and is liable for all its obligations. As Exhibit 3 shows, sole proprietorships represent the largest number of businesses in the United States, but typically they are the smallest in size.

**Partnership** A **partnership** is like a sole proprietorship in most ways, but it has two or more owners. The partners share the profits and losses of the business according to a prearranged formula. Generally, any partner can obligate the business to another party, and the personal resources of each partner can be called on to pay the obligations. A partnership must be dissolved if the ownership changes, as when a partner leaves or dies. If the business is to continue as a partnership after this occurs, a new partnership must be formed.

**Corporation** Both the sole proprietorship and the partnership are convenient ways of separating the owners' commercial activities from their personal activities. Legally,

**STUDY NOTE:** A key disadvantage of a partnership is the unlimited liability of its owners. Unlimited liability can be avoided by organizing the business as a corporation or, in some states, by forming what is known as a limited liability partnership (LLP).

\*Accounting for a sole proprietorship is simpler than accounting for a partnership or corporation. For that reason, we focus on the sole proprietorship in the early part of this book. At critical points, however, we call attention to the essential differences between accounting for a sole proprietorship and accounting for a partnership or corporation.



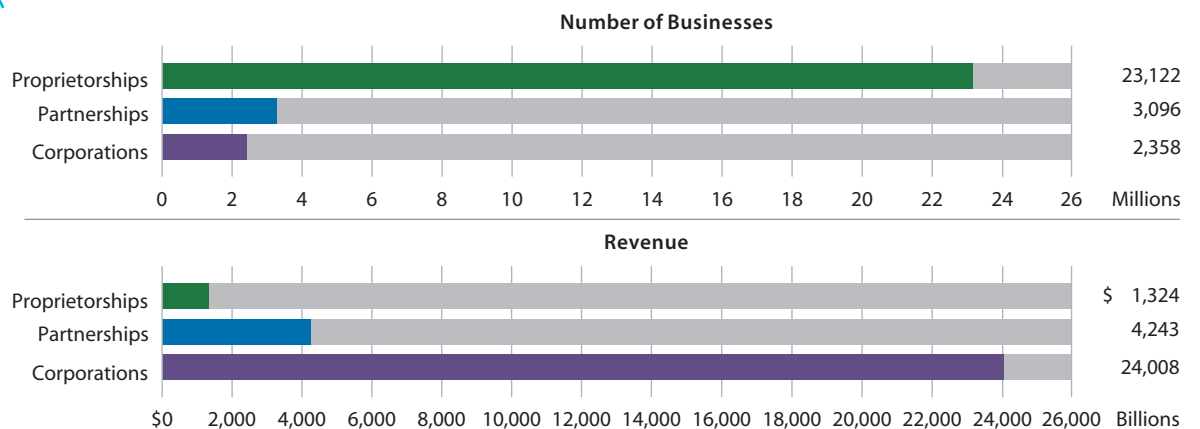
Oleg V. Ivanov/Shutterstock.com

Because this surf shop is a partnership, the owners share the profits and losses of the business, and their personal resources can be called on to pay the obligations of the business.

however, there is no economic separation between the owners and the businesses. A **corporation**, on the other hand, is a business unit chartered by the state and legally separate from its owners (the stockholders). The **stockholders**, whose ownership is represented by shares of stock, do not directly control the corporation's operations. Instead, they elect a board of directors to run the corporation for their benefit. In exchange for their limited involvement in the corporation's operations, stockholders enjoy **limited liability**; that is, their risk of loss is limited to the amount they paid for their shares. Thus, stockholders are often willing to invest in risky, but potentially profitable, activities. Also, because stockholders can sell their shares without dissolving the corporation, the life of a corporation is unlimited and not subject to the whims or health of a proprietor or a partner.

The characteristics of corporations make them very efficient in amassing capital, which enables them to grow extremely large. As Exhibit 3 shows, even though corporations are fewer in number than sole proprietorships and partnerships, they contribute much more to the U.S. economy in monetary terms. For example, in 2011, **ExxonMobil** generated more revenues than all but 28 of the world's countries.<sup>3</sup>

**Exhibit 3**  
Number and Receipts (Revenues) of U.S. Proprietorships, Partnerships, and Corporations



Source: U.S. Treasury Department, Internal Revenue Service, *Statistics of Income Bulletin*, Winter 2012.



© Alija / iStockphoto.com

## Business Perspective

### Are Most Corporations Big or Small Businesses?

Most people think of corporations as large national or global companies whose shares of stock are held by thousands of people and institutions. Indeed, corporations can be huge and have many stockholders. However, of the approximately 4 million corporations in the United States, only about 15,000 have stock that is publicly bought and sold. The vast majority of corporations are small businesses privately held by a few stockholders. Illinois alone has more than 250,000 corporations. Thus, the study of corporations is just as relevant to small businesses as it is to large ones.

## APPLY IT!

Match each description with the appropriate term. (*Hint:* Terms may be used more than once.)

- |  |                          |
|--|--------------------------|
| 1. Owners have limited liability                             | a. Business transactions |
| 2. Requires an exchange of value between two or more parties | b. Corporation(s)        |
| 3. Owned by only one person                                  | c. Money measure         |
| 4. Multiple co-owners  | d. Partnership           |
| 5. An amount associated with a business transaction          | e. Sole proprietorship   |
| 6. Management appointed by board of directors                | f. Separate entity       |
| 7. Distinct from customers, lenders, and owners              |                          |
| 8. Biggest segment of the economy                            |                          |

### SOLUTION

1. b; 2. a; 3. e; 4. d; 5. c; 6. b; 7. f; 8. b

**TRY IT! SE1, SE2, E1A, E2A, E3A, E12A, E1B, E2B, E3B, E12B**

## LO 2 Concepts Underlying Financial Position

**Financial position** refers to a company's economic resources, such as cash, inventory, and buildings, and the claims against those resources at a particular time. Another term for claims is *equities*.

Every company has two types of equities: creditors' equities, such as bank loans, and owner's equity. The sum of these equities equals a company's resources:

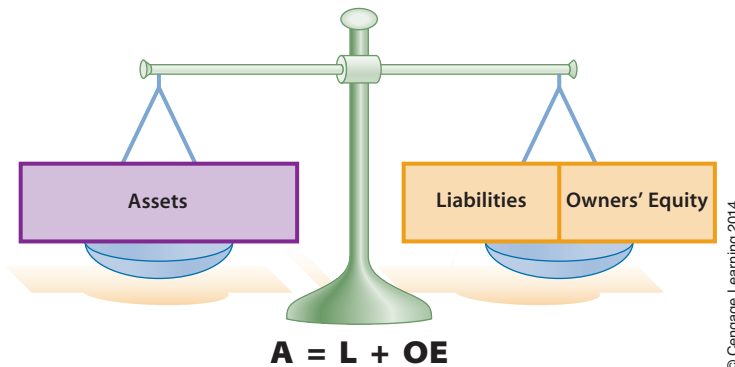
$$\text{Economic Resources} = \text{Creditors' Equities} + \text{Owner's Equity}$$

In accounting terminology, economic resources are called *assets* and creditors' equities are called *liabilities*. So the equation can be written like this:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

This equation is known as the **accounting equation (A = L + OE)**. The two sides of the equation must always be equal, or "in balance," as shown in Exhibit 4. To evaluate the financial effects of business activities, it is important to understand their effects on this equation.

**Exhibit 4**  
The Accounting Equation



### Assets

**Assets** are the economic resources that are expected to benefit the company's future operations. Certain kinds of assets—for example, cash and money that customers owe to the company (called *accounts receivable*)—are monetary items. Other assets—inventories (goods held for sale), land, buildings, and equipment—are nonmonetary, physical items. Still other assets—the rights granted by patents, trademarks, and copyrights—are nonphysical.

### Liabilities

**Liabilities** are a business's present obligations to pay cash, transfer assets, or provide services to other entities in the future. Among these obligations are amounts owed to suppliers for goods or services bought on credit (called *accounts payable*), borrowed money (e.g., money owed on bank loans), salaries and wages owed to employees, taxes owed to the government, and services to be performed.

Liabilities are claims recognized by law. That is, the law gives creditors the right to force the sale of a company’s assets if the company fails to pay its debts. Creditors have rights over owners and must be paid before the owners receive anything, even if the payment of debt uses up all the assets.

## Owner’s Equity

**Owner’s equity** represents the claims by the owner of a business to the assets of the business. Theoretically, owner’s equity is what would be left if all liabilities were paid, and it is sometimes said to equal **net assets**. By rearranging the accounting equation, we can define owner’s equity this way:

$$\text{Owner's Equity} = \text{Assets} - \text{Liabilities}$$

Owner’s equity is affected by the owner’s investments in and withdrawals from the business and by the business’s revenues and expenses.

- **Owner’s investments** are assets that the owner puts into the business (e.g., by transferring cash from a personal bank account to the business’s bank account). In this case, the assets (cash) of the business increase, and the owner’s equity in those assets also increases.
- **Withdrawals** are assets that the owner takes out of the business (e.g., by transferring cash from the business’s bank account to a personal bank account). In this case, the assets of the business decrease, as does the owner’s equity in the business.

Simply stated, **revenues** and **expenses** are the increases and decreases in owner’s equity that result from operating a business.

- ▲ For example, the amounts customers pay (or agree to pay in the future) to Keep-Fit Center for its exercise service are revenues for Keep-Fit. Keep-Fit’s assets (cash or accounts receivable) increase, as does its owner’s equity in those assets.
- ▼ On the other hand, the amount Keep-Fit must pay out (or agree to pay out) for rent and wages to instructors so that it can provide its service are expenses. In this case, the assets (cash) decrease or the liabilities (accounts payable) increase, and the owner’s equity decreases.

Generally, a company is successful if its revenues exceed its expenses.

- ▲ When revenues exceed expenses, the difference is called **net income**.
- ▼ When expenses exceed revenues, the difference is called **net loss**.

In summary, owner’s equity is the accumulated net income (revenues – expenses) minus withdrawals over the life of the business.

## APPLY IT!

Stevenson Company had assets of \$140,000 and liabilities of \$60,000 at the beginning of the year, and assets of \$200,000 and liabilities of \$70,000 at the end of the year. During the year, \$20,000 was invested in the business, and withdrawals of \$24,000 were made. What amount of net income did the company earn during the year?

### Beginning of the year

Assets	=	Liabilities	+	Owner’s Equity
\$140,000	=	\$60,000	+	<b>\$ 80,000</b>

### During the year

Investment	+	20,000
Withdrawals	–	24,000
Net income		?

### End of year

\$200,000	=	\$70,000	+	<b>\$130,000</b>
-----------	---	----------	---	------------------

### SOLUTION

Net income = \$54,000

Start by finding the owner’s equity at the beginning of the year:  
\$140,000 – \$60,000 = \$80,000

Then find the owner’s equity at the end of the year: \$200,000 – \$70,000 = \$130,000

Then determine net income by calculating how the transactions during the year led to the owner’s equity amount at the end of the year:  
\$80,000 + \$20,000 – \$24,000 + net income = \$130,000; net income = \$54,000

**TRY IT! SE3, SE4, SE5, SE6, E4A, E5A, E4B, E5B**



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Describe the income statement
- Describe the statement of owner's equity
- Describe the balance sheet
- Describe the statement of cash flows

## RELEVANT LEARNING OBJECTIVES

**LO 3** Identify the four basic financial statements and their interrelationships.

**LO 4** Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.

### LO 3 Financial Statements

Financial statements are the primary means of communicating accounting information about a business to those who have an interest in the business. These statements model the business enterprise in financial terms. As is true of all models, however, financial statements are not perfect pictures of the real thing. Four major financial statements are used to communicate accounting information: the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. Exhibit 5 presents an overview of these four financial statements and their interrelationships. The following sections examine them in more detail.

#### Income Statement

The **income statement** summarizes the revenues earned and expenses incurred by a business over an accounting period. Many people consider it the most important financial report because it shows whether a business achieved its profitability goal—that is, whether it earned an acceptable income. Exhibit 6 shows that Roland Consultancy had revenues of \$14,000. From this amount, total expenses of \$5,600 were deducted to arrive at net income of \$8,400. To show the period to which the statement applies, it is dated “For the Month Ended December 31, 2014.”

#### Statement of Owner's Equity

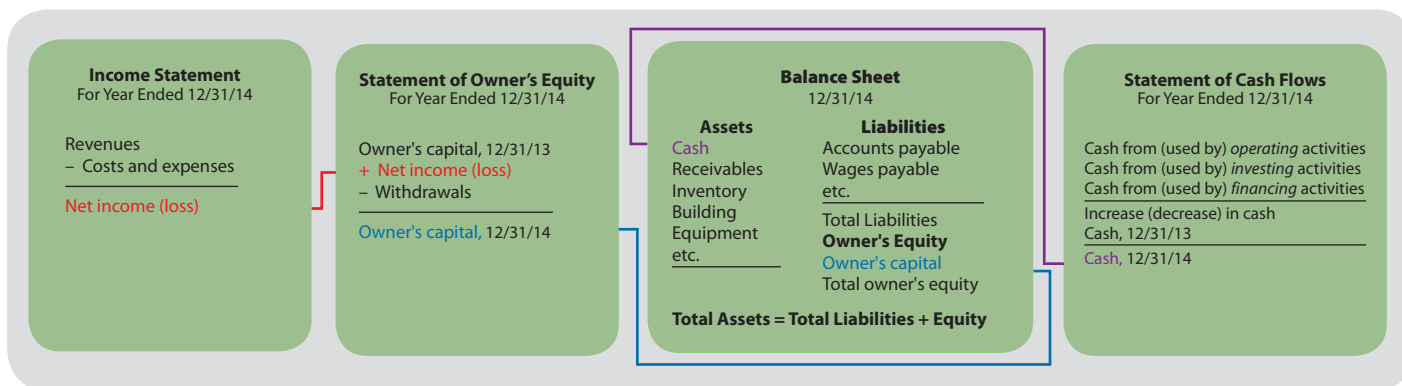
The **statement of owner's equity** shows the changes in owner's equity over an accounting period. In Exhibit 7, beginning owner's equity is zero because Roland Consultancy began operations in this period. During the month, the owner, Tom Roland, invested \$200,000 in the business, and the company earned an income (as shown on the income statement) of \$8,400. Withdrawals of \$2,400 by the owner are deducted from this amount, leaving an ending balance of \$206,000.

#### Balance Sheet

The purpose of a **balance sheet** is to show the financial position of a business on a certain date, usually the end of the month or year. For this reason, it often is called the *statement of financial position*. It's important to note that the date on the balance sheet is a single date, whereas the dates on the other three statements cover a period of time, such as a month, quarter, or year. The balance sheet presents a view of the business as the holder of resources, or assets, that are equal to the claims against those assets. The claims consist of the company's liabilities and the owner's equity. Exhibit 8 shows that Roland Consultancy has several categories of assets, which total \$208,400. These assets equal the total liabilities of \$2,400 plus the owner's equity of \$206,000. Notice that the amount of the owner's capital account on the balance sheet comes from the ending balance on the statement of owner's equity.

**Exhibit 5**  
Financial Statement Relationships

© Cengage Learning 2014



**Exhibit 6**  
Income Statement for  
Roland Consultancy

Revenues:		
Consulting fees earned		\$14,000
Expenses:		
Equipment rental expense	\$2,800	
Wages expense	1,600	
Utilities expense	1,200	
Total expenses		<u>5,600</u>
Net income		<u>\$ 8,400</u>

**Exhibit 7**  
Statement of Owner's Equity  
for Roland Consultancy

T. Roland, capital, December 1, 2014	\$ 0
Investment by T. Roland	200,000
Net income for the month	8,400
Subtotal	<u>\$208,400</u>
Less withdrawals	2,400
T. Roland, capital, December 31, 2014	<u>\$206,000</u>

**Exhibit 8**  
Balance Sheet for  
Roland Consultancy

Assets		Liabilities	
Cash	\$ 62,400	Accounts payable	\$ 2,400
Accounts receivable	4,000	Total liabilities	<u>\$ 2,400</u>
Supplies	2,000		
Land	40,000		
Buildings	100,000	<b>Owner's Equity</b>	
Total assets	<u>\$208,400</u>	T. Roland, capital	206,000
		Total liabilities and owner's equity	<u>\$208,400</u>



## CASH FLOW

**STUDY NOTE:** The statement of cash flows explains the change in cash in terms of operating, investing, and financing activities over an accounting period. This information cannot be determined in examination of the other financial statements.

## Statement of Cash Flows

Whereas the income statement focuses on a company's profitability, the **statement of cash flows** focuses on *liquidity*, that is, balancing the inflows and outflows of cash to enable it to operate and pay its bills when they are due. **Cash flows** are the inflows and outflows of cash into and out of a business. Net cash flows are the difference between the inflows and outflows.

As you can see in Exhibit 9, the statement of cash flows is organized according to three major business activities.

- **Cash flows from operating activities:** The first section of Exhibit 9 shows the cash produced by business operations. Roland's operating activities produced net cash flows of \$4,800 (liquidity) compared to net income of \$8,400 (profitability). The company used cash to increase accounts receivable and supplies. However, by borrowing funds, it increased accounts payable. This is not a good trend, which Roland should try to reverse in future months.
- **Cash flows from investing activities:** Roland used cash to expand by purchasing land and a building.
- **Cash flows from financing activities:** Roland obtained most of its cash from the owner, who then made a small cash withdrawal.

Overall, Roland had a net increase in cash of \$62,400, due in large part to the investment by the owner. In future months, Roland must generate more cash through operations.

**Exhibit 9**  
Statement of Cash Flows  
for Roland Consultancy

<b>Roland Consultancy</b>		
<b>Statement of Cash Flows</b>		
<b>For the Month Ended December 31, 2014</b>		
Cash flows from operating activities:		
Net income		\$ 8,400
Adjustments to reconcile net income to net cash flows from operating activities:		
(Increase) in accounts receivable	\$ (4,000)	
(Increase) in supplies	(2,000)	
Increase in accounts payable	2,400	(3,600)
Net cash flows from operating activities		<u>\$ 4,800</u>
Cash flows from investing activities:		
Purchase of land	\$ (40,000)	
Purchase of building	(100,000)	
Net cash flows used by investing activities		(140,000)
Cash flows from financing activities:		
Investments by owner	\$ 200,000	
Withdrawals	(2,400)	
Net cash flows from financing activities		197,600
Net increase (decrease) in cash		<u>\$ 62,400</u>
Cash at beginning of month		0
Cash at end of month		<u>\$ 62,400</u>

Note: Parentheses indicate a cash outflow.

The statement of cash flows is related directly to the other three financial statements. Notice that net income comes from the income statement and that withdrawals come from the statement of owner's equity. The other items in the statement represent changes in the balance sheet accounts: accounts receivable, supplies, accounts payable, land, and buildings.

## Relationships Among the Financial Statements

**STUDY NOTE:** Notice the sequence in which these statements are prepared: income statement, statement of owner's equity, balance sheet, and finally, the statement of cash flows.

Exhibit 10 illustrates the relationships among the four financial statements for Roland Consultancy. Notice the similarity of the headings at the top of each statement. Each identifies the company and the kind of statement. The income statement, the statement of owner's equity, and the statement of cash flows indicate the period to which they apply; the balance sheet gives the specific date to which it applies.

**Exhibit 10**  
Income Statement, Statement of Owner's Equity, Balance Sheet, and Statement of Cash Flows for Roland Consultancy

Roland Consultancy Statement of Cash Flows For the Month Ended December 31, 2014		Roland Consultancy Income Statement For the Month Ended December 31, 2014	
Cash flows from operating activities:		Revenues:	
Net income	\$ 8,400	Consulting fees	\$14,000
Adjustments to reconcile net income to net cash flows from operating activities:		Expenses:	
(Increase) in accounts receivable	\$ (4,000)	Equipment rental expense	\$2,800
(Increase) in supplies	(2,000)	Wages expense	1,600
Increase in accounts payable	2,400	Utilities expense	1,200
Net cash flows from operating activities	\$ 4,800	Total expenses	5,600
		Net income	\$ 8,400
Cash flows from investing activities:		Roland Consultancy Statement of Owner's Equity For the Month Ended December 31, 2014	
Purchase of land	\$ (40,000)	T. Roland, capital, December 1, 2014	\$ 0
Purchase of building	(100,000)	Investment by T. Roland	200,000
Net cash flows used by investing activities	(140,000)	Net income for the month	8,400
Cash flows from financing activities:		Subtotal	\$208,400
Investments by owner	\$ 200,000	Less withdrawals	2,400
Withdrawals	(2,400)	T. Roland, capital, December 31, 2014	\$206,000
Net cash flows from financing activities	197,600	Roland Consultancy Balance Sheet December 31, 2014	
Net increase (decrease) in cash	\$ 62,400	<b>Assets</b>	<b>Liabilities</b>
Cash at beginning of month	0	Cash	\$ 62,400
Cash at end of month	\$ 62,400	Accounts receivable	4,000
		Supplies	2,000
		Land	40,000
		Buildings	100,000
		Total assets	\$208,400
		Accounts payable	\$ 2,400
		Total liabilities	\$ 2,400
		<b>Owner's Equity</b>	
		T. Roland, capital	206,000
		Total liabilities and owner's equity	\$208,400

## APPLY IT!

Complete the following financial statements by determining the amounts that correspond to the letters. (Assume no new investments by owners.)

Income Statement	
Revenues	\$2,775
Expenses	(a)
Net income	\$ (b)
Statement of Owner's Equity	
Beginning balance	\$7,250
Net income	(c)
Less withdrawals	500
Ending balance	\$7,500
Balance Sheet	
Total assets	\$ (d)
Total liabilities	\$4,000
Owner's equity	(e)
Total liabilities and owner's equity	\$ (f)

### SOLUTION

Net income links the income statement and the statement of owner's equity. The ending balance of owner's equity links the statement of owner's equity and the balance sheet.

Thus, start with (c), which must equal \$750 ( $\$7,250 + \$750 - \$500 = \$7,500$ ). Then, (b) equals (c), or \$750. Thus, (a) must equal \$2,025 ( $\$2,775 - \$2,025 = \$750$ ). Because (e) equals \$7,500 (ending balance from the statement of owner's equity), (f) must equal \$11,500 ( $\$4,000 + \$7,500 = \$11,500$ ). Finally, (d) must equal (f), or \$11,500.

**TRY IT! SE7, SE8, E6A, E7A, E8A, E9A, E10A, E11A, E6B, E7B, E8B, E9B, E10B, E11B**

## LO 4 Generally Accepted Accounting Principles

To ensure that financial statements are understandable to their users, a set of **generally accepted accounting principles (GAAP)** has been developed to provide guidelines for financial accounting. "Generally accepted accounting principles encompass the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time."<sup>4</sup> In other words, GAAP arises from wide agreement on the theory and practice of accounting at a particular time. These "principles" evolve to meet the needs of decision makers, and they change as circumstances change or as better methods are developed.

In this book, we present accounting practice, or GAAP, as it is today, and we try to explain the reasons or theory on which the practice is based. Accounting is a discipline that is always growing, changing, and improving. However, it may take years for new accounting discoveries to be implemented. As a result, you may encounter practices that seem contradictory. In some cases, we point out new directions in accounting.

### GAAP and the Independent CPA's Report

Many companies of all sizes have their financial statements audited by an independent **certified public accountant (CPA)**. *Independent* means that the CPA is not an employee of the company being audited and has no financial or other compromising ties to it. CPAs are licensed by all states to protect the public by ensuring the quality of professional service. The firms listed in Exhibit 11 employ about 25 percent of all CPAs.

**Exhibit 11**  
Large International Certified  
Public Accounting Firms

Firm	Home Office	Some Major Clients
Deloitte & Touche	New York	General Motors, Procter & Gamble
Ernst & Young	New York	Coca-Cola, McDonald's
KPMG	New York	General Electric, Xerox
PricewaterhouseCoopers	New York	ExxonMobil, IBM, Ford

An **audit** is an examination of a company's financial statements and the accounting systems, controls, and records that produced them. The purpose of the audit is to ascertain that the financial statements have been prepared in accordance with generally

accepted accounting principles. If the independent CPA is satisfied that this standard has been met, his or her report contains the following language:

*In our opinion, the financial statements . . . present fairly, in all material respects . . . in conformity with generally accepted accounting principles . . .*

This wording emphasizes that accounting and auditing are not exact sciences. The auditor can render only an opinion about whether the financial statements *present fairly* or conform *in all material respects* to GAAP. The auditor's report does not preclude minor or immaterial errors in the financial statements. However, a favorable report from the auditor does imply that, on the whole, investors and creditors can rely on the financial statements. In other words, the audit lends credibility to a set of financial statements. Auditors offer opinions, based on testing, about the fairness of the presentation of a company's financial information, but they cannot attest to the absolute accuracy of such information.

Historically, auditors have enjoyed a strong reputation for competence and independence. The independent audit has been an important factor in the worldwide growth of financial markets.

## Organizations That Issue Accounting Standards

Two organizations issue accounting standards that are used in the United States: the FASB and the IASB.

- The **Financial Accounting Standards Board (FASB)** has been designated by the Securities and Exchange Commission (SEC) to issue *Statements of Financial Accounting Standards*. The FASB organizes these statements including any amendments, interpretations, or other references to them into a topical U.S. GAAP compendium called an American Standard Codification (ASC). This codification, which is available through the FASB website, makes it easy to find all references to a particular topic, such as revenues, in one place.
- The **International Accounting Standards Board (IASB)**, which issues **international financial reporting standards (IFRS)**, is becoming increasingly important because of the acceptance of its standards in many financial markets throughout the world. The SEC now allows foreign companies to use these standards in the United States rather than having to convert their statements to U.S. GAAP. The SEC is also presently considering allowing U.S. public companies to use IFRS.

IFRS

## Other Organizations That Influence GAAP

Many other organizations directly or indirectly influence GAAP:

- The **Public Company Accounting Oversight Board (PCAOB)**, a governmental body created by the Sarbanes-Oxley Act, has wide powers to determine the standards that auditors must follow. The PCAOB regulates audits of public companies registered with the SEC.
- The **American Institute of Certified Public Accountants (AICPA)**, a professional association, influences accounting practice through the activities of its senior technical committees. In addition to endorsing standards issued by the FASB, the AICPA has determined that standards issued by the IASB are also of high quality.



## International Perspective

IFRS

### The Arrival of International Financial Reporting Standards in the United States

Over the next few years, international financial reporting standards (IFRS) will become much more important in the United States and globally. The International Accounting Standards Board (IASB) has been working with the Financial Accounting Standards Board (FASB) and similar boards in other nations to achieve identical or nearly identical standards worldwide under what is called the convergence project. IFRS are now required in many parts of the world, including Europe, Canada, and parts of Asia. The Securities and Exchange Commission (SEC) allows foreign registrants in the United States to use IFRS. This is a major development because in the past, the SEC required foreign registrants to explain how the standards used in their statements differed from U.S. standards. This change affects approximately 10 percent of all public U.S. companies. In addition, the SEC may in the near future allow U.S. companies to use IFRS.<sup>5</sup>

and are thus acceptable for use in the United States.\* The AICPA is the primary professional organization of certified public accountants.

- The **Securities and Exchange Commission (SEC)**, a governmental agency, has the legal power to set and enforce accounting practices for companies whose securities are offered for sale to the general public.
- The **Governmental Accounting Standards Board (GASB)**, a separate but related body to the FASB, issues accounting standards for state and local governments.
- The **Internal Revenue Service (IRS)** interprets and enforces the tax laws that specify the rules for determining taxable income. In some cases, the rules conflict with good accounting practice, but they are nonetheless important.

## Professional Conduct

The code of professional ethics of the American Institute of Certified Public Accountants (and adopted, with variations, by each state) governs the conduct of CPAs. Fundamental to this code is the responsibility of CPAs to clients, creditors, investors, and anyone else who relies on their work. The code requires CPAs to act with:

- **Integrity:** Be honest and candid and subordinate personal gain to service and the public trust.
- **Objectivity:** Be impartial and intellectually honest.
- **Independence:** Avoid all relationships that impair or appear to impair objectivity.

Research shows that these are the attributes that business decision makers and the investing public most closely associate with CPAs.<sup>6</sup> The accountant must also exercise **due care** in all activities, carrying out professional responsibilities with competence and diligence. For example, an accountant must not accept a job for which he or she is not qualified, even at the risk of losing a client to another firm, and careless work is unacceptable. These broad principles are supported by more specific rules that public accountants must follow. For instance, with certain exceptions, client information must be kept strictly confidential. Accountants who violate the rules can be disciplined or even suspended from practice.

The **Institute of Management Accountants (IMA)**, the primary professional association of managerial accountants, also has a code of professional conduct. It emphasizes that managerial accountants have a responsibility:

- To be competent in their jobs
- To keep information confidential except when authorized or legally required to disclose it
- To maintain integrity and avoid conflicts of interest
- To communicate information objectively and without bias<sup>7</sup>

## APPLY IT!

Match the common acronym with its description.

- |          |  |
|----------|--|
| 1. GAAP  | a. Sets U.S. accounting standards                            |
| 2. IFRS  | b. Audits financial statements                               |
| 3. CPA   | c. Established by the Sarbanes-Oxley Act                     |
| 4. FASB  | d. Sets international accounting standards                   |
| 5. IASB  | e. Established by the FASB                                   |
| 6. PCAOB | f. Established by the IASB                                   |
| 7. AICPA | g. Influences accounting standards through member CPAs       |
| 8. SEC   | h. Receives audited financial statements of public companies |

## SOLUTION

1. e; 2. f; 3. b; 4. a; 5. d; 6. c; 7. g; 8. h

**TRY IT! E13A, E14A, E13B, E14B**

\*Established in January 2007, the Private Company Financial Reporting Committee of the AICPA is charged with amending FASB accounting standards so that they better suit the needs of private companies, especially as they relate to the cost or benefit of implementing certain standards. A Blue-Ribbon Committee established by the FASB, AICPA, and other organizations is currently studying this issue. Its recommendations could ultimately result in two sets of standards, one for private companies and one for public companies.

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Profitability
- Liquidity
- Ethics

RELEVANT  
LEARNING OBJECTIVES

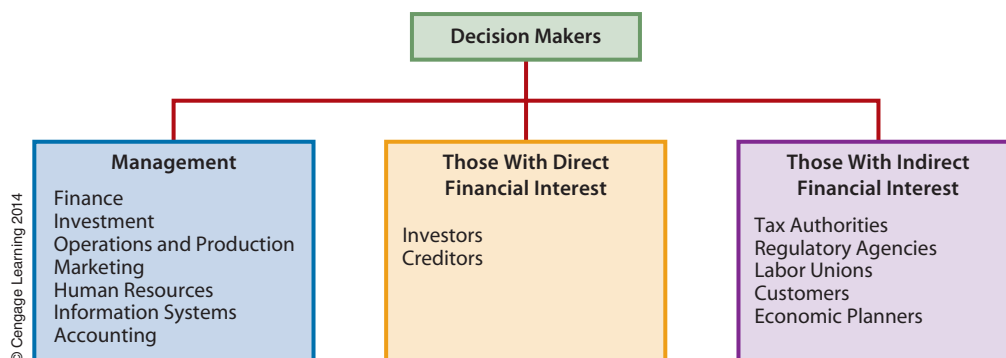
**LO 5** Identify the users of accounting information and identify business goals, activities, and performance measures.

**LO 6** Explain the importance of ethics in financial reporting.

## LO 5 Decision Makers: The Users of Accounting Information

As shown in Exhibit 12, the people who use accounting information to make decisions fall into three categories: managers (internal users of accounting information), outsiders who have a direct financial interest in the business, and outsiders who have an indirect financial interest. These categories apply to governmental and not-for-profit organizations as well as to profit-oriented ventures.

**Exhibit 12**  
The Users of Accounting Information



### Management

**Management** is responsible for ensuring that a company meets its goals of profitability and liquidity. All companies pursue these goals by engaging in operating, investing, and financing activities. Making decisions about these activities is the basic function of managers; and to make good decisions, they must have timely and valid accounting information.

To make good decisions, Jenny Mullin at Keep-Fit Center and other owners and managers need answers to such questions as:

- What were the company's earnings during the past quarter?
- Is the rate of return to the owners adequate?
- Does the company have enough cash?
- Which products or services are most profitable?

### Users with a Direct Financial Interest

Most companies periodically publish financial statements that report their success in meeting the goals of profitability and liquidity. These statements, discussed earlier, show what has happened in the past and are important indicators of what will happen in the future. Many people outside a company, particularly investors and creditors and potential investors and creditors, study these statements carefully.



**STUDY NOTE:** The primary external users of accounting information are investors and creditors.

**Investors** **Investors**, like Jenny Mullin, owner of the Keep-Fit Center, and the stockholders who have invested in **CVS**, have a direct financial interest in the success of their companies. They depend on financial statements to evaluate how their businesses have performed. A thorough study of a company's financial statements helps potential investors judge the prospects for a profitable investment.

**Creditors** **Creditors**, those who lend money or deliver goods and services before being paid, are interested mainly in whether a company will have the cash to pay interest charges and to repay the debt on time. They study a company's cash flow to determine its liquidity; they also look at its profitability. Banks, finance companies, mortgage companies, securities firms, insurance firms, suppliers, and other lenders must analyze a company's financial position before they make a loan.

## Users with an Indirect Financial Interest

In recent years, governmental and public groups have become one of the largest and most important users of accounting information. These groups include tax authorities and regulatory agencies.

**Tax Authorities** Government at every level is financed through the collection of taxes. Companies and individuals pay many kinds of taxes, including federal, state, and city income taxes; Social Security and other payroll taxes; excise taxes; and sales taxes. Proper reporting is generally a matter of law and can be very complicated.

**Regulatory Agencies** Most companies must report periodically to one or more regulatory agencies at the federal, state, and local levels. For example, all publicly traded corporations must report periodically to the Securities and Exchange Commission (SEC). This body, set up by Congress to protect the public, regulates the issuing, buying, and selling of stocks in the United States.

**Other Groups** Other groups with an indirect financial interest in accounting information include the following:

- **Labor unions:** As they prepare for contract negotiations with a company, labor unions study the company's financial statements. A company's income and expenses often play an important role in these negotiations.
- **Advisors of investors and creditors:** Financial analysts, brokers, underwriters, lawyers, economists, and the financial press all have an indirect interest in the financial performance and prospects of a business.
- **Consumer groups, customers, and the general public:** The public has become more concerned about financing and earnings as well as about the effects that corporations have on inflation, the environment, social issues, and the quality of life.
- **Economic planners:** The President's Council of Economic Advisers and the Federal Reserve Board use aggregated accounting information to set and evaluate economic policies and programs.

## Governmental and Not-for-Profit Organizations

More than 30 percent of the U.S. economy is generated by governmental and not-for-profit organizations (hospitals, universities, professional organizations, and charities). The managers of these diverse entities need accounting information and knowledge of how to use it. Their functions include raising funds from investors (including owners), creditors, taxpayers, and donors and deploying scarce resources. They must also plan how to pay for operations and to repay creditors on a timely basis. In addition, they have



an obligation to report their financial performance to legislators, boards, and donors, as well as to deal with tax authorities, regulators, and labor unions. Although most of the examples in this text focus on business enterprises, the same basic principles apply to governmental and not-for-profit organizations.



## Business Goals and Activities

A **business** is an economic unit that aims to sell goods and services at prices that will provide an adequate return to its owners. The list that follows contains the names of some well-known businesses and the principal goods or services that they sell. These businesses have similar goals and engage in similar activities, as shown in Exhibit 13.

**Wal-Mart Corp.**

Comprehensive discount goods

**Reebok International Ltd.**

Athletic footwear and clothing

**Best Buy Co.**

Consumer electronics, personal computers

**Wendy's International Inc.**

Food service

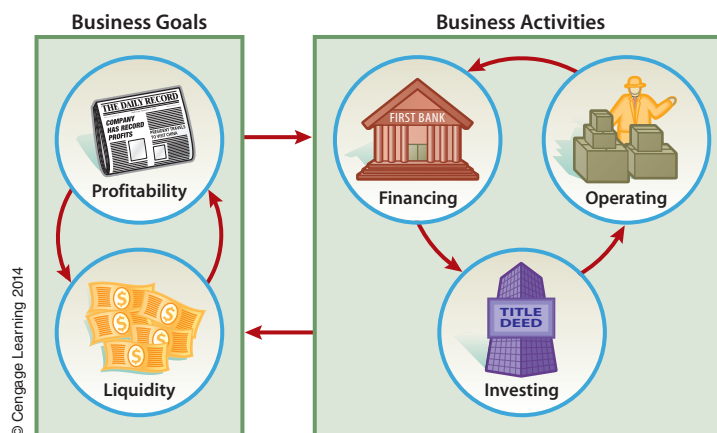
**Starbucks Corp.**

Coffee and related service

**Southwest Airlines Co.**

Passenger airline service

**Exhibit 13**  
Business Goals and  
Activities



The two major goals of all businesses are profitability and liquidity.

- **Profitability** is the ability to earn enough income to attract and hold investment capital.
- **Liquidity** is the ability to have enough cash to pay debts when they are due.

To succeed and even survive, a company must meet both goals. For example, **Toyota** may sell many cars at a price that earns a profit, but if its customers do not pay quickly enough to enable Toyota to pay its suppliers and employees, the company may not meet the goal of liquidity, which could force it into bankruptcy.

All businesses, including Jenny Mullin's Keep-Fit Center, pursue their goals by engaging in operating, investing, and financing activities.

- **Operating activities** include buying, producing, and selling goods and services; hiring managers and other employees; and paying taxes.
- **Investing activities** involve spending a company's capital in ways that will help it achieve its goals. They include buying resources for operating the business, such as land, buildings, and equipment, and selling those resources when they are no longer needed.
- **Financing activities** involve obtaining adequate funds to begin operating the business and to continue operating it. They include obtaining capital from creditors, such as banks and suppliers, and from the company's owners. They also include repaying creditors and paying a return to the owners.



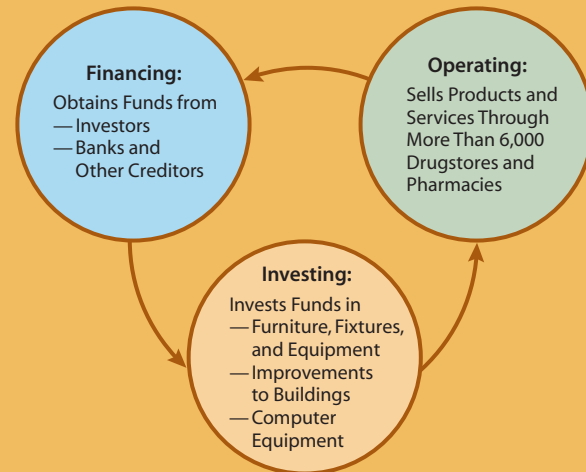
## Business Perspective

### What Does CVS Have to Say About Itself?

**CVS**, a major drug store chain, describes the company's progress in meeting its major business objectives as follows:

- **Liquidity:** "We generated \$4.6 billion in free cash for the year, exceeding our goal, and returned more than \$3.5 billion to our shareholders in the form of dividends and share repurchases."
- **Profitability:** "2011 was a year of great accomplishment for CVS Caremark. We executed successfully on a number of key initiatives across the Company and reported solid financial results, delivering on our promises. Our retail business continued to post strong top- and bottom-line results, and our PBM enjoyed strong revenue growth, another very successful selling season, and great progress on several important initiatives."<sup>8</sup>

CVS's main business activities are shown at the right.



## Financial Analysis

CASH FLOW

**Financial analysis** is the use of financial statements to determine that a business is well managed and is achieving its goals. The effectiveness of financial analysis depends on the use of relevant performance measures and financial ratios.

To be relevant, **performance measures** must be well aligned with the two major goals of business—profitability and liquidity. Profitability is commonly measured in net income, and cash flows are a common measure of liquidity. For example, in 2011, **CVS** had net income of \$3,457 million and cash flows from operating activities of \$5,856 million. These figures indicate that CVS was both profitable and liquid. In 2008, however, **General Motors** curtailed spending on new auto and truck models because its earnings were negative and, even worse, its cash flows were negative. Its cash flow problem led to its bankruptcy and a government bailout in 2009. Clearly, General Motors was not meeting either its profitability or liquidity goals.

**Financial ratios** show how the elements of financial statements relate to each other. They allow for comparisons from one period to another and from one company to another. For example, to assess Keep-Fit Center's profitability, it would be helpful to consider the ratio of its earnings to total assets, and for liquidity, the ratio of its cash flows to total assets.

## APPLY IT!

Match the terms that follow with the definitions or the type of user of accounting information. (Hint: Some answers may be used more than once.)

- |                          |   |
|--------------------------|---|
| 1. Managerial accounting | a. A business goal                                    |
| 2. Management            | b. Engaged in by all businesses                       |
| 3. Financial accounting  | c. Financial information developed for external users |
| 4. Investing activities  | d. Internal user                                      |
| 5. Regulatory agencies   | e. Direct external user                               |
| 6. Financing activities  | f. Indirect external user                             |
| 7. Profitability         | g. Accounting information used by management          |
| 8. Tax authorities       |   |
| 9. Investors             |   |
| 10. Liquidity            |   |
| 11. Creditors            |   |
| 12. Operating activities |   |

### SOLUTION

1. g; 2. d; 3. c; 4. b; 5. f; 6. b; 7. a; 8. f; 9. e; 10. a; 11. e; 12. b

### TRY IT! SE9, E12A, E13A, E12B, E13B

## LO 6 Ethical Financial Reporting

**Ethics** is a code of conduct that applies to everyday life. It addresses the question of whether actions are right or wrong. Actions—whether ethical or unethical, right or wrong—are the product of individual decisions. Thus, when an organization uses false advertising, cheats customers, pollutes the environment, or treats employees unfairly, the management and other employees have made a conscious decision to act in this manner.

Ethics is especially important in preparing financial reports because users of these reports must depend on the good faith of the people involved in their preparation. Users have no other assurance that the reports are accurate and fully disclose all relevant facts.

The intentional preparation of misleading financial statements is called **fraudulent financial reporting**.<sup>9</sup> It can result from:

- Distortion of records (e.g., the manipulation of inventory records)
- Falsified transactions (e.g., fictitious sales)
- Misapplication of various accounting principles

There are a number of motives for fraudulent reporting—for instance, to cover up financial weakness to obtain a higher price when a company is sold; to meet the expectations of investors, owners, and financial analysts; or to obtain a loan. The incentive can also be personal gain, such as additional compensation, promotion, or avoidance of penalties for poor performance.

Whatever the motive for fraudulent financial reporting, it can have dire consequences, as the accounting scandals at **Enron Corporation** and **WorldCom** in 2001 and 2002, respectively, attest. Unethical financial reporting and accounting practices at those two major corporations caused thousands of people to lose their jobs, their investment incomes, and their pensions. They also resulted in prison sentences and fines for the corporate executives who were involved.

In response to these scandals, the **Sarbanes-Oxley Act** of 2002 regulates financial reporting of public companies and their auditors. This legislation requires chief executives and chief financial officers of all publicly traded U.S. companies to swear that, based on their knowledge, their quarterly statements and annual reports filed with the Securities and Exchange Commission (SEC) are accurate and complete. Violation can result in criminal penalties.

Management expresses its duty to ensure that financial reports are not false or misleading in the management report that appears in the company's annual report. For example, in its management report, **Target Corporation** makes the following statement:

*Management is responsible for the consistency, integrity, and presentation of the information in the Annual Report.*<sup>10</sup>

However, it is accountants, not management, who physically prepare and audit financial reports. They must apply accounting concepts in such a way as to present a fair view of a company's operations and financial position and to avoid misleading the readers of their reports. Accountants have a responsibility—not only to the profession but also to employers, clients, and society as a whole—to ensure that their reports provide accurate, reliable information. The historically high regard for the accounting profession is evidence that most accountants have upheld the ethics of the profession.

### APPLY IT!

Match each definition with the appropriate terms that follow.

- |   |                                   |
|---|-----------------------------------|
| 1. The intentional preparation of misleading financial statements.          | a. Ethics                         |
| 2. A code of conduct that applies to everyday life.                         | b. Fraudulent financial reporting |
| 3. Regulates financial reporting of public companies and their auditors.    | c. Management                     |
| 4. Has a duty to ensure that financial reports are not false or misleading. | d. Sarbanes-Oxley Act             |

#### SOLUTION

1. b; 2. a; 3. d; 4. c

**TRY IT! SE10,  
E15A, E15B**

## TriLevel Problem



Andresy/Shutterstock.com

### Keep-Fit Center

The beginning of this chapter focused on Keep-Fit Center. The owner, Jenny Mullin, was considering expanding the business. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*What is accounting and what are the concepts that underlie it?*

#### Section 2: Accounting Applications

*What are three financial statements that Keep-Fit Center will need to present in a way that is useful to Mullin and to the bank?*

To answer this question, use the financial statement items and amounts listed below from the records of Keep-Fit Center for the year ended April 30, 2014, the company's first year of operations, and prepare the following:

- income statement
- statement of owner's equity
- balance sheet

For examples of the statements, refer to Exhibit 10.

Accounts payable	\$ 19,000
Accounts receivable	104,000
Cash	111,000
Equipment	47,000
Fees revenue	375,000
Investment by J. Mullin	100,000
Marketing expense	18,000
Salaries expense	172,000
Salaries payable	78,000
Rent expense	91,000
Supplies	2,000
Supplies expense	6,000
Utilities expense	11,000
Withdrawals	10,000

#### Section 3: Business Applications

*How do these financial statements help Jenny Mullin, as owner of Keep-Fit Center, measure progress toward the company's two main financial goals of profitability and liquidity? What additional financial statement information would be useful?*

## SOLUTION

#### Section 1: Concepts

Accounting is an information system that measures, processes, and communicates financial information about a business useful to internal and external decision makers. Accounting achieves its objectives by *measuring* the effects of *business transactions* on specific business *entities* in terms of *money*. It summarizes the results in financial statements based on the equation:  $Assets = Liabilities + Owner's Equity$  ( $A = L + OE$ ).



**Section 3: Business Applications**

The income statement shows that Keep-Fit Center earned \$77,000 after expenses were deducted from fees revenue. Further, it may be observed that this \$77,000 of net income is very good when compared to total assets of \$264,000 and owner's equity on the balance sheet. Thus, it can be concluded that Keep-Fit Center is profitable. It would be useful to see Keep-Fit Center's statement of cash flows to better evaluate its liquidity.

**Chapter Review**

**Define accounting, and explain the concepts underlying accounting measurement.** **LO 1**

Accounting is an information system that measures, processes, and communicates financial information about a business. It provides the information necessary to make choices among alternative uses of scarce resources in the conduct of business and economic activities.

Managerial accounting focuses on the preparation of information primarily for internal use by management. Financial accounting is concerned with the development and use of reports that are communicated to those outside the business as well as to management.

The accountant must determine what is measured, when the measurement should be made, what value should be placed on what is measured, and how to classify what is measured. The objects of accounting measurement are business transactions. Financial accounting uses a money measure to gauge the impact of these transactions on a business entity.

The three basic forms of business organization are the sole proprietorship, the partnership, and the corporation. A sole proprietorship is a business owned by one person. A partnership is like a sole proprietorship in most ways, but it has two or more owners. A corporation is a business unit chartered by the state and legally separate from its owners (the stockholders).

**Define financial position, and state the accounting equation.** **LO 2**

Financial position refers to a company's economic resources and the claims against those resources at a particular time. The accounting equation shows financial position as  $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$ . Business transactions affect financial position by decreasing or increasing assets, liabilities, and owner's equity in such a way that the accounting equation is always in balance.

**Identify the four basic financial statements and their interrelationships.** **LO 3**

The four basic financial statements are the income statement, the statement of owner's equity, the balance sheet, and the statement of cash flows. They are the primary means by which accountants communicate the financial condition and activities of a business to those who have an interest in the business.

**Explain how generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) relate to financial statements and the independent CPA's report, and identify the organizations that influence GAAP.** **LO 4**

Acceptable accounting practice consists of the conventions, rules, and procedures that make up generally accepted accounting principles. GAAP are essential to the preparation and interpretation of financial statements and the independent CPA's report. Foreign companies registered in the United States may use international financial reporting standards (IFRS).

Among the organizations that influence the formulation of GAAP are the Public Company Accounting Oversight Board, the Financial Accounting Standards Board, the American Institute of Certified Public Accountants, the Securities and Exchange Commission, and the Internal Revenue Service.



All accountants are required to follow a code of professional ethics. Accountants must act with integrity, objectivity, and independence, and exercise due care in all their activities.

The board of directors is responsible for the overall direction of the corporation for the benefit of the stockholders.

Identify the users of accounting information, and identify business goals, activities, and performance measures. **LO 5**

Accounting provides information to managers of all institutions and to individuals with a direct financial interest in those institutions, including present or potential investors and creditors. Accounting information is also important to those with an indirect financial interest in the business—tax authorities, regulatory agencies, and economic planners.

A business is an economic entity that engages in operating, investing, and financing activities to achieve goals of profitability and liquidity.

Explain the importance of ethics in financial reporting. **LO 6**

Ethical financial reporting is important to the well-being of a company. Fraudulent financial reports can have serious consequences for many people.

## Key Terms

- accounting** 2 (LO1)
- accounting equation** (A = L + OE) 6 (LO2)
- American Institute of Certified Public Accountants (AICPA)** 13 (LO4)
- assets** 6 (LO2)
- audit** 12 (LO4)
- balance sheet** 8 (LO3)
- bookkeeping** 3 (LO1)
- business** 17 (LO5)
- business transactions** 3 (LO1)
- cash flows** 10 (LO3)
- certified public accountant (CPA)** 12 (LO4)
- corporation** 5 (LO1)
- creditors** 16 (LO5)
- due care** 14 (LO4)
- economic entity** 2 (LO1)
- ethics** 19 (LO6)
- exchange rate** 4 (LO1)
- expenses** 7 (LO2)
- financial accounting** 2 (LO1)
- Financial Accounting Standards Board (FASB)** 13 (LO4)
- financial analysis** 18 (LO5)
- financial position** 6 (LO2)
- financial ratios** 18 (LO5)
- financial statements** 2 (LO1)
- financing activities** 17 (LO5)
- fraudulent financial reporting** 19 (LO6)
- generally accepted accounting principles (GAAP)** 12 (LO4)
- Governmental Accounting Standards Board (GASB)** 14 (LO4)
- income statement** 8 (LO3)
- independence** 14 (LO4)
- Institute of Management Accountants (IMA)** 14 (LO4)
- integrity** 14 (LO4)
- Internal Revenue Service (IRS)** 14 (LO4)
- International Accounting Standards Board (IASB)** 13 (LO4)
- international financial reporting standards (IFRS)** 13 (LO4)
- investing activities** 17 (LO5)
- investors** 16 (LO5)
- liabilities** 6 (LO2)
- limited liability** 5 (LO1)
- liquidity** 17 (LO5)
- management** 15 (LO5)
- management information systems (MIS)** 3 (LO1)
- managerial accounting** 3 (LO1)
- money measure** 3 (LO1)
- net assets** 7 (LO2)
- net income** 7 (LO2)
- net loss** 7 (LO2)
- objectivity** 14 (LO4)
- operating activities** 17 (LO5)
- owner's equity** 7 (LO2)
- owner's investments** 7 (LO2)
- partnership** 4 (LO1)
- performance measures** 18 (LO5)
- profitability** 17 (LO5)
- Public Company Accounting Oversight Board (PCAOB)** 13 (LO4)
- revenues** 7 (LO2)
- Sarbanes-Oxley Act** 19 (LO6)
- Securities and Exchange Commission (SEC)** 14 (LO4)
- separate entity** 4 (LO1)
- sole proprietorship** 4 (LO1)
- statement of cash flows** 10 (LO3)
- statement of owner's equity** 8 (LO3)
- stockholders** 5 (LO1)
- withdrawals** 7 (LO2)



## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1.** What makes accounting a valuable discipline?
- LO 1 **DQ2. CONCEPT** ► Are all economic events business transactions?
- LO 1 **DQ3.** Sole proprietorships, partnerships, and corporations differ legally; how and why does accounting treat them alike?
- LO 2 **DQ4.** How are expenses and withdrawals similar, and how are they different?
- LO 4 **DQ5.** How do generally accepted accounting principles (GAAP) differ from the laws of mathematics?
- LO 5 **DQ6.** Why do managers in governmental and not-for-profit organizations need to understand financial information as much as managers in profit-seeking businesses?
- LO 5 **DQ7.** In what ways are **CVS** and **Southwest Airlines** comparable? Not comparable?
- LO 6 **DQ8. BUSINESS APPLICATION** ► What are some unethical ways in which a business may do its accounting or prepare its financial statements?

### SHORT EXERCISES

- LO 1 **Accounting Concepts**
- SE1. CONCEPT** ► Indicate whether each of the following words or phrases relates most closely to (a) a business transaction, (b) a separate entity, or (c) a money measure:
1. Partnership
  2. U.S. dollar
  3. Payment of an expense
  4. Sole proprietorship
  5. Sale of an asset
- LO 1 **Forms of Business Organization**
- SE2.** Match the descriptions that follow with the appropriate forms of business organization.
1. Most numerous
  2. Commands most revenues
  3. Has two or more co-owners
  4. Has stockholders
  5. Is owned by only one person
  6. Has a board of directors
  - a. Sole proprietorship
  - b. Partnership
  - c. Corporation
- LO 2 **The Accounting Equation**
- SE3.** Determine the amount missing from each accounting equation that follows.
- |    | <b>Assets</b> | <b>=</b> | <b>Liabilities</b> | <b>+</b> | <b>Owner's Equity</b> |
|----|---------------|----------|--------------------|----------|-----------------------|
| 1. | ?             |          | \$100,000          |          | \$140,000             |
| 2. | \$312,000     |          | \$168,000          |          | ?                     |
| 3. | \$584,000     |          | ?                  |          | \$384,000             |
- LO 2 **The Accounting Equation**
- SE4.** Use the accounting equation to answer each question that follows.
1. Ambria Company's assets are \$240,000, and its liabilities are \$90,000. What is the amount of its owner's equity?
  2. Dao Company's liabilities equal one-fifth of the total assets. The owner's equity is \$40,000. What is the amount of the liabilities?

## LO 2 The Accounting Equation

**SE5.** Use the accounting equation to answer each question that follows.

1. At the beginning of the year, Palette Company's assets were \$90,000, and its owner's equity was \$50,000. During the year, assets increased by \$30,000 and liabilities increased by \$5,000. What was the owner's equity at the end of the year?
2. At the beginning of the year, Carmines Company had liabilities of \$100,000 and owner's equity of \$96,000. If assets increased by \$40,000 and liabilities decreased by \$30,000, what was the owner's equity at the end of the year?

## LO 2 The Accounting Equation and Net Income

**SE6.** Vivaldi Company had assets of \$280,000 and liabilities of \$120,000 at the beginning of the year, and assets of \$400,000 and liabilities of \$140,000 at the end of the year. During the year, the owner invested an additional \$40,000 in the business, and the company made withdrawals of \$48,000. What amount of net income did the company earn during the year?

## LO 3 Preparation and Completion of a Balance Sheet

**SE7.** Use the following accounts and balances to prepare a balance sheet with the accounts in proper order for Manteno Company at June 30, 2014, using Exhibit 8 as a model:

Accounts Receivable	\$ 3,200	Building	\$44,000
Wages Payable	1,400	Cash	?
Owner's Capital	57,400		

## LO 3 Preparation of Financial Statements

**SE8.** Randall Company engaged in activities during the first year of its operations that resulted in the following: service revenue, \$4,800; expenses, \$2,450; and withdrawals, \$410. In addition, the year-end balances of selected accounts were as follows: Cash, \$1,890; Other Assets, \$1,000; Accounts Payable, \$450; and Owner's Capital, \$2,440. Prepare Randall's income statement, statement of owner's equity, and balance sheet (assume the year ends on December 31, 2014). (*Hint:* You must solve for the beginning balance of Owner's Equity for 2014.)

## LO 5 Accounting and Business Enterprises

**SE9.** Match the terms that follow with the appropriate definitions.

- |   |   |
|---|---|
| 1. Accounting   | d. The process of generating and communicating accounting information in the form of financial statements to decision makers outside the organization |
| 2. Profitability  | e. Activities of management engaged to spend capital in ways that are productive and will help a business achieve its objectives                      |
| 3. Liquidity  | f. The ability to earn enough income to attract and hold investment capital   |
| 4. Financing activities   | g. An information system that measures, processes, and communicates financial information about an identifiable economic entity                       |
| 5. Investing activities   | h. The intentional preparation of misleading financial statements   |
| 6. Operating activities   | i. Activities of management engaged to operate the business   |
| 7. Financial accounting   | j. A code of conduct that addresses whether actions are right or wrong  |
| 8. Managerial accounting  |   |
| 9. Ethics   |   |
| 10. Fraudulent financial reporting  |   |
| a. The process of producing accounting information for the internal use of a company's management               |   |
| b. Having enough cash available to pay debts when they are due  |   |
| c. Activities of management engaged to obtain adequate funds for beginning and continuing to operate a business |   |

LO 6 **Ethics and Accounting**

**SE10. BUSINESS APPLICATION** ► Match the descriptions that follow with the appropriate terms.

- |  |                                   |
|--|-----------------------------------|
| 1. Preparation of financial statements that mislead the public.                        | a. Ethics                         |
| 2. An important underpinning of financial reporting.                                   | b. Fraudulent financial reporting |
| 3. A law that strengthened financial reporting of public companies and their auditors. | c. Accountants                    |
| 4. Have a duty to prepare financial reports that are not false or misleading.          | d. Sarbanes-Oxley Act             |

**EXERCISES: SET A**LO 1 **Business Transactions**

**E1A. CONCEPT** ► Austin owns and operates a minimart. Which of Austin's actions described below are business transactions? Explain why any other actions are not considered business transactions.

- Austin reduces the price of a gallon of milk in order to match the price offered by a competitor.
- Austin pays a high school student cash for cleaning up the driveway behind the market.
- Austin fills his son's car with gasoline in payment for his son's restocking the vending machines and the snack food shelves.
- Austin pays interest to himself on a loan he made to the business three years ago.

LO 1 **Accounting Concepts**

**E2A. CONCEPT** ► Financial accounting uses money measures to gauge the impact of business transactions on a separate business entity. Indicate whether each of the following words or phrases relates most closely to (a) a business transaction, (b) a separate entity, or (c) a money measure.

- |                        |                          |
|------------------------|--------------------------|
| 1. U.S. dollars        | 6. Corporation           |
| 2. Indian rupees       | 7. Sales of products     |
| 3. Partnership         | 8. Owner's investments   |
| 4. Receipt of cash     | 9. Japanese yen          |
| 5. Sole proprietorship | 10. Purchase of supplies |

LO 1 **Money Measure**

**E3A. CONCEPT** ► You have been asked to compare the sales and assets of four companies that make computer chips to determine which company is the largest in each category. You have gathered the following data, but they cannot be used for direct comparison because each company's sales and assets are in its own currency:

Company (Currency)	Sales	Assets
Abril Chip (U.S. dollar)	2,000,000	1,300,000
Dao (Hong Kong dollar)	5,000,000	2,400,000
Aiko (Japanese yen)	350,000,000	250,000,000
Orca (euro)	3,000,000	3,900,000

Assuming that the exchange rates in Exhibit 2 are current and appropriate, convert all the figures to U.S. dollars (multiply amount by exchange rate) and determine which company is the largest in sales and which is the largest in assets.

## LO 2 The Accounting Equation

**E4A.** Use the accounting equation to answer each question that follows. Show any calculations you make.

- Oshkosh Company's assets are \$400,000, and its owner's equity is \$155,000. What is the amount of its liabilities?
- Salvatore Company's liabilities and owner's equity are \$72,000 and \$79,500, respectively. What is the amount of the assets?
- Radisson Company's liabilities equal one-third of the total assets, and owner's equity is \$160,000. What is the amount of its liabilities?
- At the beginning of the year, Sun Company's assets were \$275,000, and its owner's equity was \$150,000. During the year, assets increased \$75,000 and liabilities decreased \$22,500. What is the owner's equity at the end of the year?

## LO 2 Owner's Equity and the Accounting Equation

**E5A.** Daiichi Company's total assets and liabilities at the beginning and end of the year follow.

	<b>Assets</b>	<b>Liabilities</b>
Beginning of the year	\$175,000	\$ 68,750
End of the year	275,000	162,500

Determine Daiichi's net income or loss for the year under each of the following alternatives:

- The owner made no investments in or withdrawals from the business during the year.
- The owner made no investments in the business but withdrew \$27,500 during the year.
- The owner invested \$16,250 in the business but made no withdrawals during the year.
- The owner invested \$12,500 in the business and withdrew \$27,500 during the year.

## LO 3 Identification of Accounts

**E6A.**

- Indicate whether each of the following accounts is an asset (A), a liability (L), or a part of owner's equity (OE):
 

a. Building	e. Cash
b. Salaries Payable	f. Accounts Payable
c. Accounts Receivable	g. Equipment
d. Owner's Capital	
- Indicate whether each account that follows would be shown on the income statement (IS), the statement of owner's equity (OE), or the balance sheet (BS).
 

a. Commissions Earned	e. Supplies Expense
b. Automobile	f. Accounts Payable
c. Utilities Expense	g. Withdrawals
d. Land	

## LO 3 Preparation of a Balance Sheet

**E7A.** Listed in random order are some of Oxford Services Company's account balances as of December 31, 2014.

Accounts Payable	\$ 50,000	Accounts Receivable	\$62,500
Building	112,500	Cash	25,000
J. Oxford, Capital	212,500	Equipment	50,000
Supplies	12,500		

Place the balances in proper order and prepare a balance sheet similar to the one in Exhibit 8.

### LO 3 Preparation and Integration of Financial Statements

**E8A.** Dukakis Company had the following accounts and balances during 2014: Service Revenue, \$13,200; Rent Expense, \$1,200; Wages Expense, \$8,340; Advertising Expense, \$1,350; Utilities Expense, \$900; and Withdrawals, \$700. In addition, the year-end balances of selected accounts were as follows: Cash, \$1,550; Accounts Receivable, \$750; Supplies, \$100; Land, \$1,000; Accounts Payable, \$450; Investment by Owner, \$1,240; and beginning capital balance of \$1,000.

Prepare Dukakis's income statement, statement of owner's equity, and balance sheet (assume the year ends on December 31, 2014). (*Hint:* You must first solve for the net income and ending balances of owner's equity for 2014.)

### LO 3 Statement of Cash Flows

CASH FLOW

**E9A.** Arlington Service Company began the year 2014 with cash of \$55,900. In addition to earning a net income of \$32,500 and making cash withdrawals of \$19,500, Arlington Service borrowed \$78,000 from the bank and purchased equipment with \$117,000 of cash. Also, Accounts Receivable increased by \$7,800, and Accounts Payable increased by \$11,700.

Determine the amount of cash on hand at December 31, 2014, by preparing a statement of cash flows similar to the one in Exhibit 9.

### LO 3 Statement of Owner's Equity

**E10A. ACCOUNTING CONNECTION** ▶ Information from Mrs. Shah's Cookies' statement of owner's equity for 2014 follows.

Withdrawals	\$	0
Net income		?
Owner's equity, January 31, 2014		159,490
Owner's equity, January 31, 2013		102,403

Prepare Mrs. Shah's Cookies' statement of owner's equity. You will need to solve for the amount of net income. What is owner's equity? Why might the owner decide not to make any withdrawals from the company?

### LO 3 Preparation and Integration of Financial Statements

**E11A.** Complete the financial statements that follow by determining the amounts that correspond to the letters. (Assume no new investments by owners.)

Income Statement	
Revenues	\$11,100
Expenses	(a)
Net income	<u>\$ (b)</u>
Statement of Owner's Equity	
Beginning balance	\$29,000
Net income	(c)
Less withdrawals	<u>2,000</u>
Ending balance	<u>\$30,000</u>
Balance Sheet	
Total assets	\$ (d)
Total liabilities	\$16,000
Owner's equity (T. Proviso, capital)	(e)
Total liabilities and owner's equity	<u>\$ (f)</u>

LO 1, 5 **Users of Accounting Information and Forms of Business Organization**

**E12A.** Avalon Pharmacy has recently been formed to develop a new type of drug treatment for cancer. Previously a partnership, Avalon has now become a corporation. Describe the various groups that will have an interest in Avalon's financial statements. What is the difference between a partnership and a corporation? What advantages does the corporate form have over the partnership form of business organization?

LO 4, 5 **The Nature of Accounting**

**E13A.** Match the terms that follow with the appropriate descriptions.

- |   |  |
|---|--|
| 1. Communication  | d. Legislation requiring CEOs and CFOs to swear that any reports they file with the SEC are accurate and complete                              |
| 2. Business transactions  | e. Show how well a company is meeting the goals of profitability and liquidity   |
| 3. Investors  | f. Collectively, the people who have overall responsibility for operating a business and meeting its goals                                     |
| 4. Financial Accounting Standards Board (FASB)  | g. People who commit money to earn a financial return  |
| 5. Creditors  | h. The interconnected subsystems that provide the information needed to run a business   |
| 6. Management   | i. The most important body for developing and issuing rules on accounting practice, called <i>Statements of Financial Accounting Standards</i> |
| 7. Bookkeeping  | j. An agency set up by Congress to protect the public by regulating the issuing, buying, and selling of stocks                                 |
| 8. Securities and Exchange Commission (SEC)   | k. Economic events that affect a business's financial position   |
| 9. Money measure  | l. People or businesses to whom money is due   |
| 10. Sarbanes-Oxley Act  |  |
| 11. Financial statements  |  |
| 12. Management information system   |  |
| a. The recording of all business transactions in terms of money   |  |
| b. A process by which information is exchanged between individuals through a common system of symbols, signs, or behavior |  |
| c. The process of identifying and assigning values to business transactions   |  |

LO 4 **Accounting Abbreviations**

**E14A.** Identify the accounting meaning of each of the following abbreviations: CPA, IRS, PCAOB, GAAP, FASB, SEC, GASB, IASB, IMA, and AICPA.

LO 6 **Ethics and Accounting**

**E15A. BUSINESS APPLICATION** ► Match the descriptions that follow with the appropriate terms.

- |  |                                   |
|--|-----------------------------------|
| 1. Responsible for the ethical preparation of financial statements   | a. Accountants                    |
| 2. Preparation of financial statements that mislead the public   | b. Ethics                         |
| 3. Underlies both management's and accountants' actions in preparing financial statements                                | c. Fraudulent financial reporting |
| 4. A law related to regulation of financial reporting of public companies and their auditors following the Enron scandal | d. Management                     |
| 5. Has overall responsibility for ensuring that financial reports are not false or misleading                            | e. Sarbanes-Oxley Act             |



## EXERCISES: SET B

Visit the textbook companion web site at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 3, 5 Preparation and Interpretation of Financial Statements

**P1.** A list of financial statement items follows.

Utilities expense	Accounts payable
Building	Rent expense
Owner's capital	Withdrawals
Net income	Fees earned
Land	Cash
Equipment	Supplies
Revenues	Wages expense
Accounts receivable	

### REQUIRED

1. Indicate whether each item is found on the income statement (IS), statement of owner's equity (OE), and/or balance sheet (BS).
2. **BUSINESS APPLICATION** ► Which statement is most closely associated with the goal of profitability?

### LO 3 Integration of Financial Statements

✓ 1f: Total liabilities and owner's equity: \$4,600

**P2.** The following three independent sets of financial statements have several amounts missing:

	Set A	Set B	Set C
<b>Income Statement</b>			
Revenues	\$1,100	\$ (g)	\$ 240
Expenses	(a)	5,200	(m)
Net income	<u>\$ (b)</u>	<u>\$ (h)</u>	<u>\$ 80</u>
<b>Statement of Owner's Equity</b>			
Beginning balance	\$2,900	\$24,400	\$ 340
Net income	(c)	1,600	(n)
Less withdrawals	200	(i)	(o)
Ending balance	<u>\$3,000</u>	<u>\$ (j)</u>	<u>\$ (p)</u>
<b>Balance Sheet</b>			
Total assets	\$ (d)	<u>\$31,000</u>	<u>\$ (q)</u>
Total liabilities	\$1,600	\$ 5,000	(r)
Owner's capital	(e)	(k)	380
Total liabilities and owner's equity	<u>\$ (f)</u>	<u>\$ (l)</u>	<u>\$ 380</u>

### REQUIRED

1. Complete each set of financial statements by determining the missing amounts that correspond to the letters.
2. **ACCOUNTING CONNECTION** ► Why is it necessary to prepare the income statement prior to the balance sheet?

## LO 3, 5

## Preparation and Interpretation of Financial Statements

## SPREADSHEET

- ✓ 1: Total net income: \$79,200
- ✓ 1: Total assets: \$136,800

**P3.** Fuel Designs' financial accounts follow. The company has just completed its tenth year of operations ended December 31, 2014.

Accounts Payable	\$ 3,600
Accounts Receivable	4,500
Cash	71,700
Commission Sales Revenue	400,000
Commissions Expense	225,000
Commissions Payable	22,700
Equipment	59,900
Marketing Expense	20,100
Office Rent Expense	36,000
Owner's Capital, December 31, 2013	64,300
Supplies	700
Supplies Expense	2,600
Telephone and Computer Expenses	5,100
Wages Expense	32,000
Withdrawals	33,000

## REQUIRED

1. Prepare Fuel Designs' income statement, statement of owner's equity, and balance sheet. There were no investments by the owner during the year.
2. **ACCOUNTING CONNECTION** ► The owner is considering expansion. What other financial statement would be useful to the owner in assessing whether the company's operations are generating sufficient funds to support the expenses? Why would it be useful?

## LO 3, 5

## Preparation and Interpretation of Financial Statements

## SPREADSHEET

- ✓ 1: Total net income: \$1,600
- ✓ 1: Total assets: \$27,300

**P4.** The accounts of Frequent Ad, an agency that develops marketing materials for print, radio, and television, follow. The agency's first year of operations just ended on January 31, 2014.

Accounts Payable	\$ 19,400
Accounts Receivable	24,600
Advertising Service Revenue	159,200
A. Francis, Capital	5,000*
Cash	1,800
Equipment Rental Expense	37,200
Marketing Expense	4,500
Office Rent Expense	10,800
Salaries Expense	86,000
Salaries Payable	1,300
Supplies	900
Supplies Expense	19,100
Withdrawals	0

\*Represents the initial investment by the owner.

## REQUIRED

1. Prepare Frequent Ad's income statement, statement of owner's equity, and balance sheet.
2. **BUSINESS APPLICATION** ► Review the financial statements and comment on the financial challenges Frequent Ad faces.

LO 3, 4, 5 **Use and Interpretation of Financial Statements**

P5. Athena Riding Club's financial statements follow.

<b>Athena Riding Club</b>		
<b>Income Statement</b>		
<b>For the Month Ended November 30, 2014</b>		
Revenues:		
Riding lesson revenue	\$4,650	
Locker rental revenue	<u>1,450</u>	
Total revenues		\$6,100
Expenses:		
Salaries expense	\$1,125	
Feed expense	750	
Utilities expense	<u>450</u>	
Total expenses		<u>2,325</u>
Net income		<u><u>\$3,775</u></u>

<b>Athena Riding Club</b>	
<b>Statement of Owner's Equity</b>	
<b>For the Month Ended November 30, 2014</b>	
Owner's capital, October 31, 2014	\$35,475
Investment by owner	6,000
Net income for the month	<u>3,775</u>
Subtotal	\$45,250
Less withdrawals	<u>2,400</u>
Owner's capital, November 30, 2014	<u><u>\$42,850</u></u>

<b>Athena Riding Club</b>			
<b>Balance Sheet</b>			
<b>November 30, 2014</b>			
<b>Assets</b>		<b>Liabilities</b>	
Cash	\$ 6,700	Accounts payable	\$11,250
Accounts receivable	900	<b>Owner's Equity</b>	
Supplies	750	Owner's capital	42,850
Land	15,750		
Building	22,500		
Horses	<u>7,500</u>		
Total assets	<u><u>\$54,100</u></u>	Total liabilities and owner's equity	<u><u>\$54,100</u></u>

**Athena Riding Club**  
**Statement of Cash Flows**  
**For the Month Ended November 30, 2014**

Cash flows from operating activities:		
Net income		\$3,775
Adjustments to reconcile net income to net cash flows from operating activities:		
Increase in accounts receivable	\$ (400)	
Increase in supplies	(550)	
Increase in accounts payable	400	(550)
Net cash flows from operating activities		<u>\$3,225</u>
Cash flows from investing activities:		
Purchase of horses	\$ (2,000)	
Sale of horses	1,000	
Net cash flows from investing activities		(1,000)
Cash flows from financing activities:		
Investment by owner	\$ 6,000	
Cash withdrawals	(2,400)	
Net cash flows from financing activities		<u>3,600</u>
Net increase in cash		\$5,825
Cash at beginning of month		875
Cash at end of month		<u><u>\$6,700</u></u>

**REQUIRED**

1. **ACCOUNTING CONNECTION** ► Explain how Athena Riding Club's four statements relate to each other.
2. **BUSINESS APPLICATION** ► Which statements are most closely associated with the goals of liquidity and profitability? Why?
3. **BUSINESS APPLICATION** ► If you were the owner of this business, how would you evaluate the company's performance? Give specific examples.
4. **ACCOUNTING CONNECTION** ► If you were a banker considering Athena Riding Club for a loan, why might you want the company to be audited by an independent CPA? What would the audit tell you?

**ALTERNATE PROBLEMS****LO 3, 5 Preparation and Interpretation of Financial Statements**

**P6.** A list of financial statement items follows.

Wages expense	Accounts payable
Equipment	Rent expense
Equipment rental expense	Withdrawals
Net income	Fees earned
Land	Cash
Owner's capital	Supplies
Revenues	Utilities expense
Accounts receivable	

**REQUIRED**

1. Indicate whether each item is found on the income statement (IS), statement of owner's equity (OE), and/or balance sheet (BS).
2. **BUSINESS APPLICATION** ► Which statement is most closely associated with the goal of profitability?

### LO 3 Integration of Financial Statements

✓ 1f: Total liabilities and owner's equity: \$9,380

**P7.** Three independent sets of financial statements with several amounts missing follow.

Income Statement	Set A	Set B	Set C
Revenues	\$2,400	\$ (g)	\$ 480
Expenses	(a)	10,000	(m)
Net income	\$ (b)	\$ (h)	\$ 296
<b>Statement of Owner's Equity</b>			
Beginning balance	\$5,800	\$48,800	\$ 480
Net income	(c)	3,200	(n)
Less withdrawals	400	(i)	(o)
Ending balance	\$6,180	\$ (j)	\$ (p)
<b>Balance Sheet</b>			
Total assets	\$ (d)	\$60,000	\$ (q)
Total liabilities	\$3,200	\$10,000	\$ (r)
Owner's capital	(e)	(k)	560
Total liabilities and owner's equity	\$ (f)	\$ (l)	\$1,160

#### REQUIRED

- Complete each set of financial statements by determining the amounts that correspond to the letters.
- ACCOUNTING CONNECTION** ► In what order is it necessary to prepare the financial statements and why?

### LO 3, 5 Preparation and Interpretation of Financial Statements

#### SPREADSHEET

✓ 1: Total net income: \$111,000  
✓ 1: Total assets: \$151,500

**P8.** Sears Labs' financial accounts follow. The company has just completed its third year of operations ended November 30, 2014.

Accounts Payable	\$ 7,400
Accounts Receivable	9,100
Cash	141,600
Design Service Revenue	248,000
Marketing Expense	19,700
Office Rent Expense	18,200
Owner's Capital, November 30, 2013	70,400
Salaries Expense	96,000
Salaries Payable	2,700
Supplies	800
Supplies Expense	3,100
Withdrawals	40,000

#### REQUIRED

- Prepare Sears Labs' income statement, statement of owner's equity, and balance sheet. There were no investments by the owner during the year.
- BUSINESS APPLICATION** ► Evaluate the company's ability to meet its bills when they come due.

### LO 1, 3 Preparation and Interpretation of Financial Statements

#### SPREADSHEET

✓ 1: Total net income: \$20,600  
✓ 1: Total assets: \$45,000

**P9.** Bachino's Pizza's accounts follow. The company has just completed its first year of operations ended September 30, 2014.

Accounts Payable	\$ 21,000
Accounts Receivable	26,400
Cash	5,200
Delivery Truck Rent Expense	14,400
Equipment	12,600
Equipment Rental Expense	5,800
Marketing Expense	3,000
Owner's Capital	4,000*
Pizza Revenue	164,000
Salaries Expense	112,000
Salaries Payable	1,400
Supplies	800
Supplies Expense	8,200
Withdrawals	2,000

\*Represents the initial investment by the owner.

### REQUIRED

1. Prepare Bachino's Pizza's income statement, statement of owner's equity, and balance sheet.
2. Why would Bachino's Pizza's owner set his business up as a sole proprietorship and not a partnership? Discuss how profits and obligations are shared in the two forms of business organizations.

LO 3, 4, 5

### Use and Interpretation of Financial Statements

**P10.** Aqua Swimming Club's financial statements follow.

#### Aqua Swimming Club Income Statement For the Month Ended November 30, 2014

Revenues:		
Swimming lesson revenue	\$4,650	
Locker rental revenue	<u>1,275</u>	
Total revenues		\$5,925
Expenses:		
Salaries expense	\$1,125	
Supplies expense	750	
Utilities expense	<u>450</u>	
Total expenses		<u>2,325</u>
Net income		<u>\$3,600</u>

#### Aqua Swimming Club Statement of Owner's Equity For the Month Ended November 30, 2014

Owner's capital, October 31, 2014	\$34,975
Investment by owner	5,000
Net income for the month	<u>3,600</u>
Subtotal	\$43,575
Less withdrawals	<u>2,400</u>
Owner's capital, November 30, 2014	<u>\$41,175</u>

(Continued)



**Aqua Swimming Club  
Balance Sheet  
November 30, 2014**

Assets		Liabilities	
Cash	\$ 7,125	Accounts payable	\$13,350
Accounts receivable	900	<b>Owner's Equity</b>	
Supplies	750	Owner's capital	41,175
Land	15,750		
Building	22,500		
Equipment	7,500		
Total assets	<u>\$54,525</u>	Total liabilities and owner's equity	<u>\$54,525</u>

**Aqua Swimming Club  
Statement of Cash Flows  
For the Month Ended November 30, 2014**

Cash flows from operating activities:			
Net income			\$3,600
Adjustments to reconcile net income to net cash flows from operating activities:			
Increase in accounts receivable	\$ (400)		
Increase in supplies	(550)		
Increase in accounts payable	400		(550)
Net cash flows from operating activities			\$3,050
Cash flows from investing activities:			
Sale of equipment	\$ 2,000		
Purchase of equipment	(1,000)		
Net cash flows from investing activities			1,000
Cash flows from financing activities:			
Investment by owner	\$ 5,000		
Cash withdrawals	(2,400)		
Net cash flows from financing activities			2,600
Net increase in cash			\$6,650
Cash at beginning of month			475
Cash at end of month			<u>\$7,125</u>

**REQUIRED**

1. **ACCOUNTING CONNECTION** ► Explain how Aqua Swimming Club's four statements relate to each other.
2. **BUSINESS APPLICATION** ► Which statements are most closely associated with the goals of liquidity and profitability? Why?
3. **BUSINESS APPLICATION** ► If you were the owner of this business, how would you evaluate the company's performance? Give specific examples.
4. **ACCOUNTING CONNECTION** ► If you were a banker considering Aqua Swimming Club for a loan, why might you want the company to be audited by an independent CPA? What would the audit tell you?

**CASES****LO 5 Conceptual Understanding: Business Activities and Management Functions**

**C1. Costco Wholesale Corporation** is America's largest membership retail company. According to its letter to stockholders:

*For the first time [in 2011], four of our locations had more than \$300 million in annual sales, including one which had more than \$400 million in sales. This rate of*

*top line revenue per building stands out in the retail industry and results from our ongoing focus on value—that winning combination of quality and price on every item we sell that, we believe, sets Costco apart from many of its competitors.<sup>11</sup>*

To achieve its strategy, Costco must organize its management by functions that relate to the principal activities of a business. Discuss the three basic activities Costco will engage in to achieve its goals, and suggest some examples of each. What is the role of Costco's management? What functions must its management perform to carry out these activities?

## LO 2 Conceptual Understanding: Concept of an Asset

**C2. CONCEPT** ► **Southwest Airlines Co.** is one of the most successful airlines in the United States. One of its annual reports contained this statement:

*We are a company of People, not Planes. That is what distinguishes us from other airlines and other companies. At Southwest Airlines, People are our most important asset.<sup>12</sup>*

Are employees considered assets in the financial statements? Why or why not? Discuss in what sense Southwest considers its employees to be assets.

## LO 4 Conceptual Understanding: Generally Accepted Accounting Principles

**C3. Fidelity Investments Company** is a well-known mutual fund investment company. It makes investments worth billions of dollars in companies listed on the New York Stock Exchange and other stock markets. Generally accepted accounting principles (GAAP) are very important for Fidelity's investment analysts. What are generally accepted accounting principles? Why are financial statements that have been prepared in accordance with GAAP and audited by an independent CPA useful for Fidelity's investment analysts? What organizations influence GAAP? Explain how they do so.

## LO 3 Interpreting Financial Reports: Analysis of Four Basic Financial Statements

**C4.** Refer to the **CVS** annual report in the Supplement to Chapter 16 to answer the questions below. Keep in mind that every company, while following basic principles, adapts financial statements and terminology to its own special needs. Therefore, the complexity of CVS's financial statements and the terminology in them will differ somewhat from the financial statements in the text.

1. What names does CVS give to its four basic financial statements? (Note that the word *consolidated* in the names of the financial statements means that these statements combine those of several companies owned by CVS.)
2. Prove that the accounting equation works for CVS on December 31, 2011 by finding the amounts for the following equation: Assets = Liabilities + Stockholders' Equity.
3. What were the total revenues of CVS for the year ended December 31, 2011?
4. Was CVS profitable in the year ended December 31, 2011? How much was net income (loss) in that year, and did it increase or decrease from the year ended December 31, 2010?
5. Did the company's cash and cash equivalents increase from December 31, 2010 to December 31, 2011? If so, by how much? In what two places in the statements can this number be found or computed?
6. Did cash flows from operating activities, cash flows from investing activities, and cash flows from financing activities increase or decrease from years 2010 to 2011?
7. Who is the auditor for the company? Why is the auditor's report that accompanies the financial statements important?

## LO 5 Comparison Analysis: Performance Measures and Financial Statements



**C5. BUSINESS APPLICATION** ► Refer to the **CVS** annual report and the financial statements of **Southwest Airlines Co.** in the Supplement to Chapter 16 to answer the questions that follow.

(Continued)

1. Which company is larger in terms of assets and in terms of revenues? What do you think is the best way to measure the size of a company?
2. Which company is more profitable in terms of net income? What is the trend of profitability over the past three years for both companies?
3. Which company has more cash? Which increased its cash the most in the last year? Which has more liquidity as measured by cash flows from operating activities?

#### LO 6 Ethical Dilemma: Professional Situations

**C6. BUSINESS APPLICATION** ► Discuss the ethical choices in the situations below. In each instance, describe the ethical dilemma, determine the alternative courses of action, and tell what you would do.

1. You are the payroll accountant for a small business. A friend asks you how much another employee is paid per hour.
2. As an accountant for the branch office of a wholesale supplier, you discover that several of the receipts the branch manager has submitted for reimbursement as selling expenses actually stem from nights out with his spouse.
3. You are an accountant in the purchasing department of a construction company. When you arrive home from work on December 22, you find a large ham in a box marked “Happy Holidays—It’s a pleasure to work with you.” The gift is from a supplier who has bid on a contract your employer plans to award next week.
4. As an auditor with one year’s experience at a local CPA firm, you are expected to complete a certain part of an audit in 20 hours. Because of your lack of experience, you know you cannot finish the job within that time. Rather than admit this, you are thinking about working late to finish the job and not telling anyone.
5. You are a tax accountant at a local CPA firm. You help your neighbor fill out her tax return, and she pays you \$200 in cash. Because there is no record of this transaction, you are considering not reporting it on your tax return.
6. The accounting firm for which you work as a CPA has just won a new client, a firm in which you own 200 shares of stock that you received as an inheritance from your grandmother. Because it is only a small number of shares and you think the company will be very successful, you are considering not disclosing the investment.

#### Continuing Case: Annual Report Project

**C7.** Choose a company in which you are interested, and obtain its most recent annual report online at the company’s website. Click on *Investor Relations*; then, select *Annual Report* or *SEC Form 10-K*. (*Hint:* When performing a search, use “*company name investor relations*” to avoid the customer-oriented home page.)

1. Identify the company by writing a summary that includes the following elements:
  - Name of the chief executive officer
  - Location of the home office
  - Ending date of latest fiscal year
  - Description of the company’s principal products or services
  - Main geographic area of activity
  - Name of the company’s independent accountants (auditors). In your own words, explain what the accountants said about the company’s financial statements.
2. Identify the company’s four financial statements. What differences, if any, do you see in the titles given to the statements as compared to those used in the chapter? Trace the interrelationships of the statements.
3. Show that the accounting equation ( $\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$ ) is in balance for the most recent year.

# CHAPTER 2

## Analyzing and Recording Business Transactions

### BUSINESS INSIGHT

#### Paws and Hoofs Clinic

After graduating from veterinary school, Jim Wright started the Paws and Hoofs Clinic. On his second day of business, he received a standing order from Quarter Horse Stables to examine its horses on a monthly basis for one year. The fee for the service was to be \$500 per visit, or \$6,000 for the year. Confident that his agreement with Quarter Horse Stables will work out, Jim is thinking of including the \$6,000 he expects to receive in his financial statements. He believes that doing so would be a good advertisement for his business, but he must answer the following questions to determine if this is acceptable practice.

- 1. CONCEPT** ► How will the concepts of recognition, valuation, and classification help Wright record the transaction properly?
- 2. ACCOUNTING APPLICATION** ► How does one enter business transactions, which are economic events, in the accounting records?
- 3. BUSINESS APPLICATION** ► Can a business transaction benefit a business even though no cash is received when the transaction takes place?

### LEARNING OBJECTIVES

- LO 1** Explain how the concepts of recognition, valuation, and classification apply to business transactions.
- LO 2** Explain the double-entry system and the usefulness of T accounts in analyzing business transactions.
- LO 3** Demonstrate how the double-entry system is applied to common business transactions.
- LO 4** Prepare a trial balance, and describe its value and limitations.
- LO 5** Record transactions in the general journal, and post transactions to the ledger.
- LO 6** Explain why ethical financial reporting depends on proper recording of business transactions.
- LO 7** Show how the timing of transactions affects cash flows and liquidity.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Recognition
- Valuation
- Classification

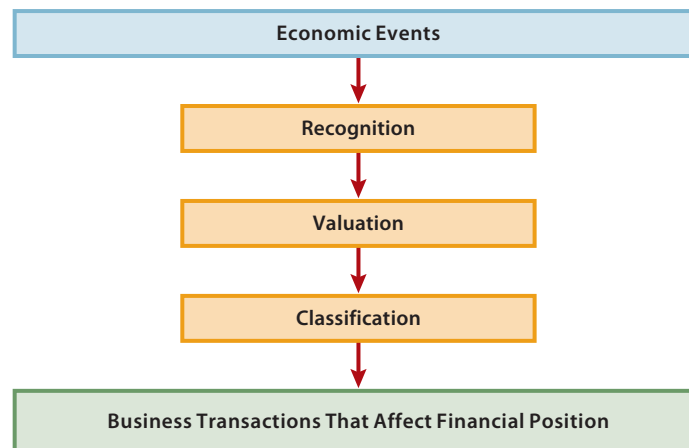
RELEVANT  
LEARNING OBJECTIVE

**LO 1** Explain how the concepts of recognition, valuation, and classification apply to business transactions.

## LO 1 Concepts Underlying Business Transactions

**Business transactions** are economic events that should be recorded in the accounting records. As illustrated in Exhibit 1, the concepts of *recognition*, *valuation*, and *classification* underlie all business transactions.

**Exhibit 1**  
Concepts Underlying Business Transactions



© Cengage Learning 2014

### Recognition

**Recognition** refers to the decision as to *when* to record a business transaction. Usually, companies set specific recognition policies, such as recognizing revenue when title to goods passes or a service is provided. For example, for Paws and Hoofs Clinic that was introduced at the beginning of the chapter, Jim needs to know when to record the \$6,000 fee in his financial statements. The resolution of this issue is important because the date on which a transaction is recorded affects amounts in the financial statements.

### Valuation

**Valuation** is the process of assigning a monetary amount to business transactions and the resulting assets and liabilities. Generally accepted accounting principles state that all business transactions should be valued at *fair value* when they occur. **Fair value**



## International Perspective

IFRS

### The Challenge of Fair Value Accounting

The measurement of fair value is a major success of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) convergence project to merge U.S. GAAP with international financial reporting standards (IFRS).<sup>1</sup> After initially recording an asset at cost, fair value is the price at which an asset *could* be sold (or a liability settled) in a current transaction between independent parties. It is not the actual, or historical, price at which the asset was acquired or the liability assumed. Because it represents the price in a hypothetical transaction, fair value is often difficult to measure and subject to judgment. For example, when there is no ready market for an asset—as might be the case for used factory equipment—the potential selling price may not be easy to determine.

© loops7 / iStockphoto.com

© Cengage Learning 2014





Aurora Photos/Alamy

Barter transactions, in which exchanges are made but no cash changes hands, can make valuation complicated. For example, if an office supply company provides a year's supply of computer paper to a local newspaper in exchange for an advertisement in the weekly paper, the value of the transaction equals the fair value of the items being traded.

is the *exchange price* of an actual or potential business transaction between market participants.<sup>2</sup> Recording transactions at the exchange price at the point of recognition is called the **cost principle**. The cost, or exchange price, is used because it is verifiable. For example, when Jim performs the service for Quarter Horse Stables, he and Quarter Horse Stables will record the transaction in their respective records at the agreed-upon price.

Normally, the value of an asset remains at its initial fair value or cost until the asset is sold, expires, or is consumed. However, if a change in the fair value of the asset (or liability) occurs, an adjustment may be required. Different fair-value rules apply to different classes of assets. For example, a building or equipment remains at cost unless convincing evidence exists that the fair value is less than cost. In this case, a loss is recorded to reduce the value from its cost to fair value. Investments, on the other

hand, are often accounted for at fair value, regardless of whether fair value is greater or less than cost.

### Classification

**Classification** is the process of assigning all the transactions in which a business engages to appropriate categories, or accounts. Classification of debts can affect a company's ability to borrow money, and classification of purchases can affect its income. One of the most important classification issues in accounting is the difference between an expense and an asset, both represented by debits in the accounts. For example, if Jim buys medicines that are used immediately at the Paws and Hoofs Clinic, their cost is classified as an expense. If the medicines will be used in the future, they are classified as assets. Similarly, if **CVS** buys paper towels to resell to customers, the cost would be recorded as an asset in the Inventory account. If the paper towels are used for cleaning in the store today, the cost is an expense.

As we explain later in the chapter, proper classification depends not only on correctly analyzing the effect of each transaction but also on maintaining a system of accounts that reflects that effect.

## APPLY IT!

Three major issues underlie every accounting transaction: recognition, valuation, and classification. Match each of these issues to the statements that are most closely associated with the issue. A company:

1. Records a piece of equipment at the price paid for it.
2. Records the purchase of the equipment on the day on which it takes ownership.
3. Records the equipment as an asset because it will benefit future periods.

### SOLUTION

1. valuation
2. recognition
3. classification

**TRY IT! SE1, SE2, SE3, E1A, E1B**



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Record business transactions
- Prepare the trial balance

## RELEVANT LEARNING OBJECTIVES

- LO 2** Explain the double-entry system and the usefulness of T accounts in analyzing business transactions.
- LO 3** Demonstrate how the double-entry system is applied to common business transactions.
- LO 4** Prepare a trial balance, and describe its value and limitations.
- LO 5** Record transactions in the general journal, and post transactions to the ledger.

**LO 2** Double-Entry System

Accounting is a very old discipline. Forms of it have been essential to commerce for more than 5,000 years. Accounting, in a version close to what we know today, gained widespread use in the 1400s, especially in Italy, where it was instrumental in the development of shipping, trade, construction, and other forms of commerce. This system of double-entry bookkeeping, i.e., *recording*, *valuing*, and *classifying* business transactions, was documented by the famous Italian mathematician, scholar, and philosopher Fra Luca Pacioli. In 1494, Pacioli published his most important work, *Summa de Arithmetica, Geometrica, Proportioni et Proportionalita*, which contained a detailed description of accounting as practiced in that age. This book became the most widely read book on mathematics in Italy and firmly established Pacioli as the “Father of Accounting.” Goethe, the famous German poet and dramatist, referred to double-entry bookkeeping as “one of the finest discoveries of the human intellect.”

What is the significance of the double-entry system? The system is based on the *principle of duality*, which means that every economic event has two aspects—such as effort and reward, sacrifice and benefit, source and use—that offset, or balance, each other. In the **double-entry system**, each transaction must be recorded with at least one debit and one credit, and the total amount of the debits must equal the total amount of the credits. All accounting systems, no matter how sophisticated, are based on the principle of duality.

**Accounts**

**Accounts** are the basic storage units for accounting data and are used to accumulate amounts from similar transactions. An accounting system has a separate account for each asset, each liability, and each component of owner’s equity, including revenues and expenses. Managers must be able to refer to accounts so that they can study their company’s financial history and plan for the future. A very small company may need only a few dozen accounts; a multinational corporation may need thousands.

An account title should describe what is recorded in the account. However, account titles can be rather confusing. For example, Wages Expense and Salaries Expense are both titles for labor expenses. Moreover, many account titles change over time as preferences and practices change.

**Chart of Accounts**

In a manual accounting system, each account is kept on a separate page or card. These pages or cards are placed together in a book or file called the **general ledger**. In computerized systems, accounts are maintained electronically. However, accountants still refer to the group of accounts as the *general ledger*, or simply the *ledger*.

To help identify accounts in the ledger and make them easy to find, the accountant often numbers them. A list of these numbers with the corresponding account titles is called a **chart of accounts**. A chart of accounts is a table of contents for the ledger. Typically, it lists accounts in the order in which they appear in the ledger, which is usually the order in which they appear in the financial statements. The numbering scheme allows for some flexibility. A very simple chart of accounts appears in Exhibit 2. The first digit in the account number identifies the major financial statement *classification*—that is, an asset account begins with the digit 1, a liability account begins with a 2, and so forth. The second and third digits identify individual accounts. The gaps in the sequence of numbers allow the accountant to expand the number of accounts within the classification.

**Exhibit 2**  
Chart of Accounts for a Small Business

Account Number	Account Name	Description
<b>Assets</b>		
111	Cash	Money and any medium of exchange (coins, currency, checks, money orders, and money on deposit in a bank)
112	Notes Receivable	Promissory notes (written promises to pay definite sums of money at fixed future dates) due from others
113	Accounts Receivable	Amounts due from others for revenues or sales on credit (sales on account)
116	Office Supplies	Prepaid expense; office supplies purchased and not used
117	Prepaid Rent	Prepaid expense; rent paid in advance and not used
118	Prepaid Insurance	Prepaid expense; insurance purchased and not expired
141	Land	Property owned for use in the business
142	Buildings	Structures owned for use in the business
143	Accumulated Depreciation—Buildings	Total of periodic allocation of the cost of buildings to expense; deducted from Buildings
146	Office Equipment	Office equipment owned for use in the business
147	Accumulated Depreciation—Office Equipment	Total of periodic allocation of the cost of office equipment to expense; deducted from Office Equipment
<b>Liabilities</b>		
211	Notes Payable	Promissory notes due to others
212	Accounts Payable	Amounts due to others for purchases on credit
213	Unearned Revenue	Unearned revenue; advance deposits for services to be provided in the future
214	Wages Payable	Amounts due to employees for wages earned and not paid
<b>Owner's Equity</b>		
311	Owner's Capital	Owner's investments in a company and claims against company assets derived from profitable operations
313	Withdrawals	Distributions of assets (usually cash) that reduce owner's capital
314	Income Summary	Temporary account used at the end of the accounting period to summarize the revenues and expenses for the period
<b>Revenues</b>		
411	Service Revenue	Amounts earned from services
<b>Expenses</b>		
511	Wages Expense	Amounts earned by employees
512	Utilities Expense	Amounts for utilities, such as water, electricity, and gas, used
513	Telephone Expense	Amounts of telephone services used
514	Rent Expense	Amounts of property and buildings rent used
515	Insurance Expense	Amounts for insurance expired
517	Office Supplies Expense	Amounts for office supplies used
518	Depreciation Expense—Buildings	Amount of buildings' cost allocated to expense
520	Depreciation Expense—Office Equipment	Amount of office equipment cost allocated to expense

## The T Account

The T account is a good place to begin the study of the double-entry system. Such an account has the following three parts:

- a title, which identifies the asset, liability, or owner's equity account
- a left side, which is called the **debit** side
- a right side, which is called the **credit** side

The **T account**, so called because it resembles the letter *T*, is a tool used to analyze transactions and is not part of the accounting records. It looks like this:

Title of Account	
Debit (left) side	Credit (right) side

**STUDY NOTE:** It is important to realize that debit simply means "left side" and credit simply means "right side." Do not let preconceived ideas about what debit and credit mean affect your understanding.

Any entry made on the left side of the account is a debit, and any entry made on the right side is a credit. The terms *debit* (abbreviated Dr., from the Latin *debere*) and *credit* (abbreviated Cr., from the Latin *credere*) are simply the accountant's words for "left" and "right" (*not* for "increase" or "decrease"). We present a more formal version of the T account, the ledger account form, later in this chapter.

**The T Account Illustrated** Suppose a company had several transactions during the month that involved the receipt or payment of cash. These transactions can be summarized in the Cash account by recording receipts on the left (debit) side of a T account and payments on the right (credit) side.

Cash	
<i>Dr.</i>	<i>Cr.</i>
100,000	70,000
3,000	400
	1,200
<b>103,000</b>	<b>71,600</b>
<b>Bal. 31,400</b>	

The cash receipts on the left total \$103,000. (The total is written in smaller, blue figures so that it cannot be confused with an actual debit entry.) The cash payments on the right side total \$71,600. These totals are simply working totals, or **footings**. Footings, which are calculated at the end of each month, are an easy way to determine cash on hand. The difference between the total debit footing and the total credit footing is called the **account balance** (or *balance*). If the balance is a debit, it is written on the left side. If it is a credit, it is written on the right side. Notice that the Cash account has a debit balance of \$31,400 (\$103,000 – \$71,600). This is the amount of cash the business has on hand at the end of the month.

## Rules of Double-Entry Accounting

The double-entry system follows two rules:

- Every transaction affects at least two accounts.
- Total debits must equal total credits.

In other words, for every transaction, one or more accounts must be debited, or entered on the left side of a T account, and one or more accounts must be credited, or entered on the right side of a T account, and the total dollar amount of the debits must equal the total dollar amount of the credits.

Look again at the accounting equation:

$$\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$$

- ▲ If a debit *increases* assets, then a credit must be used to *increase* liabilities or owner's equity because they are on opposite sides of the equal sign.
- ▼ Likewise, if a credit *decreases* assets, then a debit must be used to *decrease* liabilities or owner's equity.

These rules can be shown as follows.

Assets		=	Liabilities		+	Owner's Equity	
Debit for increases (+)	Credit for decreases (-)		Debit for decreases (-)	Credit for increases (+)		Debit for decreases (-)	Credit for increases (+)

One of the more difficult points is the application of double-entry rules to the components of owner's equity. Remember that withdrawals and expenses are deductions from owner's equity. Thus, transactions that *increase* withdrawals or expenses *decrease* owner's equity. Consider this expanded version of the accounting equation:

Assets		=	Liabilities		+	Owner's Equity							
						Owner's Capital	-	Withdrawals	+	Revenues	-	Expenses	
<b>Assets</b>		=	<b>Liabilities</b>		+	<b>Owner's Capital</b>	-	<b>Withdrawals</b>	+	<b>Revenues</b>	-	<b>Expenses</b>	
+	-		-	+		-	+	+	-	-	+	-	
(Dr.)	(Cr.)		(Dr.)	(Cr.)		(Dr.)	(Cr.)	(Dr.)	(Cr.)	(Dr.)	(Cr.)	(Dr.)	(Cr.)

**STUDY NOTE:** To remember the normal balances and the rules of debit and credit, use the acronym AWE: Assets, Withdrawals, and Expenses are always increased by debits. All other accounts are increased by credits.

### Normal Balance

The **normal balance** of an account is its usual balance and is the side (debit or credit) that increases the account. Exhibit 3 summarizes the normal account balances of the major account categories.

**Exhibit 3**  
Normal Account Balances of Major Account Categories

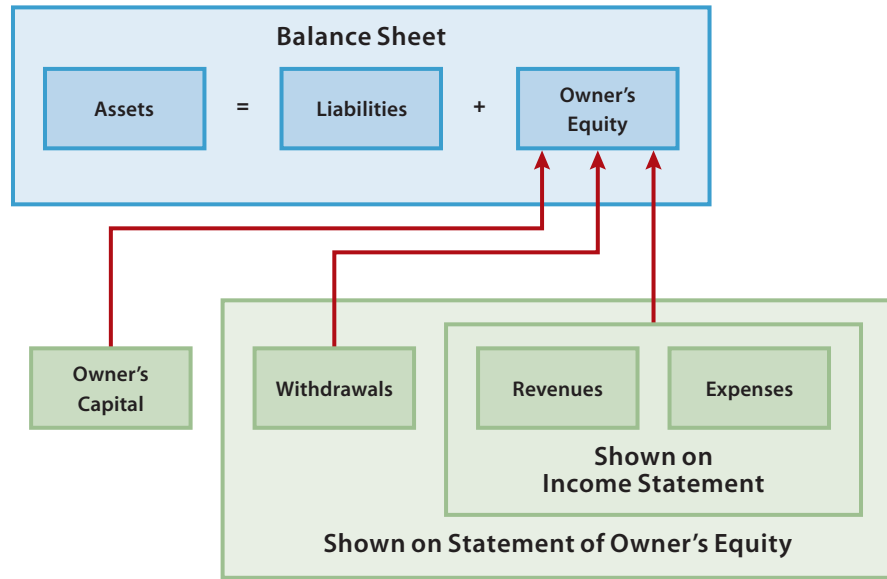
Account Category	Increases Recorded by		Normal Balance	
	Debit	Credit	Debit	Credit
Assets	×		×	
Liabilities		×		×
Owner's Equity:				
Owner's Capital		×		×
Withdrawals	×		×	
Revenues		×		×
Expenses	×		×	

© Cengage Learning 2014

### Owner's Equity Accounts

Exhibit 4 illustrates how owner's equity accounts relate to each other and to the financial statements. The distinctions among these accounts are important for both legal purposes and financial reporting. Owner's capital represents the original investments by the owner plus (or minus) income earned (or losses incurred) by the business minus withdrawals made by the owner.

**Exhibit 4**  
Relationships of  
Owner's Equity  
Accounts



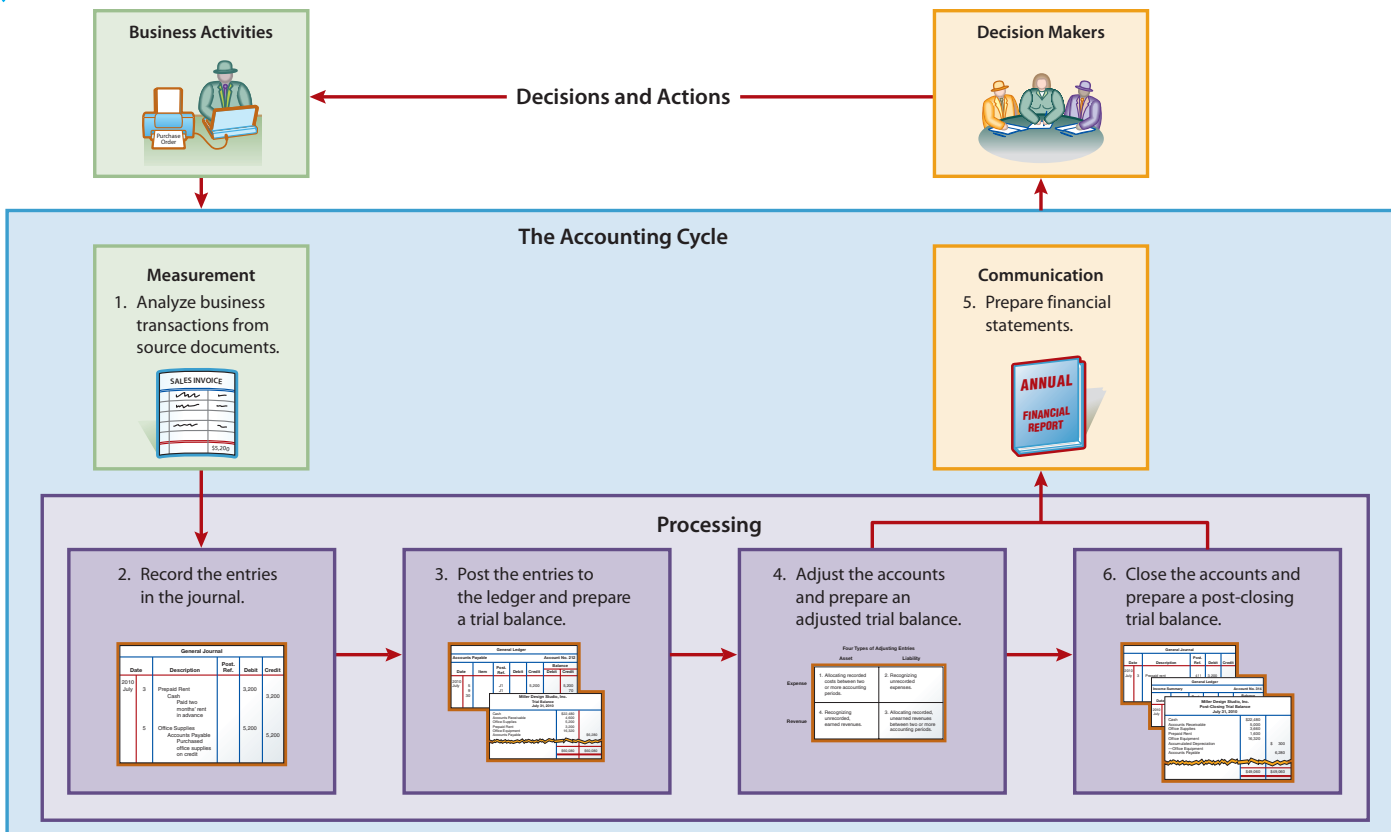
© Cengage Learning 2014

## The Accounting Cycle

As Exhibit 5 shows, the **accounting cycle** is a series of steps that measure and communicate useful information to decision makers. These steps follow.

- **Step 1.** *Analyze* business transactions from source documents.
- **Step 2.** *Record* the transactions by entering them in the general journal.

**Exhibit 5**  
Overview of the Accounting Cycle



© Cengage Learning 2014

- **Step 3.** *Post* the journal entries to the ledger, and prepare a trial balance.
- **Step 4.** *Adjust* the accounts, and prepare an adjusted trial balance.
- **Step 5.** *Prepare* financial statements.
- **Step 6.** *Close* the accounts, and prepare a post-closing trial balance.

Note that Steps 3, 4, and 6 entail preparation of trial balances, which are explained later in this chapter. The remainder of this chapter examines Steps 1–3 in detail.

## APPLY IT!

You are given the following list of accounts with dollar amounts:

D. Logan, Withdrawals	\$ 75	Cash	\$625
Accounts Payable	200	D. Logan, Capital	400
Wages Expense	150	Fees Revenue	250

Insert the account title at the top of the corresponding T account that follows and enter the dollar amount as a normal balance in the account. Then show that the accounting equation is in balance.

		<b>Owner's Equity</b>								
<b>Assets</b>	=	<b>Liabilities</b>	+	<b>D. Logan, Capital</b>	-	<b>D. Logan, Withdrawals</b>	+	<b>Revenues</b>	-	<b>Expenses</b>

### SOLUTION

<b>Cash</b>		<b>Accounts Payable</b>		<b>D. Logan, Capital</b>		<b>D. Logan, Withdrawals</b>		<b>Fees Revenue</b>		<b>Wages Expense</b>
625		200		400		75		250		150

Assets = Liabilities + Owner's Equity  
 \$625 = \$200 + (\$400 - \$75 + \$250 - \$150)  
 \$625 = \$200 + \$425  
 \$625 = \$625

**TRY IT! SE4, E2A, E3A, E2B, E3B**

## LO 3 Business Transaction Analysis

In the next few pages, we illustrate the first three steps of the accounting cycle by showing how to apply the double-entry system to some common business transactions. **Source documents**—invoices, receipts, checks, or contracts—support the details of a transaction.

Here, we focus on the transactions of a small firm, Blue Design Studio. To walk through every step of recording business transactions, each transaction will be broken into the following parts:

- **Transaction:** The date and a description of the transaction are provided.
- **Analysis:** The transaction is analyzed to determine which accounts are affected.
- **Application of Double-Entry:** T accounts show how the transaction affects the accounting equation. Note that this is *not* part of the accounting records but is undertaken before recording a transaction in order to understand the effects of the transaction.
- **Journal Entry:** A **journal entry** is a notation that records a single transaction in the chronological accounting record known as a **journal** (sometimes called the *book of original entry* because it is where transactions first enter the accounting records).

**STUDY NOTE:** T accounts are used to understand and visualize the double-entry effects of a transaction on the accounting equation. They help in recording the journal entry.



Each entry must be in proper **journal form**, which, as illustrated below, is a way of recording a transaction with the date, debit account, and debit amount shown on one line, and the credit account (indented) and credit amount shown on the next line. The amounts are shown in their respective debit and credit columns.

Date	Debit Account Name Credit Account Name	Dr. Amount	Cr. Amount
------	---	---------------	---------------

- **Comment:** Comments that offer supporting explanations will help you apply the rules of double-entry accounting.

## Owner's Investment to Form the Business

**Transaction** On July 1, Joan Blue invests \$40,000 in cash to form Blue Design Studio.

**Analysis** The journal entry to record an owner's investment in the business

- ▲ *increases* the asset account *Cash* with a debit
- ▲ *increases* the owner's equity account *J. Blue, Capital* with a credit

### Application of Double Entry

Assets		=	Liabilities	+	Owner's Equity		
Cash					J. Blue, Capital		
Dr.	Cr.				Dr.	Cr.	
July 1	40,000					July 1	40,000

### Journal Entry

Date	Debit Account Name	Dr. Amount	Cr. Amount
July 1	Cash	40,000	
	J. Blue, Capital		40,000

**Comment** If Joan Blue had invested assets other than cash in the business, the debit would be *classified* as the appropriate asset account (for example, Equipment).

## Economic Event That Is Not a Business Transaction

**Event** On July 1, Joan orders \$5,200 of office supplies for Blue Design Studio.

**Comment** When an economic event is not a business transaction, it is not *recognized* and no entry is made. In this case, there is no confirmation that the supplies have been shipped or that title has passed.

## Prepayment of Expenses in Cash

**Transaction** On July 3, Joan rents an office for Blue Design Studio. She pays \$3,200 for two months' rent in advance.

**Analysis** The journal entry to record the prepayment of office rent in cash

- ▲ *increases* the asset account *Prepaid Rent* with a debit
- ▼ *decreases* the asset account *Cash* with a credit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>							
<i>Dr.</i>	<i>Cr.</i>						
July 1 40,000	July 3 3,200						
<b>Prepaid Rent</b>							
<i>Dr.</i>	<i>Cr.</i>						
July 3 3,200							

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
July 3	Prepaid Rent	3,200	
	Cash		3,200

**Comment** A prepaid expense is *classified* as an asset because the expenditure will benefit future operations. This transaction does not affect the totals of assets or liabilities and owner's equity because it simply trades one asset for another asset. If the company had paid only July's rent, the owner's equity account *Rent Expense* would be *recognized* and debited because the total benefit of the expenditure would be used up in the current month.

## Purchase of an Asset on Credit

**Transaction** On July 5, Blue Design Studio receives the office supplies ordered on July 2 and an invoice for \$5,200.

**Analysis** The journal entry to record the purchase of office supplies on credit

- ▲ *increases* the asset account *Office Supplies* with a debit
- ▲ *increases* the liability account *Accounts Payable* with a credit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Office Supplies</b>			<b>Accounts Payable</b>				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
July 5 5,200			July 5 5,200				

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
July 5	Office Supplies	5,200	
	Accounts Payable		5,200

**Comment** Office supplies in this transaction are *classified* as an asset (prepaid expense) because they will not be used up in the current month and thus will benefit future periods. The credit is *classified* as Accounts Payable because there is a delay between the time of the purchase and the time of payment.

## Purchase of an Asset Partly in Cash and Partly on Credit

**Transaction** On July 6, Joan purchases office equipment totaling \$16,320 for Blue Design Studio. Joan pays \$13,320 in cash and agrees to pay the rest next month.

**Analysis** The journal entry to record the purchase of office equipment in cash and on credit

- ▲ *increases* the asset account *Office Equipment* with a debit
- ▼ *decreases* the asset account *Cash* with a credit
- ▲ *increases* the liability account *Accounts Payable* with a credit

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity
<b>Cash</b>			<b>Accounts Payable</b>			
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		
July 1 40,000	July 3 3,200			July 5 5,200		
	6 13,200			6 3,000		
<b>Office Equipment</b>						
July 6 16,320						

**Journal Entry**

		<i>Dr.</i>	<i>Cr.</i>
July 6	Office Equipment	16,320	
	Cash		13,320
	Accounts Payable		3,000

**Comment** As this transaction illustrates, assets may be paid for partly in cash and partly on credit. A journal entry in which more than two accounts are involved is called a **compound entry** because a portion of the entry is properly *classified* in two or more accounts.

**Payment of a Liability**

**Transaction** On July 9, Blue Design Studio makes a partial payment of \$2,600 for the amount owed for the office supplies received on July 5.

**Analysis** The journal entry to record a payment of a liability

- ▼ *decreases* the liability account *Accounts Payable* with a debit
- ▼ *decreases* the asset account *Cash* with a credit

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity
<b>Cash</b>			<b>Accounts Payable</b>			
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		
July 1 40,000	July 3 3,200		July 9 2,600	July 5 5,200		
	6 13,320			6 3,000		
	9 2,600					

**Journal Entry**

		<i>Dr.</i>	<i>Cr.</i>
July 9	Accounts Payable	2,600	
	Cash		2,600

**Comment** Note that the office supplies, which were *recognized* and recorded when they were purchased on July 5, are not part of the July 9 transaction.

## Revenue in Cash

**Transaction** On July 10, Blue Design Studio performs a service for an investment advisor by designing a series of brochures and collects a \$2,800 fee in cash.

**Analysis** The journal entry to record revenue received in cash

- ▲ *increases* the asset account *Cash* with a debit
- ▲ *increases* the owner’s equity account *Design Revenue* with a credit

### Application of Double Entry

Assets		=	Liabilities	+	Owner's Equity
<b>Cash</b>					<b>Design Revenue</b>
<i>Dr.</i>	<i>Cr.</i>			<i>Dr.</i>	<i>Cr.</i>
July 1 40,000	July 3 3,200				July 10 2,800
<b>10 2,800</b>	6 13,320				
	9 2,600				

### Journal Entry

	<i>Dr.</i>	<i>Cr.</i>
July 10 Cash	2,800	
Design Revenue		2,800

**Comment** For this transaction, revenue is *recognized* when the service is provided and the cash is received.

## Revenue on Credit

**Transaction** On July 15, Blue Design Studio performs a service for a department store by designing a TV commercial. The company bills for the \$9,600 fee now but will collect it later.

**Analysis** The journal entry to record revenue billed to a customer

- ▲ *increases* the asset account *Accounts Receivable* with a debit
- ▲ *increases* the owner’s equity account *Design Revenue* with a credit

Accounts Receivable is used to indicate the customer’s obligation until it is paid.

### Application of Double Entry

Assets		=	Liabilities	+	Owner's Equity
<b>Accounts Receivable</b>					<b>Design Revenue</b>
<i>Dr.</i>	<i>Cr.</i>			<i>Dr.</i>	<i>Cr.</i>
July 15 9,600					July 10 2,800
					<b>15 9,600</b>

### Journal Entry

	<i>Dr.</i>	<i>Cr.</i>
July 15 Accounts Receivable	9,600	
Design Revenue		9,600

**Comment** In this case, there is a delay between the time revenue is earned and the time the cash is received. Revenues are *recognized* and recorded at the time they are earned and billed regardless of when cash is received.

## Revenue Collected in Advance

**Transaction** On July 19, Blue Design Studio accepts a \$1,400 advance fee as a deposit on a series of brochures to be designed.

**Analysis** The journal entry to record revenue received in advance

- ▲ *increases* the asset account *Cash* with a debit
- ▲ *increases* the liability account *Unearned Design Revenue* with a credit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity
<b>Cash</b>			<b>Unearned Design Revenue</b>			
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		
July 1	40,000		July 3	3,200		
10	2,800		6	13,320		
19	1,400		9	2,600		
				July 19	1,400	

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
July 19	Cash	1,400	
	Unearned Design Revenue		1,400

**Comment** In this case, cash is received before the fees are earned. Unearned Design Revenue is *recognized* and *classified* as a liability because the firm must either provide the service or return the deposit.

## Collection on Account

**Transaction** On July 22, Blue Design Studio receives \$5,000 cash from customer previously billed on July 15.

**Analysis** The journal entry to record the collection of an account receivable from a customer previously billed

- ▲ *increases* the asset account *Cash* with a debit
- ▼ *decreases* the asset account *Accounts Receivable* with a credit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity
<b>Cash</b>						
<i>Dr.</i>	<i>Cr.</i>					
July 1	40,000		July 3	3,200		
10	2,800		6	13,200		
19	1,400		9	2,600		
22	5,000					
<b>Accounts Receivable</b>						
<i>Dr.</i>	<i>Cr.</i>					
July 15	9,600		July 22	5,000		

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
July 22	Cash	5,000	
	Accounts Receivable		5,000

**Comment** Note that the revenue related to this transaction was *recognized* and recorded on July 15. Thus, no revenue is recognized at this time.



## Business Perspective

### No Dollar Amount: How Can That Be?

Determining the value of a sale or purchase transaction isn't difficult when the value equals the amount of cash that changes hands. However, barter transactions, in which exchanges are made but no cash changes hands, can make valuation more complicated. Barter transactions are quite common in business today. Here are some examples:

- A consulting company provides its services to an auto dealer in exchange for the loan of a car for a year.
- An office supply company provides a year's supply of computer paper to a local weekly newspaper in exchange for an advertisement in 52 issues of the newspaper.
- Two Internet companies each provide an advertisement and link to the other's website on their own websites.

Determining the value of these transactions is a matter of determining the fair value of the items being traded.

© Alija / iStockphoto.com

© Cengage Learning 2014

## Expense Paid in Cash

**Transaction** On July 26, Blue Design Studio pays \$4,800 for four weeks of employee wages.

**Analysis** The journal entry to record this cash expense

- ▲ *increases* the owner's equity account *Wages Expense* with a debit
- ▼ *decreases* the asset account *Cash* with a credit

### Application of Double Entry

Assets		=	Liabilities	+	Owner's Equity	
<b>Cash</b>					<b>Wages Expense</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
July 1 40,000	July 3 3,200				July 26 4,800	
10 2,800	6 13,320					
19 1,400	9 2,600					
22 5,000	26 4,800					

### Journal Entry

July 26	Wages Expense	<i>Dr.</i>	<i>Cr.</i>
	→ Cash	4,800	4,800

**Comment** Wages Expense will appear on the income statement as a deduction from revenues.

## Expense to Be Paid Later

**Transaction** On July 30, Blue Design Studio receives but does not pay the utility bill that is due next month for \$680.

**Analysis** The journal entry to record this cash expense

- ▲ *increases* the owner's equity account *Utilities Expense* with a debit
- ▲ *increases* the liability account *Accounts Payable* with a credit



### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
			<b>Accounts Payable</b>			<b>Utilities Expense</b>	
	<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>	
July 9	2,600		July 5	5,200	July 30	680	
			6	3,000			
			30	680			

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
July 30	Utilities Expense	680	
	→ Accounts Payable		680

**Comment** The expense is *recognized* and recorded if the benefit has been received and the amount is owed, even if the cash is not to be paid until later.

## Withdrawals

**Transaction** On July 31, Blue Design Studio withdraws \$2,800 in cash.

**Analysis** The journal entry to record a cash withdrawal

▲ *increases* the owner's equity account *Withdrawals* with a debit

▼ *decreases* the asset account *Cash* with a credit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>						<b>J. Blue, Withdrawals</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
July 1	40,000		July 3	3,200	July 31	2,800	
10	2,800		6	13,320			
19	1,400		9	2,600			
22	5,000		26	4,800			
	31	2,800					

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
July 31	J. Blue, Withdrawals	2,800	
	→ Cash		2,800

**Comment** Cash payments to owners are not *classified* as expenses but as withdrawals.

## Summary of Transactions

Exhibit 6 uses the accounting equation to summarize the transactions of Blue Design Studio. Note that the income statement accounts appear under owner's equity and that the transactions in the Cash account will be reflected on the statement of cash flows.

**Exhibit 6**  
Summary of Transactions of Blue Design Studio

Assets				=	Liabilities				+	Owner's Equity			
<b>Cash</b>					<b>Accounts Payable</b>					<b>J. Blue, Capital</b>			
<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>			
July 1	40,000	July 3	3,200	July 9	2,600	July 5	5,200			July 1	40,000		
10	2,800	6	13,320			6	3,000						
19	1,400	9	2,600			30	680						
22	5,000	26	4,800										
		31	2,800										
	<b>49,200</b>		<b>26,720</b>		<b>2,600</b>		<b>8,880</b>						
	<b>Bal. 22,480</b>						<b>Bal. 6,280</b>						
<b>Accounts Receivable</b>					<b>Unearned Design Revenue</b>					<b>Design Revenue</b>			
<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>			
July 15	9,600	July 22	5,000			July 19	1,400			July 10	2,800		
	<b>Bal. 4,600</b>									15	9,600		
											<b>Bal. 12,400</b>		
<b>Office Supplies</b>					<b>Wages Expense</b>					<b>Utilities Expense</b>			
<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>			
July 5	5,200			July 26	4,800			July 30	680				
<b>Prepaid Rent</b>					<b>Office Equipment</b>								
<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>							
July 3	3,200			July 6	16,320								
<b>Owner's Equity Summary</b>					<b>Owner's Equity Summary</b>					<b>Owner's Equity Summary</b>			
<b>Assets</b>				=	<b>Liabilities</b>				+	<b>Owner's Equity</b>			
\$51,800				=	\$7,680				+	\$44,120			

This account links to the statement of cash flows.

These accounts link to the income statement.

© Cengage Learning 2014

**APPLY IT!**

The following accounts are applicable to Kathy's Nail Salon, a company that provides manicures and pedicures:

- |                        |                     |
|------------------------|---------------------|
| 1. Cash                | 5. Accounts Payable |
| 2. Accounts Receivable | 6. Services Revenue |
| 3. Supplies            | 7. Wages Expense    |
| 4. Equipment           | 8. Rent Expense     |

For Kathy's Nail Salon, enter the number corresponding to the proper account for each debit and credit for the following transactions:

	Debit	Credit
a. Made a rent payment for the current month.	8	1
b. Received cash from customers for current services.	_____	_____
c. Agreed to accept payment next month from a client for current services.	_____	_____
d. Purchased supplies on credit.	_____	_____
e. Purchased a new chair and table for cash.	_____	_____
f. Made a payment on accounts payable.	_____	_____

**SOLUTION**

	Debit	Credit
a. Made a rent payment for the current month.	8	1
b. Received cash from customers for current services.	1	6
c. Agreed to accept payment next month from a client for current services.	2	6
d. Purchased supplies on credit.	3	5
e. Purchased a new chair and table for cash.	4	1
f. Made a payment on accounts payable.	5	1

**TRY IT! SE2, SE5, SE6, E4A, E5A, E6A, E7A, E8A, E4B, E5B, E6B, E7B, E8B**

## LO 4 The Trial Balance

The **trial balance**, prepared periodically, is a device used to ensure that the total of debits and credits in the accounts are equal, meaning that the accounts balance. Exhibit 7 shows a trial balance for Blue Design Studio. It was prepared from the accounts in Exhibit 6.

### Exhibit 7 Trial Balance

<b>Blue Design Studio Trial Balance July 31, 2014</b>		
Cash	22,480	
Accounts Receivable	4,600	
Office Supplies	5,200	
Prepaid Rent	3,200	
Office Equipment	16,320	
Accounts Payable		6,280
Unearned Design Revenue		1,400
J. Blue, Capital		40,000
J. Blue, Withdrawals	2,800	
Design Revenue		12,400
Wages Expense	4,800	
Utilities Expense	680	
	60,080	60,080

© Cengage Learning 2014

## Preparation and Use of a Trial Balance

Although a trial balance may be prepared at any time, it is usually prepared on the last day of the accounting period. The steps involved in preparing a trial balance follow.

- **Step 1.** List each account that has a balance, with debit balances in the left column and credit balances in the right column. Accounts are listed in the following order: assets, liabilities, owner's capital, withdrawals, revenues, and expenses.
- **Step 2.** Add each column.
- **Step 3.** Compare the totals of the columns.

Once in a while, a transaction leaves an account with a balance that isn't "normal." For example, when a company overdraws its bank account, its Cash account (an asset) will show a credit balance instead of a debit balance. The "abnormal" balance should be copied into the trial balance columns as it stands, as a debit or a credit.

The trial balance proves whether the accounts are in balance. *In balance* means that the total of all debits recorded equals the total of all credits recorded. But the trial balance does not prove that the transactions were analyzed correctly or recorded in the proper accounts. For example, the trial balance does not show that a debit should have been made in Office Supplies rather than in Office Equipment. And the trial balance does not detect whether transactions have been omitted, because equal debits and credits will have been omitted. Also, if an error of the same amount is made in both a debit and a credit, it will not be evident in the trial balance. The trial balance proves only that the debits and credits in the accounts are in balance.

## Finding Trial Balance Errors

If the debit and credit balances in a trial balance are not equal, look for one or more of the following errors:

- A debit was entered in an account as a credit, or vice versa.
- The balance of an account was computed incorrectly.
- An error was made in carrying the account balance to the trial balance.
- The trial balance was summed incorrectly.

Other than simply adding the columns incorrectly, the two most common mistakes in preparing a trial balance are:

- Recording an account as a credit when it usually carries a debit balance, or vice versa. This mistake causes the trial balance to be out of balance by an amount divisible by 2.
- Transposing two digits when transferring an amount to the trial balance (for example, entering \$23,459 as \$23,549). This error causes the trial balance to be out of balance by an amount divisible by 9.

So, if a trial balance is out of balance and the addition of the columns is correct, determine the amount by which the trial balance is out of balance and divide it first by 2 and then by 9. If the amount is divisible by 2, look in the trial balance for an amount that is equal to the quotient. If you find such an amount, chances are it's in the wrong column. If the amount is divisible by 9, trace each amount back to the T account balance, checking carefully for a transposition error. If neither of these techniques is successful in identifying the error, first recompute the balance of each T account. Then, if you still have not found the error, retrace each posting to the journal or the T account.

## APPLY IT!

Prepare a trial balance for Dras Company from the following list of accounts (in alphabetical order) as of March 31, 2014. Compute the balance of cash.

Accounts Payable	\$ 9
Accounts Receivable	5
Building	10
Cash	?
Dras, Capital	16
Equipment	2
Land	1
Inventory	3

## SOLUTION

Dras Company Trial Balance March 31, 2014	
Cash	\$ 4
Accounts Receivable	5
Inventory	3
Land	1
Building	10
Equipment	2
Accounts Payable	\$ 9
Dras, Capital	16
Totals	<u>\$25</u> <u>\$25</u>

**TRY IT! SE7, E9A, E10A, E11A, E12A, E9B, E10B, E11B, E12B**

## LO 5 Recording and Posting Transactions

Earlier in the chapter, we described how transactions are analyzed according to the rules of double entry and how a trial balance is prepared. Recall in Exhibit 5, transaction analysis and preparation of a trial balance appear at several points in the process. Two intermediate steps are recording the entry in the general journal and posting the entry to the ledger. In this section, we demonstrate how these steps are accomplished in a manual accounting system.

### General Journal

Although transactions can be entered directly into the ledger accounts, identifying individual transactions or finding errors is difficult because the debit is recorded in one account and the credit in another. The solution is to record all transactions chronologically in a journal, which, as we noted earlier, is where transactions first enter the accounting records. Later, the debit and credit portions of each transaction are transferred to the appropriate accounts in the ledger.

Most businesses have more than one kind of journal. The simplest and most flexible kind is the **general journal**. Businesses may also have several special-purpose journals, each for recording a common transaction, such as credit sales, credit purchases, cash receipts, and cash disbursements. At this point, we cover only the general journal. Exhibit 8, which displays two of the transactions of Blue Design Studio, shows the format for recording entries in a general journal.

**STUDY NOTE:** The journal is a chronological record of transactions.

**Exhibit 8**  
The General Journal

$$\begin{array}{r}
 \mathbf{A} = \mathbf{L} + \mathbf{SE} \\
 + 3,200 \\
 - 3,200 \\
 \\
 \mathbf{A} = \mathbf{L} + \mathbf{SE} \\
 + 5,200 \quad + 5,200
 \end{array}$$

General Journal					Page 1
Date		Description	Post. Ref.	Debit	Credit
2014					
July	3	Prepaid Rent Cash Paid two months' rent in advance		3,200	3,200
	5	Office Supplies Accounts Payable Purchase of office supplies on credit		5,200	5,200

© Cengage Learning 2014

As you can see in Exhibit 8, the entries in a general journal include the following information about each transaction:

- **Date:** The year appears on the first line of the first column, the month on the next line of the first column, and the day in the second column opposite the month. For subsequent entries on the same page for the same month and year, the month and year can be omitted.
- **Accounts:** The names of the accounts debited and credited appear in the Description column. The names of the accounts that are debited are placed next to the left margin opposite the dates; on the line below, the names of the accounts credited are indented.
- **Amounts:** The debit amounts appear in the Debit column opposite the accounts that are debited, and the credit amounts appear in the Credit column opposite the accounts credited.
- **Explanation:** An explanation of each transaction appears in the Description column below the account names. An explanation should be brief but sufficient to identify the transaction.
- **Account numbers:** The account numbers appear in the Post. Ref. (posting reference) column, if they apply.

At the time the transactions are recorded, nothing is placed in the Post. Ref. column. Later, if the company uses account numbers to identify accounts in the ledger, the account numbers are filled in. They provide a convenient cross-reference from the general journal to the ledger and indicate that the entry has been *posted* to the ledger. If the accounts are not numbered, the accountant uses a checkmark (✓) to signify that the entry has been posted.

## General Ledger

The general journal is used to record the details of each transaction. The general ledger is used to update each account.

**The Ledger Account Form** The T account is a simple, direct means of recording transactions. In practice, a somewhat more complicated form of the account is needed to record more information. The **ledger account form** is a form of the account that contains four columns for dollar amounts, as is illustrated in Exhibit 9.

**STUDY NOTE:** A T account is a means of quickly analyzing a set of transactions. It is simply an abbreviated version of a ledger account. Ledger accounts, which provide more information, are used in the accounting records.

### Exhibit 9 Accounts Payable in the General Ledger

General Ledger							
Accounts Payable						Account No. 212	
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
2014							
July	5		J1		5,200		5,200
	6		J1		3,000		8,200
	9		J1	2,600			5,600
	30		J2		680		6,280

© Cengage Learning 2014

The account title and number appear at the top of the account form. As in the journal, the transaction date appears in the first two columns. The Item column is rarely used to identify transactions because explanations already appear in the journal. The Post. Ref. column is used to note the journal page on which the original entry for the transaction can be found. The dollar amount is entered in the appropriate Debit or Credit column, and a new account balance is computed in the last two columns opposite each entry. The advantage of this account form over the T account is that the current balance of the account is readily available.

**Posting** After transactions have been entered in the journal, they must be transferred to the ledger. This process is called **posting**. Posting is usually done after several entries have been made—for example, at the end of each day or less frequently, depending on the number of transactions. As Exhibit 10 shows, each amount in the Debit column of the journal is transferred to the Debit column of the appropriate account in the ledger, and each amount in the Credit column of the journal is transferred to the Credit column of the appropriate account in the ledger.

The steps in the posting process follow.

- **Step 1:** In the ledger, locate the debit account named in the journal entry.
- **Step 2:** Enter the date of the transaction in the ledger and, in the Post. Ref. column, the journal page number from which the entry comes.
- **Step 3:** In the Debit column of the ledger account, enter the amount of the debit as it appears in the journal.
- **Step 4:** Calculate the account balance and enter it in the appropriate Balance column.
- **Step 5:** Enter in the Post. Ref. column of the journal the account number to which the amount has been posted.



The same five steps are repeated in posting the credit side of the journal entry. As noted earlier, in addition to serving as an easy reference between the journal entry and the ledger account, the entry in the Post. Ref. column of the journal (Step 5) indicates that the entry has been posted to the ledger.

**Exhibit 10**  
Posting from the General  
Journal to the Ledger

$$\begin{array}{r} \mathbf{A} \\ + 680 \end{array} = \begin{array}{r} \mathbf{L} \\ - 680 \end{array} + \begin{array}{r} \mathbf{SE} \\ - 680 \end{array}$$

General Journal					Page 2	
Date		Description	Post. Ref.	Debit	Credit	
2014						
July	30	Utilities Expense	512	680		
		Accounts Payable	212			680
		Received bill from utility company				

General Ledger							
Accounts Payable					Account No. 212		
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
2014							
July	5		J1		5,200		5,200
	6		J1		3,000		8,200
	9		J1	2,600			5,600
	30		J2		680		6,280

General Ledger					Account No. 512		
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
2014							
July	30		J2	680		680	

© Cengage Learning 2014

## Some Notes on Presentation

Exhibit 11 offers some guidance on how to format financial statements, trial balances, journals, and ledgers in accordance with common accounting conventions.

**Exhibit 11**  
Formatting Guidelines

### BLUE DESIGN STUDIO'S FINANCIAL HIGHLIGHTS

Cash	\$22,480
Accounts receivable	4,600
Office supplies	5,200
Prepaid rent	3,200
Office equipment	16,320
Total assets	<u>\$51,800</u>

- 1 A ruled line appears in financial reports before each subtotal and total to indicate that the amounts above are added or subtracted. It is common practice to use a double line under a final total to show that it has been verified.
- 2 Dollar signs (\$) are required in all financial statements and other schedules. On these reports, a dollar sign should be placed before the first amount in each column and before the first amount in a column following a ruled line. Dollar signs in the same column are aligned. Dollar signs are not used in journals and ledgers.
- 3 On normal unruled paper, commas and decimal points are used when recording dollar amounts. On the paper used in journals and ledgers, commas and decimal points are unnecessary because ruled columns are provided to properly align dollars and cents. Commas, dollar signs, and decimal points are also unnecessary in electronic spreadsheets. In this book, because most problems and illustrations are in whole dollar amounts, the cents column usually is omitted. When accountants deal with whole dollars, they often use a dash in the cents column to indicate whole dollars rather than taking the time to write zeros.
- 4 Account names are capitalized when referenced in text or listed in work documents like the journal or ledger. In financial statements, however, only the first word of an account name is capitalized.

© Cengage Learning 2014

**APPLY IT!**

Prepare journal entries to record the following transactions. Use the following account numbers—Cash, 111; Supplies, 114; and Accounts Payable, 212—to show in the Post Ref. columns that the entries have been posted:

- June 4 Purchased supplies for \$40 on credit.  
8 Paid for the supplies purchased on June 4.

**SOLUTION**

Date		Description	Post. Ref.	Debit	Credit
June	4	Supplies	114	40	
		Accounts Payable	212		40
		Purchased supplies on credit			
	8	Accounts Payable	212	40	
		Cash	111		40
		Paid amount due for supplies			

**TRY IT! SE8, SE9, SE10, E8A, E13A, E14A, E8B, E13B, E14B**

Accounting uses a double-entry system to record business transactions based on source documents. Each transaction is recorded in a journal and then posted to the ledger. The final step of the transaction analysis is the preparation of the trial balance. As depicted in Exhibit 12, business transactions can affect all components of the accounting equation.

**Exhibit 12**  
Transaction Effects on Accounting Equation

Transaction	Assets		=	Liabilities	+	Owner's Equity			
	Cash	Other Assets				Owner's Capital	– Withdrawals	+ Revenues	– Expenses
1. Owner's cash investment	+					+			
2. Prepayment of expenses in cash	–	+							
3. Purchase of an asset on credit		+		+					
4. Purchase of an asset partly on credit and partly in cash	–	+		+					
5. Payment of liability	–			–					
6. Revenue received in cash	+							+	
7. Revenue on credit		+						+	
8. Revenue collected in advance	+			+					
9. Collection on account	+	–							
10. Expense paid in cash	–								+
11. Expense to be paid later				+					+
12. Withdrawal by owner	–						+		

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Ethics
- Cash flows
- Liquidity

RELEVANT  
LEARNING OBJECTIVES

**LO 6** Explain why ethical financial reporting depends on proper recording of business transactions.

**LO 7** Show how the timing of transactions affects cash flows and liquidity.

## LO 6 Ethical Financial Reporting and Business Transactions

Financial statements result from the recording of business transactions. Users of these financial statements have a right to expect that all business transactions have been recorded and reflected properly in the statements. Thus, *recognition*, *valuation*, and *classification* as specified under generally accepted accounting principles are important factors in ethical financial reporting. These guidelines help managers meet their obligation to their company's owners and to their creditors. Many of the most egregious financial reporting frauds result from violations of these guidelines, as the following examples show.

- **Computer Associates** violated the guidelines for recognition when it kept its books open a few days after the end of a reporting period so revenues could be counted a quarter earlier than they should have been. In all, the company prematurely reported \$3.3 billion in revenues from 363 software contracts. When the SEC ordered the company to stop the practice, Computer Associates' stock price dropped by 43 percent in a single day.
- Among its many other transgressions, **Enron Corporation** violated the guidelines for valuation when it transferred, to related companies, assets at far more than their actual value.
- By a simple violation of the guidelines for classification, **WorldCom** (now **MCI**, a component of **Verizon**) perpetrated the largest financial fraud in history. Over a period of several years, the company recorded as assets its expenditures that should have been classified as expenses, understating expenses and overstating income by more than \$10 billion.

### Recognition

The *recognition* issue can be particularly difficult to resolve. To illustrate some of the factors involved, suppose a company wants to purchase an office desk. The following events take place:

- **Event 1:** An employee sends a purchase request for the desk to the purchasing department.
- **Event 2:** The purchasing department sends a purchase order to the supplier.
- **Event 3:** The supplier ships the desk.
- **Event 4:** The company receives the desk.
- **Event 5:** The company receives the bill from the supplier.
- **Event 6:** The company pays the bill.

A transaction should be recorded when title to merchandise passes from the supplier to the purchaser and creates an obligation to pay. A purchase should usually not be recognized (recorded) before the title is transferred because, until that point, the vendor has not fulfilled its contractual obligation and the buyer has no liability. Thus, depending on the details of the shipping agreement for the desk, the transaction should be recognized (recorded) at the time of either Event 3 or 4. We generally use this guideline in this book. However, many small businesses that have simple accounting systems do not record a transaction until they receive a bill (Event 5) or pay it (Event 6), because these are the implied points of title transfer. The predetermined time at which a transaction should be recorded is the **recognition point**.

Although purchase requests and purchase orders (Events 1 and 2) are economic events, they do not affect a company's financial position, and they are not recognized in the accounting records. Even the most important economic events may not be recognized in the accounting records.



## Business Perspective

### Accounting Policies: Where Do You Find Them?

© Allija / iStockphoto.com

**The Boeing Company**, one of the world's largest makers of airliners, takes orders for planes years in advance. Although it is an important economic event to both Boeing and the buyer, neither the buyer nor the seller would record the event as a transaction. So, how do you know when companies record sales or purchase transactions? The answer to this question and others about companies' accounting policies can be found in the Summary of Significant Accounting Policies in their annual reports. For example, in that section of its annual report, Boeing states: "We recognize sales for commercial airplane deliveries as each unit is completed and accepted by the customer."<sup>3</sup>

© Cengage Learning 2014

Here are some more examples of economic events that should and should not be recorded as business transactions:

#### Events That Are Not Recorded as Transactions

- A customer inquires about the availability of a product
- A company hires a new employee.
- A company signs a contract to provide a service in the future.

#### Events That Are Recorded as Transactions

- A customer buys a product.
- A company pays an employee for work performed.
- A company performs a service.

Consider an advertising agency that is planning a major advertising campaign for a client. Employees may work on the plan several hours a day for a number of weeks. They add value to the plan as they develop it. Should this added value be recognized as the plan is being developed or at the time it is completed? Usually, the increase in value is recorded at the time the plan is finished and the client is billed for it. However, the agency and the client may agree that the client will be billed at key points during its development. In that case, a transaction is recorded at each billing.

## APPLY IT!

For each of the following ethical situations involving business transactions, indicate what accounting concept has been violated or whether there is no violation:

1. A sales transaction is recorded on the last day of the fiscal year because the customer indicates that she will be in next week to sign the agreement.
2. A purchase of an insurance policy is recorded as an asset (instead of as an expense) because it will be used in future periods.
3. A laser printer, in excellent condition, that is purchased at a garage sale for \$50 is recorded at its estimated value of \$150.

#### SOLUTION

1. Recognition concept: violated
2. Classification concept: no violation
3. Valuation concept: violated

**TRY IT! SE1, SE2, SE11, E1A, E15A, E1B, E15B**



LO 7

## Cash Flows and the Timing of Transactions

To avoid financial distress, a company must be able to pay its bills on time. Because the timing of cash flows is critical to maintaining adequate liquidity to pay bills, managers and other users of financial information must understand the difference between transactions that generate immediate cash and those that do not. Consider the transactions of Blue Design Studio shown in Exhibit 13. Most of them involve either an inflow or outflow of cash.

Blue's Cash account has more transactions than any of its other accounts. Look at the transactions of July 10, 15, and 22 in Exhibit 13:

- July 10: Blue received a design revenue payment in cash of \$2,800.
- July 15: The firm billed a customer \$9,600 for a service it had already performed.
- July 22: The firm received a partial payment of \$5,000 from the customer, but it had not received the remaining \$4,600 by the end of the month.

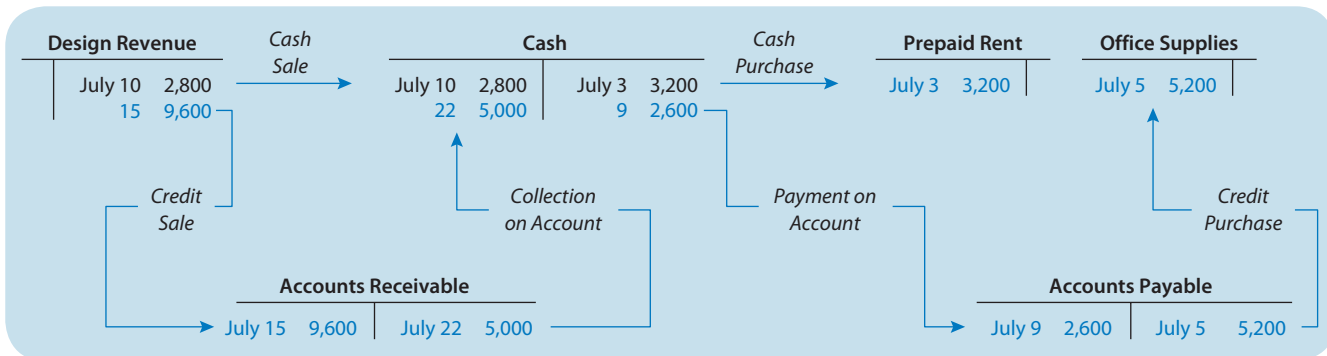
Because Blue incurred expenses in providing this service, it must pay careful attention to its cash flows and liquidity.

One way Blue can manage its expenditures is to rely on its creditors to give it time to pay. Compare the transactions of July 3, 5, and 9 in Exhibit 13.

- July 3: Blue prepaid rent of \$3,200. That immediate cash outlay may have caused a strain on the business.
- July 5: The firm received an invoice for office supplies in the amount of \$5,200. In this case, it took advantage of the opportunity to defer payment.
- July 9: The firm paid \$2,600, but it deferred paying the remaining \$2,600 until after the end of the month.

Of course, Blue expects to receive the rest of the cash from the customer that it billed on July 15, and it must eventually pay the rest of what it owes on the office supplies. In the meantime, the firm must perform a delicate balancing act with its cash flows to ensure that it achieves the goal of liquidity so that it can grow and be profitable.

### Exhibit 13 Transactions of Blue Design Studio



© Cengage Learning 2014

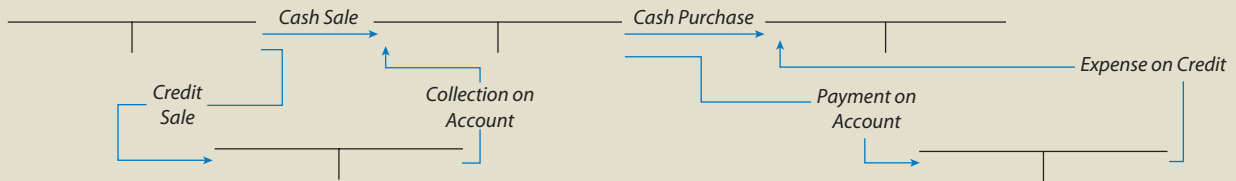
Large companies face the same challenge but often on a much greater scale. For example, it can take **Boeing** a number of years to plan and make the aircraft that customers order. At the end of 2011, Boeing had net orders of \$103 billion and a backlog of orders totaling \$356 billion.<sup>4</sup> Think of the cash outlays Boeing must make before it delivers the planes and collects payment for them. To maintain liquidity, Boeing's management must carefully plan the company's needs for cash.

# APPLY IT!

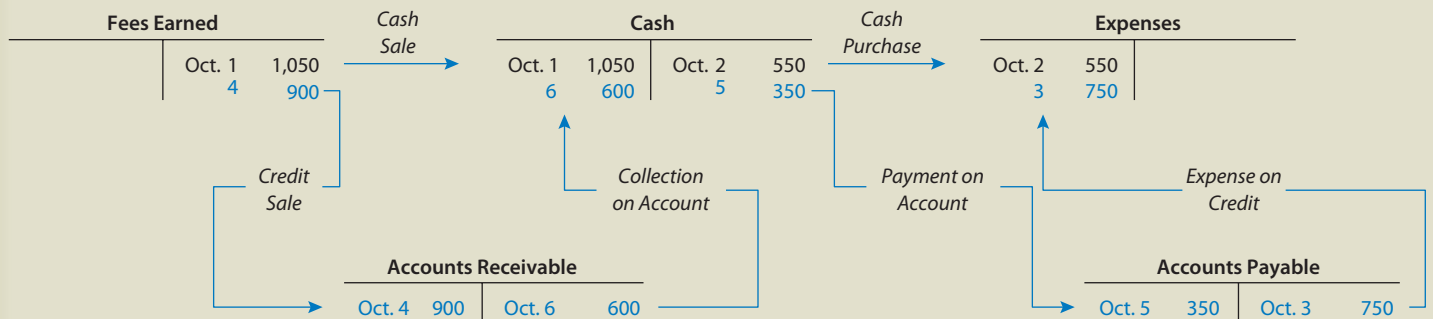
A company engaged in the following transactions:

- |        |                                       |        |                                      |
|--------|---------------------------------------|--------|--------------------------------------|
| Oct. 1 | Performed services for cash, \$1,050. | Oct. 4 | Performed services on credit, \$900. |
| 2      | Paid expenses in cash, \$550.         | 5      | Paid on account, \$350.              |
| 3      | Incurred expenses on credit, \$750.   | 6      | Collected on account, \$600.         |

Record these transactions using the T accounts below (remember to add the correct titles to the T accounts). Determine the cash balance after these transactions, the amount still to be received, and the amount still to be paid.



## SOLUTION



Cash balance after transactions:  $\$1,050 + \$600 - \$550 - \$350 = \$750$   
 Amount still to be received:  $\$900 - \$600 = \$300$   
 Amount still to be paid:  $\$750 - \$350 = \$400$

**TRY IT! SE12, E16A, E16B**

## TriLevel Problem



**Paws and Hoofs Clinic**

Arco Images GmbH/Alamy

The beginning of this chapter focused on Paws and Hoofs Clinic and the standing order for monthly service that Quarter Horse Stables placed with Paws and Hoofs. Jim Wright, the clinic's owner, was confident of receiving \$6,000 in fees over the course of the year and was thinking of including the fees in his financial statements. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*How will the concepts of recognition, valuation, and classification help Wright to record the transaction properly?*

### Section 2: Accounting Applications

*How does one enter business transactions, which are economic events, in the accounting records?*

Jim Wright needs to record the clinic's business transactions in the accounting records. Paws and Hoofs Clinic engaged in the following economic events during May 2014:



- May 1 Jim Wright invested \$20,000 in cash to form Paws and Hoofs Clinic.  
 2 Made an agreement to provide \$6,000 in services over the next year to Quarter Horse Stables.  
 3 Paid \$600 in advance for two months' rent of an office.  
 9 Purchased medical supplies for \$400 in cash.  
 12 Purchased \$4,000 of equipment on credit; made a 25 percent down payment.  
 15 Delivered a calf for a fee of \$350 on credit.  
 18 Made a payment of \$500 on the equipment purchased on May 12.  
 27 Paid a utility bill of \$140.

1. Identify the company's business transactions, and prepare journal entries to record them.
2. Post the transactions to the following T accounts: Cash; Accounts Receivable; Medical Supplies; Prepaid Rent; Equipment; Accounts Payable; J. Wright, Capital; Veterinary Fees Earned; and Utilities Expense.
3. Prepare a trial balance for the month of May.

### Section 3: Business Applications

Can a business transaction benefit a business even though no cash is received when the transaction takes place? Take a look at the May 15 transaction.

## SOLUTION

### Section 1: Concepts

*Recognition* helps decide when the transaction should be recorded, *valuation* refers to the value that is assigned to the transaction, and *classification* shows how to categorize the transaction (as an asset, expense, revenue, etc.)

### Section 2: Accounting Applications

1.

	A	B	C	D	E
1	May	1	Cash	20,000	
2			J. Wright, Capital		20,000
3			Issued \$20,000 in cash		
4			to form Paws and Hoofs Clinic		
5		3	Prepaid Rent	600	
6			Cash		600
7			Paid two months' rent in advance		
8			for an office		
9		9	Medical Supplies	400	
10			Cash		400
11			Purchased medical supplies for cash		
12		12	Equipment	4,000	
13			Accounts Payable		3,000
14			Cash		1,000
15			Purchased equipment on credit,		
16			paying 25 percent down		
17		15	Accounts Receivable	350	
18			Veterinary Fees Earned		350
19			Fee on credit for delivery of a calf		
20		18	Accounts Payable	500	
21			Cash		500
22			Partial payment for equipment		
23			purchased May 12		
24		27	Utilities Expense	140	
25			Cash		140
26			Paid utility bill		
27					



## Chapter Review

**Explain how the concepts of recognition, valuation, and classification apply to business transactions.** **Lo 1**

To measure a business transaction, you must determine when the transaction occurred (recognition), what value to place on the transaction (valuation), and how the components of the transaction should be categorized (classification). In general, recognition occurs when title passes, and a transaction is valued at the exchange price—the fair value or cost at the time the transaction is recognized. Classification refers to assigning transactions to the appropriate accounts.

**Explain the double-entry system and the usefulness of T accounts in analyzing business transactions.** **Lo 2**

In the double-entry system, each transaction must be recorded with at least one debit and one credit, and the total amount of the debits must equal the total amount of the credits. Each asset, liability, and component of owner's equity, including revenues and expenses, has a separate account, which is a device for storing transaction data. The chart of accounts is a list of account numbers and titles. It serves as a table of contents for the ledger. The T account is a useful tool for quickly analyzing the effects of transactions. It shows how increases and decreases in assets, liabilities, and owner's equity are recorded. The accounting cycle is a series of steps whose basic purpose is to produce financial statements for decision makers.

**Demonstrate how the double-entry system is applied to common business transactions.** **Lo 3**

The double-entry system is applied by analyzing transactions to determine which accounts are affected and by using T accounts to show how the transactions affect the accounting equation. The transactions may be recorded in journal form with the date, debit account, and debit amount shown on one line, and the credit account (indented) and credit amount on the next line. The amounts are shown in their respective debit and credit columns.

**Prepare a trial balance, and describe its value and limitations.** **Lo 4**

A trial balance is used to check that the debit and credit balances are equal. It is prepared by listing each account balance in the appropriate Debit or Credit column. The two columns are then added, and the totals are compared. The major limitation of a trial balance is that it does not guarantee that the transactions were analyzed correctly or recorded in the proper accounts.

**Record transactions in the general journal, and post transactions to the ledger.** **Lo 5**

The general journal is a chronological record of all transactions. It contains the date of each transaction, the titles of the accounts involved, the amounts debited and credited, and an explanation of each entry. After transactions have been entered in the general journal, they are posted to the ledger. Posting transfers the amounts in the Debit and Credit columns of the general journal to the Debit and Credit columns of the corresponding account in the ledger. After each entry is posted, a new balance is entered in the appropriate Balance column.

**Explain why ethical financial reporting depends on proper recording of business transactions.** **Lo 6**

GAAP provides guidance about the treatment of business transactions in terms of recognition, valuation, and classification. Failure to follow these guidelines is a major reason some companies issue fraudulent financial statements. Usually, a transaction should be recorded when title to merchandise passes from the supplier to the purchaser and creates an obligation to pay.

**Show how the timing of transactions affects cash flows and liquidity.** **Lo 7**

Some transactions generate immediate cash. For those that do not, there is a holding period in either Accounts Receivable or Accounts Payable before the cash is received or paid. The timing of cash flows is critical to a company's ability to maintain adequate liquidity so that it can pay its bills on time.

## Key Terms

**account balance** 44 (LO2)  
**accounting cycle** 46 (LO2)  
**accounts** 42 (LO2)  
**business transactions** 40 (LO1)  
**chart of accounts** 42 (LO2)  
**classification** 41 (LO1)  
**compound entry** 50 (LO3)  
**cost principle** 41 (LO1)  
**credit** 44 (LO2)

**debit** 44 (LO2)  
**double-entry system** 42 (LO2)  
**fair value** 40 (LO1)  
**footings** 44 (LO2)  
**general journal** 58 (LO5)  
**general ledger** 42 (LO2)  
**journal** 47 (LO3)  
**journal entry** 47 (LO3)  
**journal form** 48 (LO3)

**ledger account form** 59 (LO5)  
**normal balance** 45 (LO2)  
**posting** 59 (LO5)  
**recognition** 40 (LO1)  
**recognition point** 62 (LO6)  
**source documents** 47 (LO3)  
**T account** 44 (LO2)  
**trial balance** 56 (LO4)  
**valuation** 40 (LO1)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1.** A company incurs a cost for a part that is needed to repair a piece of equipment. Is the cost an asset or an expense? Explain.
- LO 1, 6 **DQ2. CONCEPT** ► Which is the most important issue in recording a transaction: recognition, valuation, or classification?
- LO 2 **DQ3.** Which account would be most likely to have an account balance that is not normal?
- LO 2 **DQ4.** How would the asset accounts in the chart of accounts for Blue Design Studio differ if it were a retail company that sold promotional products instead of a service company?
- LO 2, 3 **DQ5.** How are assets and expenses related, and why are the debit and credit effects for asset accounts and expense accounts the same?
- LO 2, 3 **DQ6.** In what way are unearned revenues the opposite of prepaid expenses?
- LO 6 **DQ7. CONCEPT** ► What is an example of how a company could make false financial statements through a violation of the recognition concept?
- LO 7 **DQ8. BUSINESS APPLICATION** ► If a company's cash flows for expenses temporarily exceed its cash flows from revenues, how might it make up the difference so that it can maintain liquidity?

CASH FLOW

### SHORT EXERCISES

- LO 1 **Classification of Accounts**
- SE1. CONCEPT** ► Tell whether each of the following accounts is an asset, a liability, a revenue, an expense, or none of these:
- |                     |                        |
|---------------------|------------------------|
| a. Accounts Payable | e. Supplies Expense    |
| b. Supplies         | f. Accounts Receivable |
| c. Withdrawals      | g. Unearned Revenue    |
| d. Fees Earned      | h. Equipment           |

LO 1, 3, 6 **Recognition, Valuation, and Classification**

**SE2. CONCEPT** ► Tell how the concepts of recognition, valuation, and classification apply to the transaction that follows.

Cash			Supplies		
Dr.		Cr.	Dr.		Cr.
	June 1	1,000		June 1	1,000

LO 1, 6 **Recognition**

**SE3. CONCEPT** ► Which of the following events would be recognized and entered in Hallmark Company's accounting records? Why?

- Jan. 10 Hallmark places an order for office supplies.
- Feb. 15 Hallmark receives the office supplies and a bill for them.
- Mar. 1 Hallmark pays for the office supplies.

LO 2 **Normal Balances**

**SE4.** Tell whether the normal balance of each account in **SE1** is a debit or a credit.

LO 3 **Transaction Analysis**

**SE5.** Shawn Michael started a computer programming business, Michael's Programming Service. For each transaction that follows, indicate which account is debited and which account is credited.

- May 2 Shawn Michael invested \$10,000.
- 5 Purchased a computer for \$5,000 in cash.
- 7 Purchased supplies on credit for \$600.
- 19 Received cash for programming services performed, \$1,000.
- 22 Received cash for programming services to be performed, \$1,200.
- 25 Paid the rent for May, \$1,300.
- 31 Billed a customer for programming services performed, \$500.

LO 3 **Recording Transactions in T Accounts**

**SE6.** Set up T accounts and record each transaction in **SE5**. Determine the balance of each account.

LO 4 **Preparing a Trial Balance**

**SE7.** From the T accounts created in **SE6**, prepare a trial balance dated May 31, 2014.

LO 5 **Recording Transactions in the General Journal**

**SE8.** Prepare a general journal form like the one in Exhibit 8 and label it Page 4. Record the following transactions in the journal:

- Sept. 6 Billed a customer for services performed, \$3,800.
- 16 Received partial payment from the customer billed on September 6, \$1,800.

LO 5 **Posting to the Ledger Accounts**

**SE9.** Prepare three ledger account forms like the one in Exhibit 9 for the following accounts: Cash (111), Accounts Receivable (113), and Service Revenue (411). Post the transactions that are recorded in **SE8** to the ledger accounts for 2014, at the same time making the proper posting references. Also prepare a trial balance.

LO 5 **Recording Transactions in the General Journal**

**SE10.** Record the transactions in **SE5** in the general journal for 2014.

LO 6 **Identifying Ethical Transactions**

**SE11. CONCEPT** ► For each of the following ethical situations involving business transactions, indicate what accounting concept has been violated or whether there is no violation:

1. A sales transaction is recorded on the first day of the fiscal year when payment was received even though the service for the customer was completed in the year before.
2. A laser printer in excellent condition purchased at a garage sale has an estimated value of \$150, but is recorded at the \$50 paid for it.
3. A purchase of truck fuel is recorded as an expense (instead of as an asset) because it will be used in the current period.

LO 7 **Timing and Cash Flows**

**SE12. BUSINESS APPLICATION** ► Use the T account for Cash below to record the portion of each of the following transactions, if any, that affect cash. How do these transactions affect the company's liquidity?

Cash	
Jan. 2	Provided services for cash, \$2,400.
4	Paid expenses in cash, \$1,400.
8	Provided services on credit, \$2,200.
9	Incurred expenses on credit, \$1,600.

**EXERCISES: SET A**LO 1,6 **Recognition**

**E1A. CONCEPT** ► Which of the following events would be recognized and recorded in Abril Company's accounting records on the date indicated?

- Jan. 15 Abril offers to purchase a tract of land for \$280,000. There is a high likelihood that the offer will be accepted.
- Feb. 2 Abril receives notice that its rent will increase from \$1,000 to \$1,200 per month effective March 1.
- Mar. 29 Abril receives its utility bill for the month of March. The bill is not due until April 9.
- June 10 Abril places an order for new office equipment costing \$42,000.
- July 6 The office equipment Abril ordered on June 10 arrives. Payment is not due until August 1.

LO 2 **T Accounts, Normal Balance, and the Accounting Equation**

**E2A.** You are given the following list of accounts with dollar amounts:

Rent Expense	\$ 900
Cash	3,450
Service Revenue	1,500
T. Captain, Withdrawals	750
Accounts Payable	1,200
T. Captain, Capital	2,400

Insert each account name at the top of its corresponding T account and enter the dollar amount as a normal balance in the account. Then show that the accounting equation is in balance.

*(Continued)*



			Owner's Equity							
Assets	=	Liabilities	+	T. Captain, Capital	-	T. Captain, Withdrawals	+	Revenues	-	Expenses

### LO 1, 2 Classification of Accounts

**E3A. CONCEPT** ► The following ledger accounts are for Afocentric Service Company:

- |   |   |
|---|---|
| <ul style="list-style-type: none"> <li>a. Supplies</li> <li>b. Utilities Expense</li> <li>c. Accounts Receivable</li> <li>d. D. Minimus, Capital</li> <li>e. Land</li> <li>f. Prepaid Rent</li> <li>g. Accounts Payable</li> <li>h. Investments in Securities</li> <li>i. Service Revenue</li> <li>j. Supplies Expense</li> <li>k. Prepaid Insurance</li> <li>l. Wages Expense</li> </ul> | <ul style="list-style-type: none"> <li>m. Fees Earned</li> <li>n. D. Minimus, Withdrawals</li> <li>o. Wages Payable</li> <li>p. Unearned Revenue</li> <li>q. Office Equipment</li> <li>r. Rent Payable</li> <li>s. Notes Receivable</li> <li>t. Interest Expense</li> <li>u. Notes Payable</li> <li>v. Cash</li> <li>w. Interest Receivable</li> <li>x. Rent Expense</li> </ul> |
|---|---|

Complete the following table, using X's to indicate each account's classification and normal balance (whether a debit or a credit increases the account).

Item	Type of Account						Normal Balance	
	Asset	Liability	Owner's Equity				(increases balance)	
			D. Minimus, Capital	D. Minimus, Withdrawals	Revenue	Expense		
a.	X						X	

### LO 3 Transaction Analysis

**E4A.** Analyze transactions a–g, using the example that follows.

- a. Melissa Faubert invested \$2,400 in cash to establish Faubert's Beauty Parlor.
- b. Paid two months' rent in advance, \$1,680.
- c. Purchased supplies on credit, \$120.
- d. Received cash for salon services, \$600.
- e. Paid for supplies purchased in c.
- f. Paid utility bill, \$72.
- g. Withdrew \$100 in cash.

**Example**

- a. The asset account Cash was increased. Increases in assets are recorded by debits. Debit Cash \$2,400. A component of owner's equity, M. Faubert, Capital, was increased. Increases in owner's capital are recorded by credits. Credit M. Faubert, Capital \$2,400.

### LO 3 Transaction Analysis

**E5A.** The accounts that follow are applicable to Harold's Car Service, a company that repairs cars.

- |                        |                            |
|------------------------|----------------------------|
| 1. Cash                | 5. Accounts Payable        |
| 2. Accounts Receivable | 6. Repair Services Revenue |
| 3. Supplies            | 7. Wages Expense           |
| 4. Equipment           | 8. Rent Expense            |

Harold's completed the following transactions:

	Debit	Credit
a. Paid for supplies purchased on credit last month.	5	1
b. Received cash from customers billed last month.	—	—
c. Made a payment on accounts payable.	—	—
d. Purchased supplies on credit.	—	—
e. Billed a client for repair services.	—	—
f. Made a rent payment for the current month.	—	—
g. Received cash from customers for repair services not yet billed.	—	—
h. Paid employee wages.	—	—
i. Ordered equipment.	—	—
j. Received and paid for the equipment ordered in i.	—	—

Analyze each transaction and show the accounts affected by entering the corresponding numbers in the appropriate debit or credit columns as shown in transaction **a**. Indicate no entry, if appropriate.

**LO 3 Recording Transactions in T Accounts**

**E6A.** Open the following T accounts: Cash; Repair Supplies; Repair Equipment; Accounts Payable; C. Ferdinand, Capital; Withdrawals; Repair Fees Earned; Salaries Expense; and Rent Expense. Record the following transactions for the month of June directly in the T accounts; use the letters to identify the transactions in your T accounts. Determine the balance in each account.

- Collin Ferdinand opened Ferdinand Repair Service by investing \$8,600 in cash and \$3,200 in repair equipment.
- Paid \$800 for the current month's rent.
- Purchased repair supplies on credit, \$1,000.
- Purchased additional repair equipment for cash, \$600.
- Paid salary to an employee, \$900.
- Paid \$400 of amount purchased on credit in c.
- Accepted cash for repairs completed, \$3,720.
- Withdrew \$1,200 in cash.

**LO 3 Analysis of Transactions**

**E7A.** Explain each transaction (a–h) entered in the following T accounts:

<b>Cash</b>		<b>Accounts Receivable</b>		<b>Equipment</b>	
a. 10,000	b. 3,750	c. 2,000	g. 375	b. 3,750	h. 225
g. 375	e. 900			d. 2,250	
h. 225	f. 1,125				
<b>Accounts Payable</b>		<b>F. Mills, Capital</b>		<b>Service Revenue</b>	
f. 1,125	d. 2,250		a. 10,000		c. 2,000
<b>Wages Expense</b>					
e. 900					

**LO 3, 5 Analysis of Unfamiliar Transactions**

**E8A.** Managers and accountants often encounter transactions with which they are unfamiliar. Use your analytical skills to analyze and prepare journal entries for the following transactions, which have not yet been discussed in the text.

- May 1 Purchased merchandise inventory on account, \$1,200.  
 2 Purchased marketable securities for cash, \$2,800.  
 3 Returned part of merchandise inventory purchased for full credit, \$250.  
 4 Sold merchandise inventory on account, \$800 (record sale only).  
 5 Purchased land and a building for \$300,000. Payment is \$60,000 cash, and there is a 30-year mortgage for the remainder. The purchase price is allocated as follows: \$100,000 to the land and \$200,000 to the building.  
 6 Received an order for \$12,000 in services to be provided. With the order was a deposit of \$4,000.

**LO 4 Trial Balance**

**E9A.** After recording the transactions in **E6A**, prepare a trial balance in proper sequence for Ferdinand Repair Service as of June 30, 2014.

**LO 4 Preparing a Trial Balance**

**E10A.** The list that follows presents Shah Company's accounts (in alphabetical order) as of March 31, 2014. The list does not include the amount of Accounts Payable.

A. Shah, Capital	\$18,870	Equipment	\$ 7,200
Accounts Receivable	1,800	Land	3,120
Building	20,400	Notes Payable	12,000
Cash	5,400	Prepaid Insurance	660

Prepare a trial balance with the proper heading (see Exhibit 7) and with the accounts listed in the chart of accounts sequence (see Exhibit 2). Compute the balance of Accounts Payable.

**LO 4 Effects of Errors on a Trial Balance**

**E11A. ACCOUNTING CONNECTION** ► Which of the following errors would cause a trial balance to have unequal totals? Explain your answers.

- A payment to a creditor was recorded as a debit to Accounts Payable for \$258 and as a credit to Cash for \$204.
- A payment of \$300 to a creditor for an account payable was debited to Accounts Receivable and credited to Cash.
- A purchase of office supplies of \$840 was recorded as a debit to Office Supplies for \$84 and as a credit to Cash for \$84.
- A purchase of equipment for \$900 was recorded as a debit to Supplies for \$900 and as a credit to Cash for \$900.

**LO 4 Correcting Errors in a Trial Balance**

**E12A.** Hasson Services' trial balance at the end of July 2014 follows. It does not balance because of a number of errors. Hasson's accountant compared the amounts in the trial balance with the ledger, recomputed the account balances, and compared the postings. He found the following errors:

- The balance of Cash was understated by \$400.
- A cash payment of \$210 was credited to Cash for \$120.
- A debit of \$60 to Accounts Receivable was not posted.
- Supplies purchased for \$30 were posted as a credit to Supplies.
- A debit of \$90 to Prepaid Insurance was not posted.
- The Accounts Payable account had debits of \$2,660 and credits of \$4,590.
- The Notes Payable account, with a credit balance of \$1,200, was not included on the trial balance.
- The debit balance of N. Hasson, Withdrawals was listed in the trial balance as a credit.

- i. A \$100 debit to N. Hasson, Withdrawals was posted as a credit.  
 j. The actual balance of Utilities Expense, \$130, was listed as \$13 in the trial balance.

<b>Hasson Services Trial Balance July 31, 2014</b>		
	<b>Debits</b>	<b>Credits</b>
Cash	1,720	
Accounts Receivable	2,830	
Supplies	60	
Prepaid Insurance	90	
Equipment	3,700	
Accounts Payable		2,270
N. Hasson, Capital		5,280
N. Hasson, Withdrawals		350
Revenues		2,960
Salaries Expense	1,300	
Rent Expense	300	
Advertising Expense	170	
Utilities Expense	13	
	10,183	10,860

Prepare a corrected trial balance.

**LO 5 Recording Transactions in the General Journal**

**E13A.** Record the transactions in **E6A** in the general journal.

**LO 5 Recording Transactions in the General Journal and Posting to the Ledger Accounts**

**E14A.** Open a general journal form like the one in Exhibit 8, and label it Page 10. Then record the following transactions in the journal:

- Dec. 14 Purchased equipment for \$12,000, paying \$4,000 as a cash down payment.  
 28 Paid \$6,000 of the amount owed on the equipment.

Prepare three ledger account forms like the one shown in Exhibit 9. Use the following account numbers: Cash, 111; Office Equipment, 146; and Accounts Payable, 212. Then post the two transactions from the general journal to the ledger accounts, being sure to make proper posting references. Assume that the Cash account has a debit balance of \$16,000 on the day prior to the first transaction.

**LO 6 Application of Recognition Point**

**E15A. BUSINESS APPLICATION** ► Affordable Flower Shop uses a large amount of supplies in its business. The following table summarizes selected transaction data for supplies that Affordable purchased:

Order	Date Shipped	Date Received	Amount
a	June 26	July 5	\$ 600
b	July 10	July 15	1,500
c	July 16	July 22	800
d	July 23	July 30	1,200
e	July 27	Aug. 1	1,500
f	Aug. 3	Aug. 7	1,000

Determine the total purchases of supplies for July alone under each of the following assumptions:

1. Affordable recognizes purchases when orders are shipped.
2. Affordable recognizes purchases when orders are received.

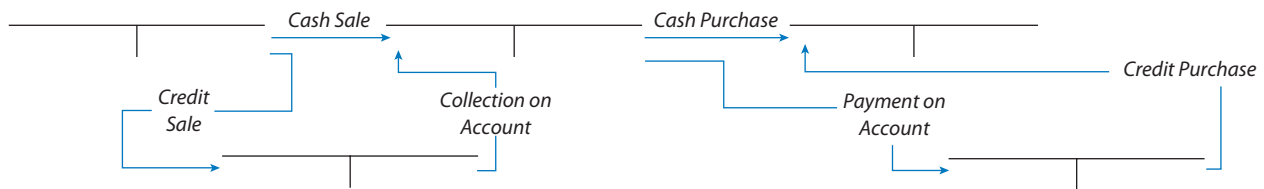
LO 7 **Cash Flow Analysis**



**E16A. BUSINESS APPLICATION** ▶ A company engaged in the following transactions:

- Dec. 1 Performed services for cash, \$1,500.
- 1 Paid expenses in cash, \$1,100.
- 2 Performed services on credit, \$1,800.
- 3 Collected on account, \$1,200.
- 4 Incurred expenses on credit, \$1,300.
- 5 Paid on account, \$700.

Enter the correct titles on the following T accounts and enter the above transactions in the accounts. Determine the cash balance after these transactions, the amount still to be received, and the amount still to be paid.



**EXERCISES: SET B**

Visit the textbook companion web site at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS**

LO 2 **T Accounts, Normal Balance, and The Accounting Equation**

✓ Total assets: \$145,580

**P1.** Highland Design Company creates radio and television advertising for local businesses in the twin cities. The following alphabetical list shows Highland Design’s account balances as of January 31, 2014:

Accounts Payable	\$ 6,420	Rent Expense	\$ 11,880
Accounts Receivable	78,000	R. Mehta, Capital	74,000
Cash	18,400	R. Mehta, Withdrawals	36,000
Design Revenue	210,000	Telephone Expense	960
Equipment	?	Unearned Revenue	18,000
Loans Payable	10,000	Wages Expense	124,000

**REQUIRED**

Insert the account title at the top of its corresponding T account and enter the dollar amount as a normal balance in the account. Determine the balance of Equipment and then show that the accounting equation is in balance.

		Owner's Equity								
Assets	=	Liabilities	+	R. Mehta, Capital	-	R. Mehta, Withdrawals	+	Revenues	-	Expenses

**LO 3 Transaction Analysis**

**P2.** The following accounts are applicable to George’s Warehouse Sweeps:

- |                        |                             |
|------------------------|-----------------------------|
| 1. Cash                | 7. Accounts Payable         |
| 2. Accounts Receivable | 8. R. Marcuson, Capital     |
| 3. Supplies            | 9. R. Marcuson, Withdrawals |
| 4. Prepaid Insurance   | 10. Service Revenue         |
| 5. Equipment           | 11. Rent Expense            |
| 6. Notes Payable       | 12. Repair Expense          |

George’s Warehouse Sweeps completed the following transactions:

	Debit	Credit
a. Paid for supplies purchased on credit last month.	7	1
b. Received a bill for repairs.	—	—
c. Paid the current month’s rent.	—	—
d. Purchased supplies on credit.	—	—
e. Received cash from customers for services performed but not yet billed.	—	—
f. Purchased equipment on account.	—	—
g. Billed customers for services performed.	—	—
h. Returned part of the equipment purchased in f for a credit.	—	—
i. Received payments from customers previously billed.	—	—
j. Paid the bill received in b.	—	—
k. Received an order for services to be performed.	—	—
l. Paid for repairs with cash.	—	—
m. Made a payment to reduce the principal of the note payable.	—	—
n. Made a cash withdrawal.	—	—

**REQUIRED**

Analyze each transaction and show the accounts affected by entering the corresponding numbers in the appropriate debit or credit column as shown in transaction a. Indicate no entry, if appropriate.

**LO 3, 4, 7**

**RATIO**

**CASH FLOW**

**SPREADSHEET**

**GENERAL LEDGER**

**Transaction Analysis, T Accounts, and Trial Balance**

**P3.** Jennifer Lopez opened a school for administrative skills called Lopez Office Training and completed the following transactions:

a. Contributed the following assets to the business:

Cash	\$5,700
Computers	4,300
Office Equipment	3,600

- b. Found a location for her business and paid the first month’s rent, \$260.
- c. Paid for an advertisement announcing the opening of the school, \$190.
- d. Received applications from three students for a four-week secretarial program and two students for a ten-day keyboarding course. The students will be billed a total of \$1,300.
- e. Purchased supplies on credit, \$330.
- f. Billed the enrolled students, \$1,740.
- g. Purchased a second-hand computer, \$480, and office equipment, \$380, on credit.
- h. Paid for the supplies purchased on credit in e, \$330.
- i. Paid cash to repair a broken computer, \$40.
- j. Received partial payment from students previously billed, \$1,080.
- k. Paid the utility bill for the current month, \$90.
- l. Paid an assistant one week’s salary, \$440.
- m. Made a cash withdrawal of \$300.

✓ 3: Trial balance: \$16,200

*(Continued)*

**REQUIRED**

1. Set up the following T accounts: Cash; Accounts Receivable; Supplies; Computers; Office Equipment; Accounts Payable; J. Lopez, Capital; J. Lopez, Withdrawals; Tuition Revenue; Salaries Expense; Utilities Expense; Rent Expense; Repair Expense; and Advertising Expense.
2. Record the transactions directly in the T accounts, using the transaction letter to identify each debit and credit.
3. Prepare a trial balance using today's date.
4. **BUSINESS APPLICATION** ► Examine transactions f and j. What were the revenues, and how much cash was received from the revenues? What business issues might you see arising from the differences in these numbers?

LO 1, 3, 4

GENERAL LEDGER

✓ 3: Trial balance: \$21,080

**Transaction Analysis, Journal Form, T Accounts, and Trial Balance**

**P4.** Sid Patel bid for and won a concession to rent bicycles in the local park during the summer. During the month of April, Patel completed the following transactions for his bicycle rental business:

- Apr. 2 Began business by placing \$14,400 in a business checking account in the name of the company.
- 3 Purchased supplies on account for \$300.
- 4 Purchased 10 bicycles for \$5,000, paying \$2,400 down and agreeing to pay the rest in 30 days.
- 5 Paid \$5,800 in cash for a small shed to store the bicycles and to use for other operations.
- 8 Paid \$800 in cash for shipping and installation costs (considered an addition to the cost of the shed) to place the shed at the park entrance.
- 9 Hired a part-time assistant to help out on weekends at \$14 per hour.
- 10 Paid a maintenance person \$150 to clean the grounds.
- 13 Received \$1,940 in cash for rentals.
- 17 Paid \$300 for the supplies purchased on April 3.
- 18 Paid a \$110 repair bill on bicycles.
- 23 Billed a company \$220 for bicycle rentals for an employee outing.
- 25 Paid the \$200 fee for April to the Park District for the right to operate the bicycle concession.
- 27 Received \$1,920 in cash for rentals.
- 29 Paid the assistant \$480.
- 30 Made a cash withdrawal of \$1,000.

**REQUIRED**

1. Prepare journal entries to record these transactions.
2. Set up the following T accounts and post all the journal entries: Cash; Accounts Receivable; Supplies; Shed; Bicycles; Accounts Payable; S. Patel, Capital; S. Patel, Withdrawals; Rental Revenue; Wages Expense; Maintenance Expense; Repair Expense; and Concession Fee Expense.
3. Prepare a trial balance for Patel Rentals as of April 30, 2014.
4. **CONCEPT** ► Compare and contrast how the issues of recognition, valuation, and classification are settled in the transactions of April 3 and 10.

LO 3, 4, 5, 7

CASH FLOW

SPREADSHEET

GENERAL LEDGER

✓ 5: Trial balance: \$30,900

**Transaction Analysis, General Journal, Ledger Accounts, and Trial Balance**

**P5.** Nordtown Company is a marketing firm. The company's trial balance on August 31, 2014, follows.



**Nordtown Company**  
**Trial Balance**  
**August 31, 2014**

Cash (111)	10,590	
Accounts Receivable (113)	5,500	
Office Supplies (116)	610	
Office Equipment (146)	4,200	
Accounts Payable (212)		2,600
D. Guetta, Capital (311)		18,300
	20,900	20,900

During the month of September, the company completed the following transactions:

- Sept. 2 Paid rent for September, \$650.  
 3 Received cash from customers on account, \$2,300.  
 7 Ordered supplies, \$380.  
 10 Billed customers for services provided, \$2,800.  
 12 Made a payment on accounts payable, \$1,300.  
 14 Received the supplies ordered on September 7 and agreed to pay for them in 30 days, \$380.  
 17 Discovered some of the supplies were not as ordered and returned them for full credit, \$80.  
 19 Received cash from a customer for services provided, \$4,800.  
 24 Paid the utility bill for September, \$250.  
 26 Received a bill, to be paid in October, for advertisements placed in the local newspaper during the month of September to promote Nordstrom Company, \$700.  
 29 Billed a customer for services provided, \$2,700.  
 30 Paid salaries for September, \$3,800.  
 30 Made a cash withdrawal of \$1,200.

**REQUIRED**

1. Open accounts in the ledger for the accounts in the trial balance plus the following accounts: D. Guetta, Withdrawals (313); Marketing Fees (411); Salaries Expense (511); Utilities Expense (512); Rent Expense (514); and Advertising Expense (516).
2. Enter the August 31, 2014, account balances from the trial balance.
3. Enter the September transactions in the general journal (page 22).
4. Post the journal entries to the ledger accounts. Be sure to make the appropriate posting references in the journal and ledger as you post.
5. Prepare a trial balance as of September 30, 2014.
6. **BUSINESS APPLICATION** ▶ Examine the transactions for September 3, 10, 19, and 29. What were the revenues, and how much cash was received from the revenues? What business issues might you see arising from the differences in these numbers?

## ALTERNATE PROBLEMS

LO 2

### T Accounts, Normal Balance, and the Accounting Equation

✓ Total assets: \$57,880

**P6.** Carlson Construction Company builds foundations for buildings and parking lots. The following alphabetical list shows Carlson's account balances as of April 30, 2014:

*(Continued)*

Accounts Payable	\$ 3,900	Notes Payable	\$20,000
Accounts Receivable	10,120	Revenue Earned	17,400
B. Carlson, Capital	40,000	Supplies	6,500
B. Carlson, Withdrawals	7,000	Supplies Expense	7,200
Cash	?	Utilities Expense	420
Equipment	27,500	Wages Expense	8,800

**REQUIRED**

Insert the account at the top of its corresponding T account, and enter the dollar amount as a normal balance in the account. Determine the balance of cash and then show that the accounting equation is in balance.

Assets	=	Liabilities	+	Owner's Equity						
			+	B. Carlson, Capital	-	B. Carlson, Withdrawals	+	Revenues	-	Expenses

**LO 3 Transaction Analysis**

**P7.** The following accounts are applicable to Raymond's Chimney Sweeps:

- |                        |                         |
|------------------------|-------------------------|
| 1. Cash                | 7. Accounts Payable     |
| 2. Accounts Receivable | 8. R. Foth, Capital     |
| 3. Supplies            | 9. R. Foth, Withdrawals |
| 4. Prepaid Insurance   | 10. Service Revenue     |
| 5. Equipment           | 11. Rent Expense        |
| 6. Notes Payable       | 12. Repair Expense      |

Raymond's Chimney Sweeps completed the following transactions:

	Debit	Credit
a. Paid for supplies purchased on credit last month.	7	1
b. Billed customers for services performed.	—	—
c. Paid the current month's rent.	—	—
d. Purchased supplies on credit.	—	—
e. Received cash from customers for services performed but not yet billed.	—	—
f. Purchased equipment on account.	—	—
g. Received a bill for repairs.	—	—
h. Returned part of the equipment purchased in <b>f</b> for a credit.	—	—
i. Received payments from customers previously billed.	—	—
j. Paid the bill received in <b>g</b> .	—	—
k. Received an order for services to be performed.	—	—
l. Paid for repairs with cash.	—	—
m. Made a payment to reduce the principal of the note payable.	—	—
n. Made a cash withdrawal.	—	—

**REQUIRED**

Analyze each transaction and show the accounts affected by entering the corresponding numbers in the appropriate debit or credit column as shown in transaction **a**. Indicate no entry, if appropriate.

LO 3, 4, 7

CASH FLOW

SPREADSHEET

GENERAL LEDGER

✓ 3: Trial balance: \$32,400

**Transaction Analysis, T Accounts, and Trial Balance****P8.** B. Turner opened a school for administrative skills called Blitz Secretarial Training.

a. Turner contributed the following assets to the business:

Cash	\$11,400
Computers	8,600
Office Equipment	7,200

- b. Found a location for his business and paid the first month's rent, \$520.  
 c. Paid for an advertisement announcing the opening of the school, \$380.  
 d. Received applications from three students for a four-week secretarial program and two students for a ten-day keyboarding course. The students will be billed a total of \$2,600.  
 e. Purchased supplies on credit, \$660.  
 f. Billed the enrolled students, \$3,480.  
 g. Purchased a second-hand computer, \$960, and office equipment, \$760, on credit.  
 h. Paid for the supplies purchased on credit in e, \$660.  
 i. Paid cash to repair a broken computer, \$80.  
 j. Received partial payment from students previously billed, \$2,160.  
 k. Paid the utility bill for the current month, \$180.  
 l. Paid an assistant one week's salary, \$880.  
 m. Made a cash withdrawal of \$600.

**REQUIRED**

- Set up the following T accounts: Cash; Accounts Receivable; Supplies; Computers; Office Equipment; Accounts Payable; B. Turner, Capital; B. Turner, Withdrawals; Tuition Revenue; Salaries Expense; Utilities Expense; Rent Expense; Repair Expense; and Advertising Expense.
- Record the transactions directly in the T accounts, using the transaction letter to identify each debit and credit.
- Prepare a trial balance using today's date.
- BUSINESS APPLICATION** ▶ Examine transactions f and j. What were the revenues and how much cash was received from the revenues? What business issues might you see arising from the differences in these numbers?

LO 1, 3, 4

GENERAL LEDGER

✓ 3: Trial balance: \$37,600

**Transaction Analysis, T Accounts, and Trial Balances****P9.** David Roberts began an upholstery cleaning business on August 1 and engaged in the following transactions during the month:

- Aug. 1 Began business by depositing \$30,000 in a bank account in the name of the company.  
 2 Ordered cleaning supplies, \$6,000.  
 3 Purchased cleaning equipment for cash, \$5,600.  
 4 Made two months' van lease payment in advance, \$2,400.  
 7 Received the cleaning supplies ordered on August 2 and agreed to pay half the amount in 10 days and the rest in 30 days.  
 9 Paid for repairs on the van with cash, \$2,160.  
 12 Received cash for cleaning upholstery, \$1,920.  
 17 Paid half the amount owed on supplies received on August 7, \$3,000.  
 21 Billed customers for cleaning upholstery, \$2,680.  
 24 Paid cash for additional repairs on the van, \$160.  
 27 Received \$1,200 from the customers billed on August 21.  
 31 Made a cash withdrawal of \$1,400.

**REQUIRED**

- Set up the following T accounts: Cash; Accounts Receivable; Cleaning Supplies; Prepaid Lease; Cleaning Equipment; Accounts Payable; D. Roberts, Capital; D. Roberts, Withdrawals; Cleaning Revenue; and Repair Expense.

*(Continued)*

2. Record transactions directly in the T accounts. Identify each entry by date.
3. Prepare a trial balance for Roberts Upholstery Cleaning as of August 31, 2014.
4. **CONCEPT** ► Compare and contrast how the issues of recognition, valuation, and classification are settled in the transactions of August 7 and 9.

LO 3, 4, 5, 7

CASH FLOW

SPREADSHEET

GENERAL LEDGER

✓ 5: Trial balance: \$23,805

### Transaction Analysis, General Journal, Ledger Accounts, and Trial Balance

**P10.** Mount Prospect Nursery School Company provides baby-sitting and child-care programs. On January 31, 2014, the company had the following trial balance:

**Mount Prospect Nursery School Company**  
**Trial Balance**  
**January 31, 2014**

	Debits	Credits
Cash (111)	1,870	
Accounts Receivable (113)	1,700	
Equipment (141)	1,040	
Buses (143)	17,400	
Notes Payable (211)		15,000
Accounts Payable (212)		1,640
J. Ziden, Capital (311)		5,370
	22,010	22,010

During the month of February, the company completed the following transactions:

- Feb. 2 Paid this month's rent, \$270.
- 3 Received fees for this month's services, \$650.
- 4 Purchased supplies on account, \$85.
- 5 Reimbursed the bus driver for gas expenses, \$40.
- 6 Ordered playground equipment, \$1,000.
- 8 Made a payment on account, \$170.
- 9 Received payments from customers on account, \$1,200.
- 10 Billed customers who had not yet paid for this month's services, \$700.
- 11 Paid for the supplies purchased on February 4.
- 13 Purchased and received playground equipment ordered on February 6 for cash, \$1,000.
- 17 Purchased equipment on account, \$290.
- 19 Paid this month's utility bill, \$145.
- 22 Received payment for one month's services from customers previously billed, \$500.
- 26 Paid part-time assistants for services, \$460.
- 27 Purchased gas and oil for the bus on account, \$325.
- 28 Made a cash withdrawal of \$110.

#### REQUIRED

1. Open accounts in the ledger for the accounts in the trial balance plus the following ones: Supplies (115); J. Ziden, Withdrawals (313); Service Revenue (411); Rent Expense (511); Gas and Oil Expense (512); Wages Expense (513); and Utilities Expense (514).
2. Enter the January 31, 2014, account balances from the trial balance.
3. Enter the above transactions in the general journal (Pages 17 and 18).
4. Post the entries to the ledger accounts. Be sure to make the appropriate posting references in the journal and ledger as you post.
5. Prepare a trial balance as of February 28, 2014.
6. **BUSINESS APPLICATION** ► Examine the transactions for February 3, 9, 10, and 22. What were the revenues, and how much cash was received from the revenues? What business issue might you see arising from the differences in these numbers?

## CASES

### LO 1, 3 **Conceptual Understanding: Valuation and Classification of Business Transactions**

**C1. CONCEPT** ► Tower Garden Center purchased two pre-owned trucks at a cash-only auction for 15 percent below current market value. The owners have asked you to record this purchase at current market value. You don't think that is correct. Write the owners a brief business memorandum in good form based on your knowledge of Chapter 2. Explain how the purchase of the pre-owned trucks will affect the balance sheet, include the entry to record the transaction, and explain why the amount must be at the price paid for the trucks.

### LO 1, 3, 6 **Conceptual Understanding: Recording of Rebates**

**C2. CONCEPT** ► Is it revenue or a reduction of an expense? That is the question companies that receive manufacturer's rebates for purchasing a large quantity of product must answer. Food companies like **Sara Lee**, **Kraft Foods**, and **Nestlé** give supermarkets special manufacturer's rebates of up to 45 percent, depending on the quantities purchased. Some firms recorded these rebates as revenue, and others recorded them as a reduction of the cost until the SEC said that only one way is correct. What, then, is the correct way for supermarkets to record these rebates? Does your answer change net income?

### LO 1, 2, 3 **Interpreting Financial Statements: Interpreting a Bank's Financial Statements**

**C3. Mellon Bank** is a large bank holding company. Selected accounts from the company's 2011 annual report are as follows (in millions):<sup>5</sup>

Cash and Due from Banks	\$ 4,175
Loans to Customers	43,585
Securities Available for Sale	78,467
Deposits by Customers	219,094

1. Indicate whether each of these accounts is an asset, a liability, or a component of stockholders' equity on Mellon Bank's balance sheet.
2. Assume that you are in a position to do business with Mellon. Show how Mellon Bank's accountants would prepare the entry in T account form to record each of the following transactions:
  - a. You sell securities in the amount of \$2,000 to the bank.
  - b. You deposit in the bank the \$2,000 received from selling the securities.
  - c. You borrow \$5,000 from the bank.

### LO 7 **Interpreting Financial Statements: Cash Flows**



**C4. BUSINESS APPLICATION** ► Having been promoted recently, you now have access to your firm's monthly financial statements. You notice that revenues are increasing rapidly and that income is at an all-time high. The balance sheet shows growth in receivables, and accounts payable have declined. However, the chief financial officer is concerned because the firm's cash flows from operating activities are decreasing. What are some reasons why a company with a positive net income may fall short of cash from its operating activities? What could be done to improve this situation?

### **Annual Report Case: Recognition, Valuation, and Classification**

**C5. CONCEPT** ► Refer to the Summary of Significant Accounting Policies in the notes to the financial statements in the **CVS** annual report in the Supplement to Chapter 16.

1. How does the concept of recognition apply to advertising costs?
2. How does the concept of valuation apply to inventories?
3. How does the concept of classification apply to cash and cash equivalents?

**LO 1,6 Comparison Analysis: Revenue Recognition**

**C6. BUSINESS APPLICATION** ▶ Refer to the financial statements of **CVS** and **Southwest Airlines Co.** in the Supplement to Chapter 16. What is the total revenue for CVS and Southwest on the respective income statements? How do you think the nature of each business will affect revenue recognition for prescriptions filled for CVS versus airline tickets for Southwest? When do you think cash is received and revenues are earned for each company?

**LO 1,6 Ethical Dilemma: Recognition Point and Ethical Considerations**

**C7. BUSINESS APPLICATION** ▶ Robert Shah, a sales representative for Quality Office Supplies Corporation, will receive a substantial bonus if he meets his annual sales goal. The company's recognition point for sales is the day of shipment. On December 31, Shah realizes he needs sales of \$2,000 to reach his sales goal and receive the bonus. He calls a purchaser for a local insurance company, whom he knows well, and asks him to buy \$2,000 worth of copier paper today. The purchaser says, "But Robert, that's more than a year's supply for us." Shah says, "Buy it today. If you decide it's too much, you can return however much you want for full credit next month." The purchaser says, "Okay, ship it." The paper is shipped on December 31 and recorded as a sale. On January 15, the purchaser returns \$1,750 worth of paper for full credit (approved by Shah) against the bill. Should the shipment on December 31 be recorded as a sale? Discuss the ethics of Shah's action.

**Continuing Case: Annual Report Project**

**C8. CONCEPT** ▶ Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, identify in the first note to the financial statements (usually labeled: Significant Accounting Policies) an accounting policy that illustrates each of the following:

1. Recognition
2. Valuation
3. Classification



# CHAPTER 3

## Adjusting the Accounts

### BUSINESS INSIGHT

#### Reliable Answering Service

Reliable Answering Service takes telephone messages for doctors, lawyers, and other professionals and relays them immediately when they involve an emergency. At the end of any accounting period, Reliable has many transactions that will affect future periods. Examples include *office supplies* and *prepaid expenses*, which will benefit future periods and, therefore, are recorded as assets. Another example is *unearned revenue*, which represents receipts for services the company will not perform and earn until a future period. If prepaid expenses and unearned revenue are not accounted for properly at the end of a period, the company's income will be misstated. Similar misstatements can occur when a company fails to record (accrue) expenses that it incurred or revenue that it has earned but not yet received. Knowing the answers to the following questions will help prevent such misstatements.

- 1. CONCEPT** ► *Why are the concepts of continuity, periodicity, and accrual accounting necessary for Reliable to account for transactions that span accounting periods?*
- 2. ACCOUNTING APPLICATION** ► *How does Reliable adjust its revenues and expenses so that its net income is properly measured?*
- 3. BUSINESS APPLICATION** ► *Which accounts on Reliable's income statement are potentially affected by adjusting entries? Which account on Reliable's balance sheet is never affected by an adjusting entry?*

### LEARNING OBJECTIVES

- LO 1** Define *net income*, and explain the concepts underlying income measurement.
- LO 2** Distinguish cash basis of accounting from accrual accounting, and explain how accrual accounting is accomplished.
- LO 3** Identify four situations that require adjusting entries, and illustrate typical adjusting entries.
- LO 4** Prepare financial statements from an adjusted trial balance.
- LO 5** Explain the importance of ethical measurement of net income and the relation of net income to cash flows.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Net income
- Revenues
- Expenses
- Continuity
- Periodicity
- Accrual accounting (matching rule)
- Revenue recognition

## RELEVANT LEARNING OBJECTIVES

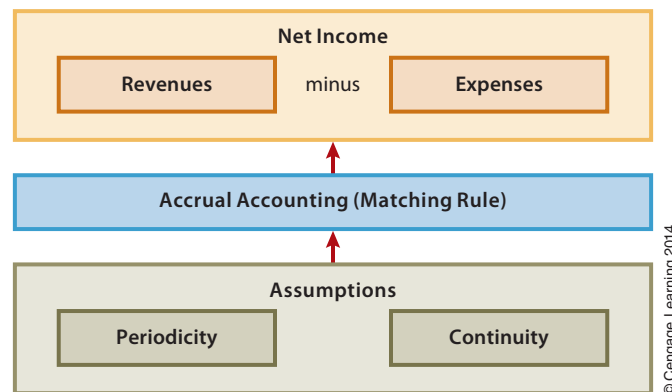
**LO 1** Define *net income*, and explain the concepts underlying income measurement.

**LO 2** Distinguish cash basis of accounting from accrual accounting, and explain how accrual accounting is accomplished.

## LO 1 Concepts Underlying Income Measurement

For a business to succeed or even survive, it must earn a profit. Profit, however, means different things to different people. Accountants prefer to use the term **net income** because it can be precisely defined as the *net increase in owner's equity that results from a company's operations*. Exhibit 1 illustrates the concepts underlying the measurement of net income.

**Exhibit 1**  
Concepts Underlying Net Income



### Net Income

Net income is accumulated in the Owner's Capital account and reported on the income statement. Management, owners, and others use it to assess a company's progress in meeting the goal of profitability. Readers of income statements need to understand net income and its strengths and weaknesses as an indicator of a company's performance.

In its simplest form, net income results when revenues exceed expenses:

$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$

When expenses exceed revenues, a **net loss** occurs.

**Revenues** are *increases in owner's equity* resulting from selling goods, rendering services, or performing other business activities. When a business delivers a product or provides a service to a customer, it usually receives cash or a promise from customers to pay cash in the near future. In other words, revenue may be *earned* through the sale of goods or services, even though the cash may not be received until later. The promise to pay is recorded in either Accounts Receivable or Notes Receivable. The total of these accounts and the total cash received from customers in an accounting period are the company's revenues for that period.

**Expenses** are *decreases in owner's equity* resulting from the cost of selling goods or rendering services and the cost of the activities necessary to carry on a business, such as attracting and serving customers. Examples include salaries expense, rent expense, advertising expense, utilities expense, and depreciation (allocation of cost) of a building or office equipment. These expenses are often called the *cost of doing business* or *expired costs*. Note that the primary purpose of an expense is to generate revenue.

Not all increases in owner's equity arise from revenues, nor do all decreases in owner's equity arise from expenses. Owner's investments increase owner's equity but are not revenues, and withdrawals decrease owner's equity but are not expenses.

## Income Measurement Assumptions

Users of financial reports should be aware that estimates and assumptions play a major role in the measurement of net income and other key indicators of performance. The major assumptions made in measuring business income are *continuity*, *periodicity*, and *accrual accounting* (the *matching rule*).

**Continuity** Certain expense and revenue transactions are allocated over several accounting periods. Choosing the number of accounting periods raises the issue of *continuity*. What is the expected life of the business? Many businesses last less than five years, and in any given year, thousands of businesses go bankrupt. The majority of companies present annual financial statements on the assumption that the business will continue to operate indefinitely—that is, that the company is a **going concern**. The **continuity** assumption is as follows.

*Unless there is evidence to the contrary, the accountant assumes that the business is a going concern and will continue to operate indefinitely.*

The continuity assumption allows the cost of certain assets to be held on the balance sheet until a future accounting period, when the cost will become an expense. When a firm is facing bankruptcy, the accountant may prepare financial statements based on the assumption that the firm will go out of business and sell all of its assets.

**Periodicity** Not all transactions can be easily assigned to specific periods. For example, when a company purchases a building, it must estimate the number of years the building will be in use. The portion of the cost of the building that is assigned to each period depends on this estimate and requires an assumption about **periodicity**. The assumption is as follows.

*Although the lifetime of a business is uncertain, it is nonetheless useful to estimate the business's net income in terms of accounting periods.*

**STUDY NOTE:** Accounting periods are of equal length so that one period can be compared with the next.

Financial statements may be prepared for any time period, but generally, to make comparisons easier, the periods are of equal length. A 12-month accounting period is called a **fiscal year**; accounting periods of less than a year are called **interim periods**. The fiscal year of many organizations is the calendar year, January 1 to December 31. However, retailers and other companies often end their fiscal years during a slack season, so that the fiscal year corresponds to the yearly cycle of business activity. For example, **Toys "R" Us's** fiscal year ends in January and **Apple Computer's** ends in September.

**Accrual Accounting (Matching Rule)** Under **accrual accounting** (often referred to as *the matching rule*) net income is measured by assigning:

- Revenues to the accounting period in which the goods are sold or the services performed.
- Expenses to the accounting period in which they are used to produce revenue.

A direct relationship between expenses and revenues is often difficult to identify. When there is no direct means of connecting expenses and revenues, costs are allocated among the accounting periods that benefit from the costs. For example, a building's cost is expensed over the building's expected useful life, and interest on investments is recorded as income even though it may not have been received.

## APPLY IT!

Match the assumptions or actions with the concepts that follow.

- |   |               |
|---|---------------|
| 1. Increases in owner's equity resulting from selling goods, rendering services, or performing other business activities.   | a. Net income |
| 2. Increase in owner's equity that results from a company's operations.   | b. Revenues   |
| 3. Decreases in owner's equity resulting from the cost of selling goods, rendering services, and other business activities. | c. Expenses   |

### SOLUTION

1. b; 2. a; 3. c

**TRY IT! SE1, E1A, E1B**

## LO 2 Concepts Underlying Accrual Accounting

The **cash basis of accounting** is the practice of accounting for revenues in the period in which cash is received and for expenses in the period in which cash is paid. With this method, taxable income is calculated as the difference between cash receipts from revenues and cash payments for expenses. Although this method works well for some small businesses and many individuals, it does not fit the needs of most businesses.

In contrast, as noted above, in *accrual accounting*, revenues and expenses are recorded when they are earned or incurred rather than when they are received or paid. Adjusting the accounts is a technique used to accomplish accrual accounting.

### Recognizing Revenues

As you may recall, the process of determining when revenue should be recorded is called **revenue recognition**. The Securities and Exchange Commission requires that all the following conditions be met before revenue is recognized:<sup>1</sup>

- Persuasive evidence of an arrangement exists.
- A product or service has been delivered.
- The seller's price to the buyer is fixed or determinable.
- Collectibility is reasonably ensured.

For example, suppose Blue Design Studio has created a brochure for a customer and that the transaction meets the SEC's four criteria:

- The company and the customer agree that the customer owes for the service.
- The service has been rendered.
- Both parties understand the price.
- There is a reasonable expectation that the customer will pay the bill.

When Blue bills the customer, it records the transaction as revenue by debiting Accounts Receivable and crediting Design Revenue. Note that revenue can be recorded because there is a reasonable expectation that cash will be received.



## International Perspective

IFRS

### Revenue Recognition: Principles Versus Rules

Revenue recognition highlights the differences between international and U.S. accounting standards. Although U.S. standards are referred to as generally accepted accounting *principles*, the FASB has issued extensive *rules* (specific guidance) for revenue recognition in various situations and industries. The IASB, on the other hand, generally has a few broad IFRS for revenue recognition and leaves it to companies and their auditors to determine how to apply the broad *principle* in specific situations. The FASB and IASB are currently working together to converge on a single standard for revenue recognition; but it is a challenge, given the very different approaches.

## Recognizing Expenses

Expenses are recorded when all of the following conditions are met:

- There is an agreement to purchase goods or services.
- The goods have been delivered or the services rendered.
- A price has been established or can be determined.
- The goods or services have been used to produce revenue.

For example, when Blue Design Studio receives its utility bill, it recognizes the expense as having been incurred and as having helped produce revenue. Blue records this transaction by debiting Utilities Expense and crediting Accounts Payable. Until the bill is paid, Accounts Payable serves as a holding account. Note that recognition of the expense does not depend on the payment of cash.

### APPLY IT!

Four conditions must be met before revenue can be recognized. Identify which of these conditions applies to the following actions:

- a. Determines that the firm has a good credit rating.
- b. Agrees to a price for services before it performs them.
- c. Performs services.
- d. Signs a contract to perform services.

#### SOLUTION

- a. Collectibility is reasonably assured.
- b. The seller's price to the buyer is fixed or determinable.
- c. A product or service has been delivered.
- d. Persuasive evidence of an arrangement exists.

**TRY IT! E1A, E2A, E1B, E2B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Prepare adjusting entries
- Prepare financial statements from an adjusted trial balance

RELEVANT  
LEARNING OBJECTIVES

**LO 3** Identify four situations that require adjusting entries, and illustrate typical adjusting entries.

**LO 4** Prepare financial statements from an adjusted trial balance.

### LO 3 The Adjustment Process

*Accrual accounting* also involves adjusting the accounts. Adjustments are necessary because the accounting period, by definition, ends on a particular day. The balance sheet must list all assets and liabilities as of the end of that day, and the income statement must contain all revenues and expenses applicable to the period ending on that day. Although operating a business is a continuous process, there must be a cutoff point for the periodic reports. Some transactions invariably span the cutoff point, and therefore, some accounts need adjustment.

In Exhibit 2, some of the accounts in Blue Design Studio's trial balance as of July 31 do not show the correct balances for preparing the financial statements. The trial balance lists prepaid rent of \$3,200 for the months of July and August. So, on July 31, one-half of the \$3,200 represents rent expense for July, and the remaining \$1,600 represents an asset that will be used in August. An adjustment is needed to reflect the \$1,600 balance in the Prepaid Rent account and the \$1,600 rent expense. As you will see, several other accounts in Blue's trial balance do not reflect their correct balances. Like the Prepaid Rent account, they need to be adjusted.

#### Exhibit 2 Trial Balance for Blue Design Studio

<b>Blue Design Studio</b>	
<b>Trial Balance</b>	
<b>July 31, 2014</b>	
Cash	22,480
Accounts Receivable	4,600
Office Supplies	5,200
Prepaid Rent	3,200
Office Equipment	16,320
Accounts Payable	6,280
Unearned Design Revenue	1,400
J. Blue, Capital	40,000
J. Blue, Withdrawals	2,800
Design Revenue	12,400
Wages Expense	4,800
Utilities Expense	680
	60,080
	60,080

© Cengage Learning 2014

When transactions span more than one accounting period, *accrual accounting* requires the use of **adjusting entries**. Exhibit 3 shows the four situations in which adjusting entries must be made. Each adjusting entry affects one balance sheet account and one income statement account. Note that adjusting entries provide information about past or future cash flows but never involve an entry to the Cash account.

### Exhibit 3 The Four Types of Adjustments

		Balance Sheet	
		Asset	Liability
Income Statement	Expense	1. Allocating recorded costs between two or more accounting periods.	2. Recognizing unrecorded expenses.
	Revenue	4. Recognizing unrecorded, earned revenues.	3. Allocating recorded, unearned revenues between two or more accounting periods.

© Cengage Learning 2014

The four types of adjusting entries are as follows.

- **Type 1. Allocating recorded costs between two or more accounting periods.** Examples of these costs are prepayments of rent, insurance, and supplies and the depreciation of plant and equipment. The adjusting entry involves an asset account and an expense account.
- **Type 2. Recognizing unrecorded expenses.** Examples of these expenses are wages and interest that have been incurred but are not recorded during an accounting period. The adjusting entry involves an expense account and a liability account.
- **Type 3. Allocating recorded, unearned revenues between two or more accounting periods.** Examples include payments received in advance and deposits made for goods or services to be delivered or provided in the future. The adjusting entry involves a liability account and a revenue account.
- **Type 4. Recognizing unrecorded, earned revenues.** An example is revenue that a company has earned for providing a service but for which it has not billed or collected a fee by the end of the accounting period. The adjusting entry involves an asset account and a revenue account.

Adjusting entries are either deferrals or accruals.

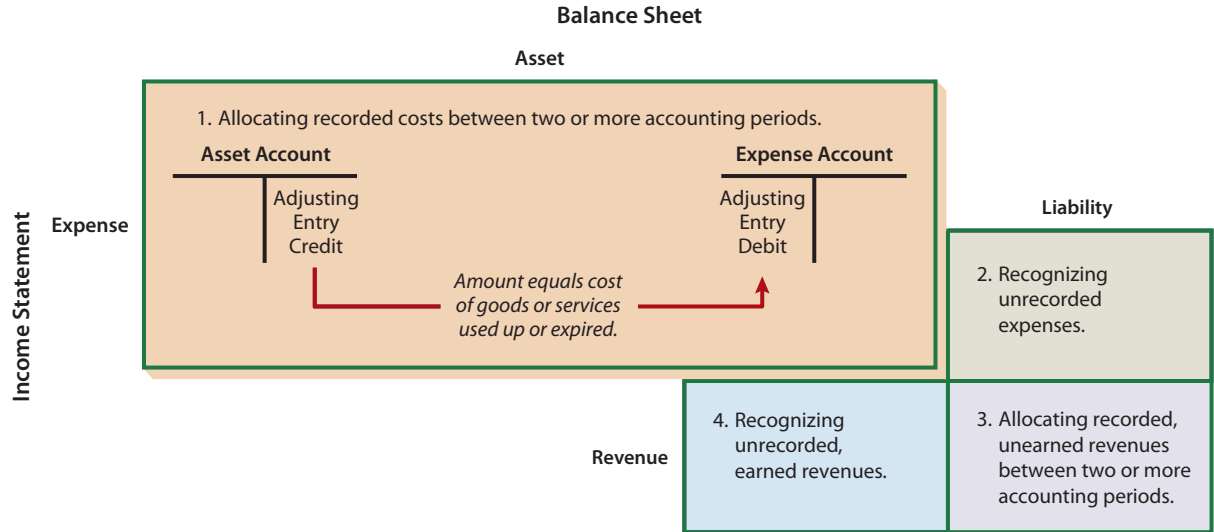
- A **deferral** is the postponement of the *recognition* of an expense already paid (Type 1 adjustment) or of revenue received in advance (Type 3 adjustment). The cash payment or receipt is recorded before the adjusting entry is made.
- An **accrual** is the *recognition* of expense (Type 2 adjustment) or a revenue (Type 4 adjustment) that has arisen but not been recorded during the accounting period. The cash payment or receipt occurs in a future accounting period, after the adjusting entry has been made.

## Type 1 Adjustment: Allocating Recorded Costs (Deferred Expenses)

Companies often make expenditures that benefit more than one period. These costs are debited to an asset account. At the end of an accounting period, the amount of the asset that has been used is transferred from the asset account to an expense account. Two important adjustments of this type are for prepaid expenses and the depreciation of plant and equipment.

**Prepaid Expenses** Companies customarily pay some expenses, including those for rent, supplies, and insurance, in advance. These costs are called **prepaid expenses**. By the end of an accounting period, a portion or all of the prepaid services or goods will have been used. The required adjusting entry reduces the asset and increases the expense, as shown in Exhibit 4. The amount of the adjustment equals the cost of the goods or services used or expired.

**STUDY NOTE:** The expired portion of a prepayment is converted to an expense; the unexpired portion remains an asset.



**Exhibit 4**  
Adjustment for Prepaid  
(Deferred) Expenses

If adjusting entries for prepaid expenses are not made at the end of an accounting period, both the balance sheet and the income statement will present incorrect information. The company’s assets will be overstated, and its expenses will be understated. Thus, owner’s equity on the balance sheet and net income on the income statement will be overstated. Examples of adjusting entries for Blue Design Studio follow.

**Adjustment for Prepaid Rent**

**Transaction** Blue Design Studio paid two months’ rent in advance at the beginning of July. The advance payment resulted in an asset—the right to occupy the office for two months. As each day in the month passed, part of the asset’s cost expired and became an expense. By July 31, one-half of the asset’s cost (\$1,600) had expired.

**Analysis** The journal entry to record the expiration of prepaid rent

- ▼ *decreases* the asset account *Prepaid Rent* with a credit
- ▲ *increases* the expense account *Rent Expense* with a debit

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Prepaid Rent</b>						<b>Rent Expense</b>	
<i>Dr.</i>	<i>Cr.</i>					<i>Dr.</i>	<i>Cr.</i>
July 3 3,200	July 31 1,600					July 31 1,600	
Bal. 1,600							

**Journal Entry**

July 31	Rent Expense	1,600	Dr.	1,600	Cr.	1,600	
	Prepaid Rent						

**Comment** The Prepaid Rent account now has a balance of \$1,600, which represents one month’s rent that will be expensed during August.





Ragnarock/Shutterstock

Think of accounting for supplies as using a storage cabinet in an office. Supplies are put in the cabinet when purchased (assets). Employees take some out and use them during the accounting period (expenses). At the end of the accounting period, the supplies left in the cabinet can be used in the next period (assets).

### Adjustment for Supplies

**Transaction** Blue Design Studio purchased \$5,200 of office supplies in early July. At the end of July, an inventory shows that office supplies costing \$3,660 are still on hand. This means that of the \$5,200 of supplies originally purchased, \$1,540 worth were used (became an expense) by July 31.

**Analysis** The journal entry to record the consumption of office supplies

- ▼ *decreases* the asset account *Office Supplies* with a credit
- ▲ *increases* the expense account *Office Supplies Expense* with a debit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Office Supplies</b>						<b>Office Supplies Expense</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
July 5	5,200		July 31	1,540		July 31	1,540
Bal.	3,660						

Journal Entry	
July 31	Office Supplies Expense
	Office Supplies
	<i>Dr.</i> <i>Cr.</i>
	→ 1,540                      → 1,540

**Comment** The asset account Office Supplies now reflects the correct balance of \$3,660 of supplies yet to be consumed.

**STUDY NOTE:** In accounting, depreciation refers only to the allocation of an asset's cost, not to any decline in the asset's value.

**STUDY NOTE:** The difficulty in estimating an asset's useful life is further evidence that the net income figure is, at best, an estimate.

**Depreciation of Plant and Equipment** When a company buys a long-term asset—such as a building, truck, computer, or store fixture—it is, in effect, prepaying for the usefulness of that asset for as long as it benefits the company. Because a long-term asset is a deferral of an expense, the accountant must allocate the cost of the asset over its estimated useful life. The amount allocated to any one accounting period is called **depreciation** (or *depreciation expense*).

It is often impossible to tell exactly how long an asset will last or how much of the asset has been used in any one period. For this reason, depreciation must be estimated. Accountants have developed a number of methods for estimating depreciation.<sup>2</sup>

To maintain historical costs, separate accounts are used to accumulate the depreciation on each long-term asset. These **Accumulated Depreciation** accounts are called *contra accounts*. A **contra account** is paired with a related account—in our example, an asset account. The balance of a contra account is shown on a financial statement as a deduction from its related account. The net amount is called the **carrying value** (or *book value*) of the asset. As time passes, the accumulated depreciation grows, and the carrying value of the asset declines.

### Adjustment for Plant and Equipment

**Transaction** On July 31, Blue Design Studio records \$300 of depreciation of office equipment.

**Analysis** The journal entry to record depreciation

- ▲ *increases* the contra account *Accumulated Depreciation—Office Equipment* with a credit
- ▲ *increases* the expense account *Depreciation Expense—Office Equipment* with a debit

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Office Equipment</b>						<b>Depreciation Expense— Office Equipment</b>	
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
July 6	16,320					July 31	300
<b>Accumulated Depreciation— Office Equipment</b>							
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
				300			

**Journal Entry**

			<i>Dr.</i>	<i>Cr.</i>
July 31		Depreciation Expense— Office Equipment	300	
		Accumulated Depreciation— Office Equipment		300

**Comment** The carrying value of Office Equipment is \$16,020 (\$16,320 – \$300) and is presented on the balance sheet as follows.

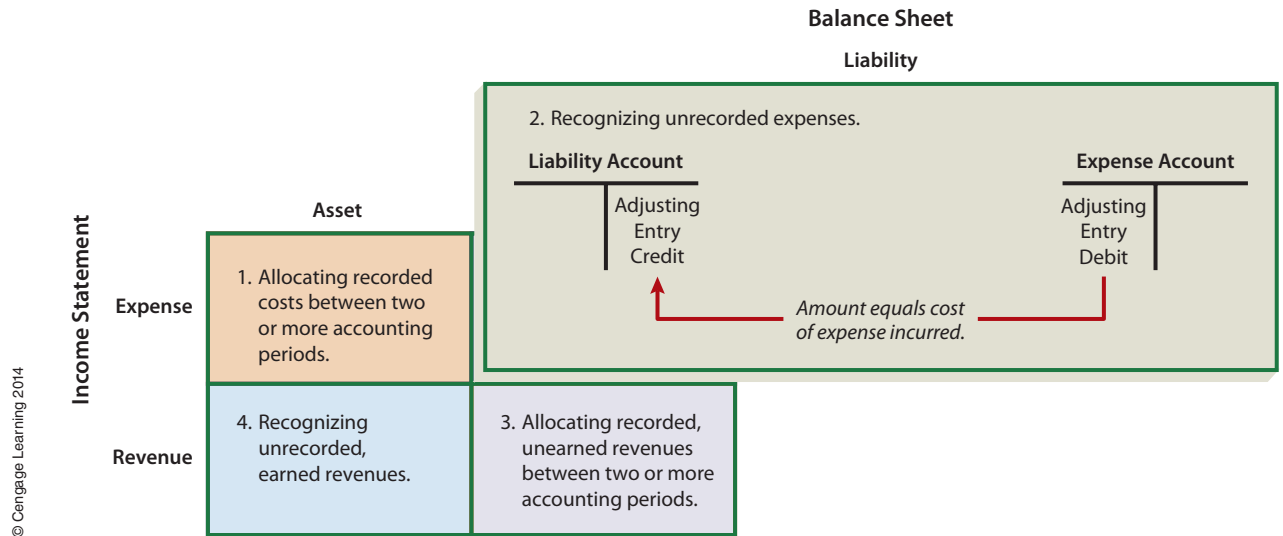
<b>Property, Plant, and Equipment</b>		
Office equipment	\$16,320	
Less accumulated depreciation	300	\$16,020

**Business Application Netflix** has prepaid expenses and property and equipment similar to those in the examples we have presented. Among Netflix’s prepaid expenses are payments to movie companies for rights to DVDs called Prepaid Content. By paying in advance, Netflix is able to negotiate lower prices. These fixed payments are debited to Prepaid Content. When the movies produce revenue, the prepaid amounts are transferred to expense through adjusting entries.<sup>3</sup>

## Type 2 Adjustment: Recognizing Unrecorded Expenses (Accrued Expenses)

**STUDY NOTE:** Remember that in accrual accounting, an expense must be recorded in the period in which it is incurred regardless of when payment is made.

Usually, at the end of an accounting period, some expenses incurred during the period have not been recorded in the accounts. These expenses require adjusting entries. One such expense is interest on borrowed money. Each day, interest accumulates on the debt. As shown in Exhibit 5, an adjusting entry records the accumulated interest, which is an expense of the period, and the corresponding liability to pay the interest. Other common unrecorded expenses are wages and utilities. As the expense and the corresponding liability accumulate, they are said to *accrue*—hence the term **accrued expenses**.



**Exhibit 5**  
Adjustment for Unrecorded (Accrued) Expenses

### Adjustment for Unrecorded (Accrued) Wages

**Transaction** Suppose Blue Design Studio has two pay periods a month rather than one. In July, its pay periods end on the 12th and the 26th, as indicated in the calendar below.

July						
Sun	M	T	W	Th	F	Sa
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

By the end of business on July 31, Blue’s assistant will have worked three days (Monday, Tuesday, and Wednesday) beyond the last pay period. The employee has earned the wages for those days but will not be paid until the first payday in August. The wages for these three days are rightfully an expense for July, and the liabilities should reflect that the company owes the assistant for those days. Because the assistant’s wage rate is \$2,400 every two weeks, or \$240 per day ( $\$2,400 \div 10$  working days), the expense is \$720 ( $\$240 \times 3$  days). On July 31, Blue would record the \$720 accrual of unrecorded wages.

**Analysis** The journal entry to record the accrual of wages

- ▲ increases the owner’s equity account *Wages Expense* with a debit
- ▲ increases the liability account *Wages Payable* with a credit

#### Application of Double Entry

Assets	=	Liabilities	+	Owner’s Equity
		<b>Wages Payable</b>		<b>Wages Expense</b>
		Dr.      Cr.		Dr.      Cr.
		July 31    720		July 26 4,800
				<b>31 720</b>
				Bal. 5,520

#### Journal Entry

	Dr.      Cr.	
July 31    Wages Expense	720	← 720
Wages Payable		→ 720

**Comment** Note that the increase in Wages Expense will *decrease* owner’s equity and that total wages for the month are \$5,520, of which \$720 will be paid next month.

**Business Application** In 2011, **Netflix** had accrued expenses of \$63,693,000. If the expenses had not been accrued, Netflix’s liabilities would be significantly understated, as would the corresponding expenses on Netflix’s income statement. The end result would be an overstatement of the company’s earnings.

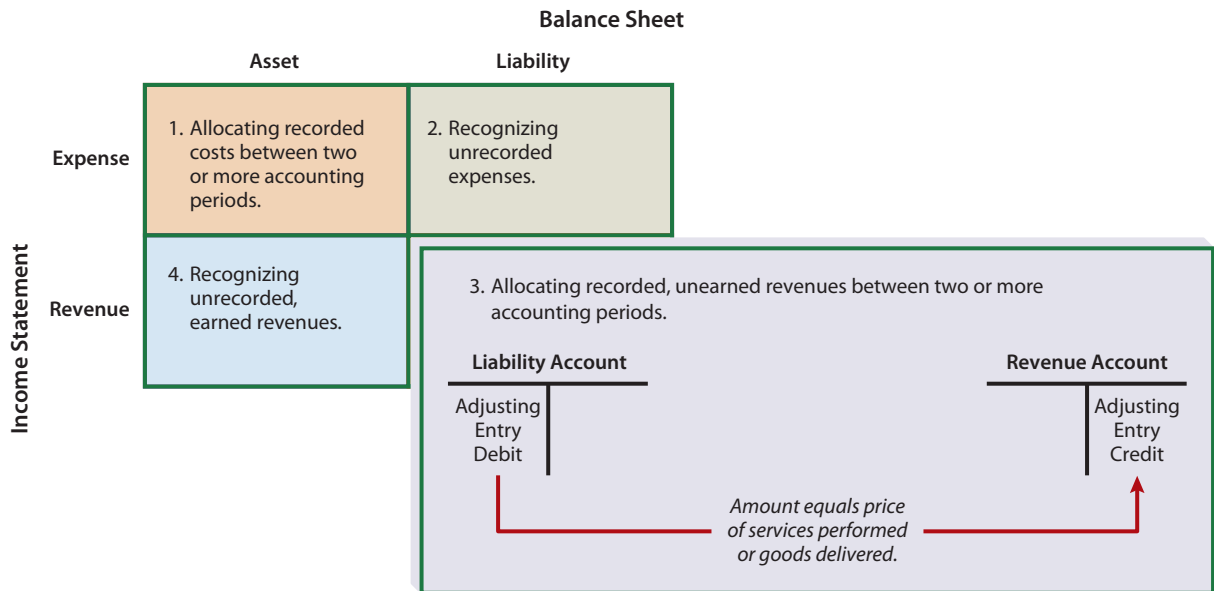
### Type 3 Adjustment: Allocating Recorded, Unearned Revenues (Deferred Revenues)

**STUDY NOTE:** Unearned revenue is a liability because there is an obligation to deliver goods or perform a service, or to return the payment. Once the goods have been delivered or the service performed, the liability is transferred to revenue.

When a company receives revenues in advance, it has an obligation to deliver goods or perform services. **Unearned revenues** are therefore shown in a liability account.

For example, publishing companies usually receive cash in advance for magazine subscriptions. These receipts are recorded in a liability account, Unearned Subscriptions. If the company fails to deliver the magazines, subscribers are entitled to their money back. As the company delivers each issue of the magazine, it earns a part of the advance receipts. This earned portion must be transferred from the Unearned Subscriptions account to the Subscription Revenue account, as shown in Exhibit 6.

**Exhibit 6**  
Adjustment for Unearned (Deferred) Revenues



### Adjustment for Unearned Revenue

**Transaction** During July, Blue Design Studio received \$1,400 from another firm as advance payment for a series of brochures. By the end of the month, it had completed \$800 of work on the brochures, and the other firm had accepted the work. On July 31, Blue would record the performance of services for which \$800 cash was received in advance.

**Analysis** The journal entry to record performing services for which cash was received in advance

- ▲ increases the owner’s equity account *Design Revenue* with a credit
- ▼ decreases the liability account *Unearned Design Revenue* with a debit

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
			<b>Unearned Design Revenue</b>			<b>Design Revenue</b>	
	<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>	
July 31	800		July 19	1,400		July 10	2,800
			Bal.	600		15	9,600
						<b>31</b>	<b>800</b>
						Bal.	13,200

**Journal Entry**

July 31	Unearned Design Revenue	<i>Dr.</i>	800	<i>Cr.</i>	Design Revenue	800
---------	-------------------------	------------	-----	------------	----------------	-----

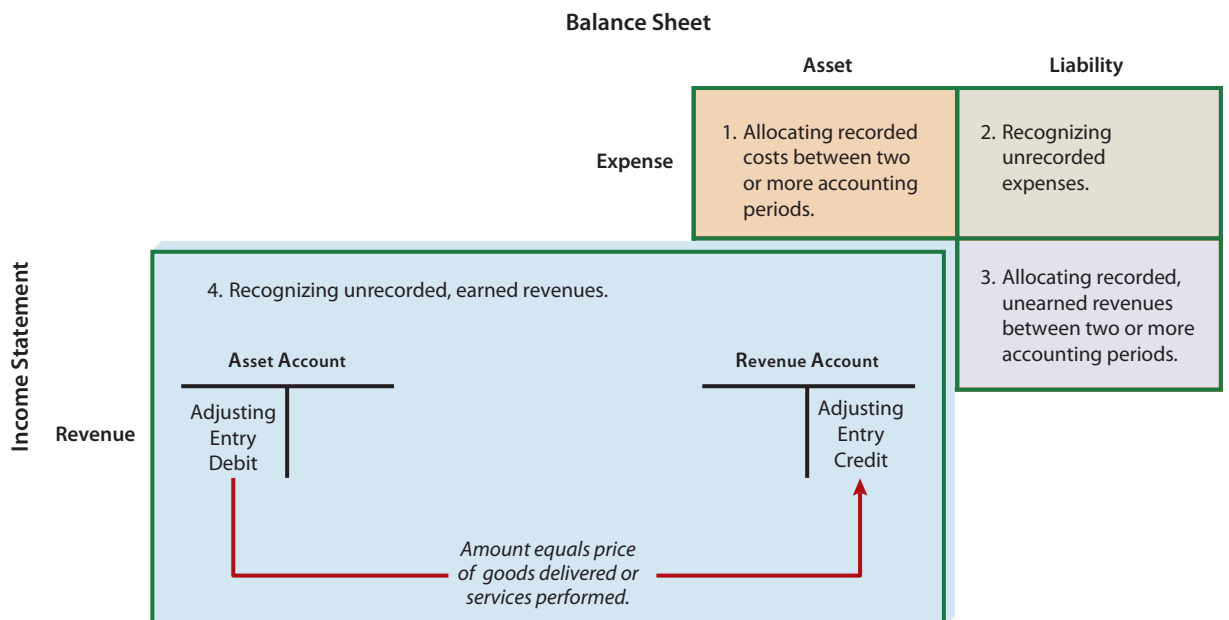
**Comment** Unearned Design Revenue now reflects the amount of work still to be performed, \$600.

**Business Application** Netflix has a current liability account called Deferred (Unearned) Revenue. Deferred revenue consists of subscriptions (monthly payments) billed in advance to customers. Subscription revenues are pro-rated over each subscriber's monthly subscription period. As time passes and customers use the service, the revenue is transferred from Netflix's Deferred Revenue account to its Subscription Revenue account.

**Type 4 Adjustment: Recognizing Unrecorded, Earned Revenues (Accrued Revenues)**

**Accrued revenues** are revenues that a company has earned by performing a service or delivering goods but for which no entry has been made in the accounting records. Any revenues earned but not recorded during an accounting period require an adjusting entry that debits an asset account and credits a revenue account, as shown in Exhibit 7. For example, the interest on a note receivable is earned day by day but may not be received until another accounting period. In this case, Interest Receivable should be

**Exhibit 7**  
Adjustment for Unrecorded (Accrued) Revenues



debited and Interest Income should be credited for the interest accrued at the end of the current period.

When a company earns revenue by performing a service—such as designing a series of brochures—but will not receive the revenue until a future accounting period, it must make an adjusting entry. This type of adjusting entry involves an asset account and a revenue account.

### Adjustment for Design Revenue

**Transaction** During July, Blue Design Studio agrees to create two advertisements for Maggio's Pizza Company and to finish the first advertisement by July 31. By the end of July, Blue has earned \$400 for completing the first advertisement, but it will not bill Maggio's until the entire project has been completed. On July 31, Blue records the accrual of \$400 of unrecorded revenue.

**Analysis** The journal entry to record the accrual of unrecorded revenue

- ▲ *increases* the owner's equity account *Design Revenue* with a credit
- ▲ *increases* the asset account *Accounts Receivable* with a debit

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Accounts Receivable</b>						<b>Design Revenue</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
July 15	9,600		July 22	5,000		July 10	2,800
<b>31</b>	<b>400</b>					15	9,600
Bal.	5,000					31	800
						<b>31</b>	<b>400</b>
						Bal.	13,600

### Journal Entry

	<i>Dr.</i>	<i>Cr.</i>
July 31	Accounts Receivable	
	Design Revenue	
	400	400

**Comment** Design Revenue now reflects the total revenue earned during July, \$13,600. On the balance sheet, revenues that have been earned but not recorded are usually combined with accounts receivable.

**Business Application** Since **Netflix's** subscribers pay their subscriptions in advance by credit card, Netflix does not need to bill customers for services provided but not paid. The company is in the enviable position of having no accounts receivable and thus a high degree of liquidity.

## A Note About Business Transactions

Thus far, we have presented a full analysis of each journal entry and showed you the thought process behind each entry. Because you should now be fully aware of the effects of transactions on the accounting equation and the rules of debit and credit, we present simplified journal entries in the rest of the book.

**APPLY IT!**

On December 31, the end of the current fiscal year, the following information is available to assist Bora Company's accountants in making adjusting entries:

- Bora's Supplies account shows a beginning balance of \$6,000. Purchases during the year were \$10,300. The end-of-year inventory reveals supplies on hand of \$3,000.
  - On July 1, the company completed negotiations with a client and accepted an advance of \$4,800 for services to be performed monthly for a year. The \$4,800 was credited to Unearned Services Revenue.
  - Among the assets of the company is a note receivable in the amount of \$100,000. On December 31, the accrued interest on this note amounted to \$6,000.
  - On Saturday, January 3, the company, which is on a six-day workweek, will pay its regular employees their weekly wages of \$9,000.
- Identify each adjustment as a Type 1, 2, 3, or 4 adjusting entry.
  - Prepare adjusting entries for each item listed.

**SOLUTION**

- a. Type 1; b. Type 3; c. Type 4; d. Type 2
- 

		Dr.	Cr.
a. Dec. 31	Supplies Expense	13,300	
	Supplies		13,300
	To record supplies used ( $\$6,000 + \$10,300 - \$3,000 = \$13,300$ )		
b. Dec. 31	Unearned Services Revenue	2,400	
	Services Revenue		2,400
	To record service revenue earned [( $\$4,800/12$ months) $\times$ 6 months = \$2,400]		
c. Dec. 31	Interest Receivable	6,000	
	Interest Income		6,000
	To record interest earned but not received		
d. Dec. 31	Wages Expense	4,500	
	Wages Payable		4,500
	To record wages incurred but not paid [( $\$9,000/6$ days) $\times$ 3 days = \$4,500]		

**TRY IT! SE2, SE3, SE4, SE5, SE6, E1A, E3A, E4A, E5A, E6A, E7A, E8A, E9A, E1B, E3B, E4B, E5B, E6B, E7B, E8B, E9B**

## **LO 4** Using the Adjusted Trial Balance to Prepare Financial Statements

After adjusting entries have been recorded and posted, an **adjusted trial balance** is prepared by listing all accounts and their balances. If the adjusting entries have been posted to the accounts correctly, the adjusted trial balance will have equal debit and credit totals. Exhibit 8 shows the adjusted trial balance for Blue Design Studio and its relationship to the company's income statement, balance sheet, and statement of owner's equity. Some accounts in Exhibit 8, such as Cash and Accounts Payable, have the same balances as in the trial balance in Exhibit 2 because no adjusting entries affected them. The balances of other accounts, such as Office Supplies and Prepaid Rent, differ from those in the trial balance because adjusting entries did affect them. The adjusted trial balance also includes accounts that do not appear in the trial balance—for example, depreciation accounts and Wages Payable.



**Exhibit 8**

Relationship of the Adjusted Trial Balance to the Income Statement, Statement of Owner's Equity, and Balance Sheet

**Blue Design Studio**  
**Adjusted Trial Balance**  
**July 31, 2014**

Cash	22,480	
Accounts Receivable	5,000	
Office Supplies	3,660	
Prepaid Rent	1,600	
Office Equipment	16,320	
Accumulated Depreciation— Office Equipment		300
Accounts Payable		6,280
Unearned Design Revenue		600
Wages Payable		720
J. Blue, Capital		40,000
J. Blue, Withdrawals	2,800	
Design Revenue		13,600
Wages Expense	5,520	
Utilities Expense	680	
Rent Expense	1,600	
Office Supplies Expense	1,540	
Depreciation Expense— Office Equipment	300	
	<u>61,500</u>	<u>61,500</u>

**Blue Design Studio**  
**Income Statement**  
**For the Month Ended July 31, 2014**

<b>Revenues:</b>		
Design revenue		\$13,600
<b>Expenses:</b>		
Wages expense	\$5,520	
Utilities expense	680	
Rent expense	1,600	
Office supplies expense	1,540	
Depreciation expense— office equipment	300	
<b>Total expenses</b>		<u>9,640</u>
<b>Net income</b>		<u>\$ 3,960</u>

**Blue Design Studio**  
**Statement of Owner's Equity**  
**For the Month Ended July 31, 2014**

J. Blue, capital, July 1, 2014	\$ 0
Investment by J. Blue	40,000
Net income	<u>3,960</u>
Subtotal	\$43,960
Less withdrawals	<u>2,800</u>
J. Blue, capital, July 31, 2014	<u>\$41,160</u>

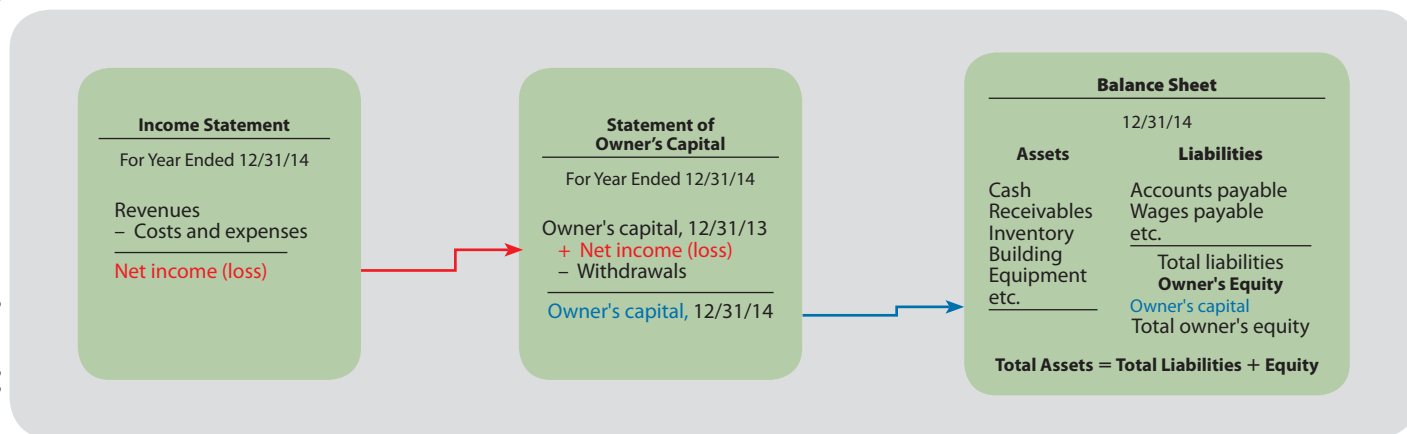
**Blue Design Studio**  
**Balance Sheet**  
**July 31, 2014**

<b>Assets</b>	
Cash	\$22,480
Accounts receivable	5,000
Office supplies	3,660
Prepaid rent	1,600
Office equipment	\$16,320
Less accumulated depreciation	<u>300</u>
Total assets	<u>\$48,760</u>
<b>Liabilities</b>	
Accounts payable	\$ 6,280
Unearned design revenue	600
Wages payable	<u>720</u>
Total liabilities	<u>\$ 7,600</u>
<b>Owner's Equity</b>	
J. Blue, capital	41,160
Total liabilities and owner's equity	<u>\$48,760</u>

**STUDY NOTE:** The net income figure from the income statement is needed to prepare the statement of owner's equity, and the bottom-line figure of that statement is needed to prepare the balance sheet. This dictates the order in which the statements are prepared.

**Exhibit 9**  
Effects of Adjusting Entries on the Financial Statements

© Cengage Learning 2014



The adjusted trial balance facilitates the preparation of the income statement, the statement of owner’s equity, and the balance sheet. As shown in Exhibit 8, the revenue and expense accounts are used to prepare the income statement, and the asset and liability accounts are used to prepare the balance sheet.

Notice that the net income from the income statement is combined with the Withdrawals account on the statement of owner’s equity to give the net change in the J. Blue, Capital account. The balance of J. Blue, Capital at July 31 is used in preparing the balance sheet.

## Adjusting Entries and the Financial Statements

Exhibit 9 shows that adjusting entries always affect at least one balance sheet account and one income statement account but not the statement of cash flows.

### APPLY IT!

The adjusted trial balance for Carroll Company on December 31, 2014, contains the following accounts and balances: D. Carroll, Capital, \$300 (as of December 1, 2014); D. Carroll, Withdrawals, \$100; Service Revenue, \$1,000; Rent Expense, \$300; Wages Expense, \$400; and Telephone Expense, \$100. Compute net income and prepare a statement of owner’s equity in proper form for the month of December.

**SOLUTION**

$$\begin{aligned} \text{Net income} &= \text{Service Revenue} - \text{Rent Expense} - \text{Wages Expense} - \text{Telephone Expense} \\ &= \$1,000 - \$300 - \$400 - \$100 \\ &= \$1,000 - \$800 \\ &= \$200 \end{aligned}$$

**Carroll Company**  
**Statement of Owner’s Equity**  
**For the Month Ended December 31, 2014**

D. Carroll, capital, December 1, 2014	\$300
Net income	<u>200</u>
Subtotal	\$500
Less withdrawals	<u>100</u>
D. Carroll, capital, December 31, 2014	<u>\$400</u>

**TRY IT! SE7, SE8, E10A, E10B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Ethics
- Cash flows
- Liquidity

RELEVANT  
LEARNING OBJECTIVE

**LO 5** Explain the importance of ethical measurement of net income and the relation of net income to cash flows.

## **LO 5** Net Income: Ethical Measurement and Cash Flows

In this section, we consider the ethical measurement of net income and the relation of accrual-based net income to cash flows.

### Ethical Considerations for Business

Account adjustments take time to calculate and enter in the records. Also, adjusting entries do not affect cash flows in the current period because they never involve the Cash account. You might ask, “Why go to all the trouble of making them? Why worry about them?” For one thing, the SEC has identified issues related to *accrual accounting* and adjustments as an area of utmost importance because of the potential for abuse and misrepresentation.<sup>4</sup>

All adjustments are important because of their effect on profitability and liquidity. Adjusting entries affect net income, and they affect profitability comparisons from one period to the next. They also affect assets and liabilities on the balance sheet and thus provide information about a company’s *future* cash inflows and outflows. This information is needed to assess the need for cash to pay ongoing obligations. The potential for abuse arises because judgment underlies the adjusting entries. When this judgment is misused, performance measures can be misleading.

Applying *accrual accounting* involves making assumptions. It also involves exercising judgment. Consider the assumptions and judgment involved in estimating the useful life of a building. The estimate should be based on realistic assumptions, but management has latitude in making that estimate, and its judgment will affect the final net income that is reported.

The manipulation of revenues and expenses to achieve a specific outcome is called **earnings management**. Research has shown that companies that manage their earnings are much more likely to exceed projected earnings targets by a little than to fall short by a little. Management may want to manage earnings to keep them from falling short in order to:

- Meet a previously announced goal and thus meet the expectations of the market.
- Keep the company’s stock price from dropping.
- Meet a goal that will enable it to earn bonuses.
- Avoid embarrassment.

Earnings management, though not the best practice, is not always illegal. However, when the estimates involved in earnings management begin moving outside a reasonable range, the financial statements become misleading. For instance, net income is misleading when revenue is overstated by a significant amount or when expenses are understated by a significant amount. As noted earlier in the text, the preparation of financial statements that are intentionally misleading constitutes fraudulent financial reporting. Evidence of fraudulent financial reporting is often evidenced by lack of sufficient cash flows as explained in the next section.



## Business Perspective

### Adjusting Entries and Fraudulent Financial Reporting

Improper adjusting entries often play an important role in companies that fraudulently prepare the financial statements. The reason is that adjustments may easily be falsely prepared or ignored. The most common fraud technique involved improper *revenue recognition*, followed by the overstatement of existing assets or capitalization of expenses. Revenue may be overstated by simply debiting Accounts Receivable and crediting Revenue. Expenses may be understated by recording expenses as assets or keeping on the balance sheet assets that have been used up. The SEC investigated 347 alleged cases of public company fraudulent financial reporting from 1998 to 2007. Consistent with the high-profile frauds at **Enron**, **WorldCom**, etc., the dollar magnitude of fraudulent financial reporting soared in the last decade, with an average of nearly \$400 million per case.<sup>5</sup>

© Allija / iStockphoto.com

#### CASH FLOW

## Using Accrual-Based Information to Make Management Decisions

Management has the short-range goal of ensuring that it has sufficient cash to ensure the company's liquidity. Ultimately, cash must flow from income-producing activities for a company to be successful. To plan payments to creditors and assess the need for short-term borrowing, managers must know how to use accrual-based information to analyze cash flows.

Almost every revenue or expense account on the income statement has one or more related accounts on the balance sheet. For instance, Supplies Expense is related to Supplies, Wages Expense is related to Wages Payable, and Design Revenue is related to Unearned Design Revenue. As we have shown, these accounts are related by making adjusting entries, the purpose of which is to apply *accrual accounting* to the measurement of net income.

A company's cash inflows and cash outflows can also be determined by analyzing these relationships. For example, suppose that after receiving the financial statements in Exhibit 8, management wants to know how much cash was expended for office supplies. On the income statement, Office Supplies Expense is \$1,540, and on the balance sheet, Office Supplies is \$3,660. Because July was the company's first month of operation, there was no prior balance of office supplies, so the amount of cash expended for office supplies during the month was \$5,200 ( $\$1,540 + \$3,660 = \$5,200$ ). Thus, the cash flow used in purchasing office supplies—\$5,200—was much greater than the amount expended in determining income—\$1,540. Management can anticipate that the cash needed may be less than the amount expended because the company will probably not have to buy office supplies in August. Understanding these cash flow effects enables management to better predict the business's need for cash.

The general rule for determining the cash flow received from any revenue or paid for any expense (except depreciation, which is a special case) is to determine the potential cash payments or cash receipts and deduct the amount not paid or not received. As shown in Exhibit 10, the application of the general rule varies with the type of asset or liability account.



## Business Perspective

### Are Misstatements of Earnings Always Overstatements?

Not all misstatements of earnings are overstatements. For instance, privately held companies, which do not have to be concerned about the effect of their earnings announcements on owners or investors, may understate income to reduce or avoid income taxes. In an unusual case involving a public company, the SEC cited and fined **Microsoft** for understating its income. Microsoft, a very successful company, accomplished this by overstating its unearned revenue on the balance sheet. The company's motive in trying to appear less successful than it actually was may have been that it was facing government charges of being a monopoly.<sup>6</sup>

© Allija / iStockphoto.com

Type of Account	Potential Payment or Receipt Not Paid or Received	Result
Prepaid Expense	Ending Balance + Expense for the Period – Beginning Balance	= Cash Payments for Expenses
Unearned Revenue	Ending Balance + Revenue for the Period – Beginning Balance	= Cash Receipts from Revenues
Accrued Payable	Beginning Balance + Expense for the Period – Ending Balance	= Cash Payments for Expenses
Accrued Receivable	Beginning Balance + Revenue for the Period – Ending Balance	= Cash Receipts from Revenues

### Exhibit 10 Determination of Cash Flows from Accrual-Based Information

For instance, suppose that on May 31, the balance of Prepaid Insurance was \$480, and that on June 30, the balance was \$670. If the insurance expense during June was \$120, the amount of cash expended on insurance during June can be computed as follows.

Prepaid Insurance at June 30	\$670
Insurance Expense during June	<u>120</u>
Potential cash payments for insurance	\$790
Less Prepaid Insurance at May 31	<u>480</u>
Cash payments for insurance during June	<u>\$310</u>

The beginning balance is deducted because it was paid in a prior period. Note that the cash payments equal the expense plus the increase in the balance of the Prepaid Insurance account [ $\$120 + (\$670 - \$480) = \$310$ ]. In this case, the cash paid was almost three times the amount of insurance expense. In future months, cash payments are likely to be less than the expense.

## APPLY IT!

Supplies had a balance of \$400 at the end of May and \$360 at the end of June. Supplies Expense was \$550 for the month of June. How much cash was paid for supplies during June?

### SOLUTION

Supplies at June 30	\$360
Supplies Expense during June	<u>550</u>
Potential cash payments for supplies	\$910
Less Supplies at May 31	<u>400</u>
Cash payments for supplies during June	<u>\$510</u>

**TRY IT! SE9, SE10, E11A, E12A, E11B, E12B**

## TriLevel Problem



Jasmin Awad/iStockphoto

The beginning of this chapter focused on Reliable Answering Service, a company that has many transactions that span accounting periods. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

As we learned in the chapter opener, Reliable has many transactions that will affect future periods like office supplies, prepaid expenses, and unearned revenue. *Why are the concepts of continuity, periodicity, and accrual accounting necessary for Reliable to account for transactions that span accounting periods?*

### Section 2: Accounting Applications

*How does Reliable adjust its revenues and expenses so that its net income is properly measured?*

### Reliable Answering Service

Reliable's trial balance follows.

	A	B	C	D	E
1	<b>Reliable Answering Service</b>				
2	<b>Trial Balance</b>				
3	<b>December 31, 2014</b>				
4					
5	Cash			2,160	
6	Accounts Receivable			1,250	
7	Office Supplies			180	
8	Prepaid Insurance			240	
9	Office Equipment			3,400	
10	Accumulated Depreciation—Office Equipment				600
11	Accounts Payable				700
12	Unearned Revenue				460
13	T. Ramos, Capital				4,870
14	T. Ramos, Withdrawals			400	
15	Answering Service Revenue				2,900
16	Wages Expense			1,500	
17	Rent Expense			400	
18				9,530	9,530
19					

The following information is also available for the company on December 31, 2014:

- Insurance that expired during December amounted to \$40.
- Office supplies on hand on December 31 totaled \$75.
- Depreciation for December totaled \$100.
- Accrued wages on December 31 totaled \$120.
- Revenues earned for services performed in December but not billed by the end of the month totaled \$300.
- Revenues received in advance of services still to be performed totaled \$300 at the end of the year.

### Required

In order to understand how Reliable adjusts its revenues and expenses so that its net income is properly measured, complete the following:

- Determine the required adjusting entries, and record them in the general journal.
- Post the entries to the T accounts. Open new T accounts as needed.
- Prepare an adjusted trial balance.
- Prepare an income statement, a statement of owner's equity, and a balance sheet for the month ended December 31, 2014.

### Section 3: Business Applications

Which accounts on Reliable's income statement are potentially affected by adjusting entries? Which account on Reliable's balance sheet is never affected by an adjusting entry?

## SOLUTION

### Section 1: Concepts

Reliable applies the concept of *continuity* when its accountants assume that it will continue to operate indefinitely. The company applies the concept of *periodicity* by estimating its net income in terms of accounting periods. Reliable uses *accrual accounting* to measure net income by *recognizing revenues* when they are earned, and *recognizing expenses* when they are incurred. This process may require adjustment of income statement and balance sheet accounts except Cash.

**Section 2: Accounting Applications**

- |   |     |     |
|---|-----|-----|
|   | Dr. | Cr. |
| a. Dec. 31 Insurance Expense  | 40  |     |
| Prepaid Insurance   |     | 40  |
| To record expired insurance   |     |     |
| b. Dec. 31 Office Supplies Expense                                  | 105 |     |
| Office Supplies   |     | 105 |
| To record office supplies used (\$180 – \$75 = \$105)               |     |     |
| c. Dec. 31 Depreciation Expense                                     | 100 |     |
| Accumulated Depreciation—Office Equipment                           |     | 100 |
| To record depreciation expense                                      |     |     |
| d. Dec. 31 Wages Expense  | 120 |     |
| Wages Payable   |     | 120 |
| To record wages incurred but not paid                               |     |     |
| e. Dec. 31 Accounts Receivable                                      | 300 |     |
| Answering Service Revenue   |     | 300 |
| To record revenues earned but not received                          |     |     |
| f. Dec. 31 Unearned Revenues  | 160 |     |
| Answering Service Revenue   |     | 160 |
| To record revenues earned by end of year<br>(\$460 – \$300 = \$160) |     |     |

2.

	A	B	C	D	E	F	G	H	I	J	K	L	M	N
<b>1</b>	<b>Cash</b>				<b>Accounts Receivable</b>					<b>Office Supplies</b>				
<b>2</b>	Bal.	2,160			Bal.	1,250				Bal.	180	(b)	105	
<b>3</b>					(e)	300				Bal.	75			
<b>4</b>					Bal.	1,550								
<b>5</b>					<b>Accumulated Depreciation—</b>					<b>Office Equipment</b>				
<b>6</b>	<b>Prepaid Insurance</b>				<b>Office Equipment</b>					<b>Office Equipment</b>				
<b>7</b>	Bal.	240	(a)	40	Bal.	3,400						Bal.	600	
<b>8</b>	Bal.	200											(c)	100
<b>9</b>												Bal.	700	
<b>10</b>					<b>Unearned Revenue</b>					<b>Wages Payable</b>				
<b>11</b>	<b>Accounts Payable</b>				(f)	160	Bal.	460					(d)	120
<b>12</b>			Bal.	700				Bal.	300					
<b>13</b>					<b>T. Ramos, Withdrawals</b>					<b>Answering</b>				
<b>14</b>	<b>T. Ramos, Capital</b>				Bal.	400				<b>Service Revenue</b>				
<b>15</b>			Bal.	4,870								Bal.	2,900	
<b>16</b>													(e)	300
<b>17</b>													(f)	160
<b>18</b>												Bal.	3,360	
<b>19</b>					<b>Rent Expense</b>					<b>Insurance Expense</b>				
<b>20</b>	<b>Wages Expense</b>				Bal.	400				(a)	40			
<b>21</b>	Bal.	1,500												
<b>22</b>	(d)	120			<b>Depreciation Expense—</b>									
<b>23</b>	Bal.	1,620			<b>Office Equipment</b>									
<b>24</b>					(c)	100								
<b>25</b>	<b>Office Supplies Expense</b>				<b>Office Equipment</b>									
<b>26</b>	(b)	105												
<b>27</b>														
<b>28</b>														



3.

	A	B	C	D	E
1	<b>Reliable Answering Service</b>				
2	<b>Adjusted Trial Balance</b>				
3	<b>December 31, 2014</b>				
4					
5	Cash			2,160	
6	Accounts Receivable			1,550	
7	Office Supplies			75	
8	Prepaid Insurance			200	
9	Office Equipment			3,400	
10	Accumulated Depreciation—Office Equipment				700
11	Accounts Payable				700
12	Unearned Revenue				300
13	Wages Payable				120
14	T. Ramos, Capital				4,870
15	T. Ramos, Withdrawals			400	
16	Answering Service Revenue				3,360
17	Wages Expense			1,620	
18	Rent Expense			400	
19	Insurance Expense			40	
20	Office Supplies Expense			105	
21	Depreciation Expense—Office Equipment			100	
22				10,050	10,050
23					

4.

	A	B	C	D	E
1	<b>Reliable Answering Service</b>				
2	<b>Income Statement</b>				
3	<b>For the Month Ended December 31, 2014</b>				
4					
5	<b>Revenues</b>				
6		Answering service revenue			\$3,360
7					
8	<b>Expenses</b>				
9		Wages expense		\$1,620	
10		Rent expense		400	
11		Insurance expense		40	
12		Office supplies expense		105	
13		Depreciation expense—office equipment		100	
14		Total expenses			2,265
15	<b>Net income</b>				
16					\$1,095

	A	B	C	D	E
1	<b>Reliable Answering Service</b>				
2	<b>Statement of Owner's Equity</b>				
3	<b>For the Month Ended December 31, 2014</b>				
4					
5	T. Ramos, capital, November 30, 2014				\$4,870
6	Net income				1,095
7	Subtotal				\$5,965
8	Less T. Ramos, withdrawals				400
9	T. Ramos, capital, December 31, 2014				\$5,565
10					

	A	B	C	D	E
1	<b>Reliable Answering Service</b>				
2	<b>Balance Sheet</b>				
3	<b>December 31, 2014</b>				
4					
5	<b>Assets</b>				
6	Cash				\$2,160
7	Accounts receivable				1,550
8	Office supplies				75
9	Prepaid insurance				200
10	Office equipment		\$3,400		
11		Less accumulated depreciation	700		2,700
12	Total assets				\$6,685
13					
14	<b>Liabilities</b>				
15	Accounts payable				\$ 700
16	Unearned revenue				300
17	Wages payable				120
18	Total liabilities				\$1,120
19					
20	<b>Owner's Equity</b>				
21	T. Ramos, capital, December 31, 2014				5,565
22	Total liabilities and owner's equity				\$6,685
23					
24					

### Section 3: Business Applications

All accounts on the income statement are potentially affected by adjusting entries. On the other hand, cash on the balance sheet is never affected by an adjusting entry.

## Chapter Review

Define *net income*, and explain the concepts underlying income measurement. **LO 1**

Net income is the net increase in owner's equity that results from a company's operations. Net income equals revenues minus expenses; when expenses exceed revenues, a net loss results. Revenues equal the price of goods sold or services rendered during a specific period. Expenses are the costs of goods and services used in the process of producing revenues.

The continuity assumption recognizes that, without evidence to the contrary, accountants must assume that a business will continue to operate indefinitely. The periodicity assumption recognizes that it is useful to estimate the business's net income in terms of accounting periods. Accrual accounting holds that revenues must be assigned to the period in which the goods are sold or the services performed, and expenses must be assigned to the period in which they are used to produce revenue.

Distinguish cash basis of accounting from accrual accounting, and explain how accrual accounting is accomplished. **LO 2**

The cash basis of accounting is based on cash received and cash paid. In contrast, accrual accounting consists of all the techniques accountants use to measure net income, which include recognizing revenues when they are earned, expenses when they are incurred, and adjusting the accounts.

**Identify four situations that require adjusting entries, and illustrate typical adjusting entries.** **LO 3**

Adjusting entries are required when (1) recorded costs must be allocated between two or more accounting periods; (2) unrecorded expenses exist; (3) recorded, unearned revenues must be allocated between two or more periods; and (4) unrecorded, earned revenues exist. The preparation of adjusting entries is summarized as follows.

Type of Adjusting Entry	Type of Account		Examples of Balance Sheet Accounts
	Debited	Credited	
1. Allocating recorded costs (previously paid, expired)	Expense	Asset (or contra-asset)	Prepaid rent Prepaid insurance Office supplies Accumulated depreciation—office equipment
2. Accrued expenses (incurred, not paid)	Expense	Liability	Interest payable Wages payable
3. Allocating recorded, unearned revenues (previously received, earned)	Liability	Revenue	Unearned revenue
4. Accrued revenues (earned, not received)	Asset	Revenue	Accounts receivable Interest receivable

**Prepare financial statements from an adjusted trial balance.** **LO 4**

An adjusted trial balance is prepared after adjusting entries have been posted to the accounts. Its purpose is to test whether total debits equal total credits after the adjusting entries have been posted and before the financial statements are prepared. The balances in the revenue and expense accounts in the adjusted trial balance are used to prepare the income statement. The balances in the asset and liability accounts in the adjusted trial balance and in the statement of owner's equity are used to prepare the balance sheet.

**Explain the importance of ethical measurement of net income and the relation of net income to cash flows.** **LO 5**

Because applying accrual accounting involves making assumptions and exercising judgment, it can lead to earnings management, which is the manipulation of revenues and expenses to achieve a specific outcome. When the estimates involved in earnings management move outside a reasonable range, financial statements become misleading. Financial statements that are intentionally misleading constitute fraudulent financial reporting.

To ensure a company's liquidity, managers must know how to use accrual-based information to analyze cash flows. The general rule for determining the cash flow received from any revenue or paid for any expense (except depreciation) is to determine the potential cash payments or cash receipts and deduct the amount not received or not paid.

## Key Terms

<b>accrual</b> 91 (LO3)	<b>cash basis of accounting</b> 88 (LO2)	<b>interim periods</b> 87 (LO1)
<b>accrual accounting (matching rule)</b> 87 (LO1)	<b>continuity</b> 87 (LO1)	<b>net income</b> 86 (LO1)
<b>accrued expenses</b> 94 (LO3)	<b>contra account</b> 93 (LO3)	<b>net loss</b> 86 (LO1)
<b>accrued revenues</b> 97 (LO3)	<b>deferral</b> 91 (LO3)	<b>periodicity</b> 87 (LO1)
<b>Accumulated Depreciation</b> 93 (LO3)	<b>depreciation</b> 93 (LO3)	<b>prepaid expenses</b> 91 (LO3)
<b>adjusted trial balance</b> 99 (LO4)	<b>earnings management</b> 102 (LO5)	<b>revenue recognition</b> 88 (LO2)
<b>adjusting entries</b> 90 (LO3)	<b>expenses</b> 86 (LO1)	<b>revenues</b> 86 (LO1)
<b>carrying value</b> 93 (LO3)	<b>fiscal year</b> 87 (LO1)	<b>unearned revenues</b> 96 (LO3)
	<b>going concern</b> 87 (LO1)	

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1.** When a company has net income, what happens to its assets and/or to its liabilities?
- LO 3 **DQ2.** Will the carrying value of a long-term asset normally equal its market value?
- LO 5 **DQ3.** If, at the end of the accounting period, you were looking at the T account for a prepaid expense like supplies, would you look for the amounts expended in cash on the debit or credit side? On which side would you find the amount expended during the period?
- LO 5 **DQ4. BUSINESS APPLICATION** ► Is accrual accounting more closely related to a company's goal of profitability or liquidity?
- LO 5 **DQ5. BUSINESS APPLICATION** ► Would you expect net income to be a good measure of a company's liquidity? Why or why not?
- LO 5 **DQ6. BUSINESS APPLICATION** ► Can you think of some situations when earnings management is acceptable?

### SHORT EXERCISES

#### LO 1, 2 **Accrual Accounting Concepts**

**SE1. CONCEPT** ► Match the concepts of accrual accounting that follow with the appropriate assumptions or actions.

- |  |                        |
|--|------------------------|
| 1. Assumes expenses should be assigned to the accounting period in which they are used to produce revenues | a. Periodicity         |
| 2. Assumes a business will last indefinitely   | b. Continuity          |
| 3. Assumes revenues are earned at a point in time  | c. Accrual accounting  |
| 4. Assumes net income that is measured for a short period of time, such as one quarter                     | d. Revenue recognition |

#### LO 3 **Adjustment for Prepaid Insurance**

**SE2.** The Prepaid Insurance account began the year with a balance of \$460. During the year, insurance in the amount of \$1,040 was purchased. At the end of the year (December 31), the amount of insurance still unexpired was \$700. Prepare the year-end journal entry to record the adjustment for insurance expense for the year.

**LO 3 Adjustment for Supplies**

**SE3.** The Supplies account began the year with a balance of \$380. During the year, supplies in the amount of \$980 were purchased. At the end of the year (December 31), the inventory of supplies on hand was \$440. Prepare the year-end journal entry to record the adjustment for supplies expense for the year.

**LO 3 Adjustment for Depreciation**

**SE4.** The depreciation expense on office equipment for the month of March is \$100. This is the third month that the office equipment, which cost \$1,900, has been owned. Prepare the adjusting entry to record depreciation for March and show the balance sheet presentation for office equipment and related accounts after the March 31 adjustment.

**LO 3 Adjustment for Accrued Wages**

**SE5.** Wages are paid each Saturday for a six-day workweek. Wages are currently \$1,380 per week. Prepare the adjusting entry required on June 30, assuming July 1 falls on a Tuesday.

**LO 3 Adjustment for Unearned Revenue**

**SE6.** During the month of August, deposits in the amount of \$1,100 were received for services to be performed. By the end of the month, services in the amount of \$760 had been performed. Prepare the necessary adjustment for Service Revenue at the end of the month.

**LO 4 Preparation of an Income Statement and Statement of Owner's Equity from an Adjusted Trial Balance**

**SE7.** Shah Company's adjusted trial balance on December 31, 2014, contains the following accounts and balances: A. Shah, Capital, \$8,600; A. Shah, Withdrawals, \$350; Service Revenue, \$2,600; Rent Expense, \$400; Wages Expense, \$900; Utilities Expense, \$200; and Telephone Expense, \$50. Prepare an income statement and statement of owner's equity for the month of December.

**LO 4 Preparation of an Income Statement and Statement of Owner's Equity from an Adjusted Trial Balance**

**SE8.** Malesherbes Company's adjusted trial balance on June 30, 2014, contains the following accounts and balances: C. Fondren, Capital, \$12,750; C. Fondren, Withdrawals, \$580; Service Revenue, \$6,300; Rent Expense, \$900; Wages Expense, \$1,050; Utilities Expense, \$300; and Telephone Expense, \$90. Prepare an income statement and statement of owner's equity for the month of June.

**LO 5 Determination of Cash Flows**

**SE9. BUSINESS APPLICATION** ► Unearned Revenue had a balance of \$650 at the end of November and \$450 at the end of December. Service Revenue was \$2,550 for the month of December. How much cash was received for services provided during December?

**LO 5 Determination of Cash Flows**

**SE10. BUSINESS APPLICATION** ► Unearned Revenue had a balance of \$1,120 at the end of November and \$890 at the end of December. Service Revenue was \$4,600 for the month of December. How much cash was received for services provided during December?

## EXERCISES: SET A

### LO 1, 2, 3 Applications of Accounting Concepts Related to Accrual Accounting

**E1A. CONCEPT** ▶ Carlos Company's accountant makes the assumptions or performs the activities listed below. Tell which of the following concepts of accrual accounting most directly relates to each assumption or action: (a) periodicity, (b) continuity, (c) accrual accounting, (d) revenue recognition, (e) deferral, and (f) accrual.

1. Recognizes the usefulness of financial statements prepared on a monthly basis even though they are based on estimates.
2. Prepares an income statement that shows the revenues earned and the expenses incurred during the accounting period.
3. In estimating the life of a building, assumes that the business will last indefinitely.
4. Postpones the recognition of a one-year insurance policy as an expense by initially recording the expenditure as an asset.
5. Records a sale when the customer is billed.
6. Recognizes, by making an adjusting entry, wages expense that has been incurred but not yet recorded.

### LO 2 Application of Conditions for Revenue Recognition

**E2A. CONCEPT** ▶ Four conditions must be met before revenue should be recognized. In each of the following cases, tell which condition has *not* been met:

- a. Company Alpha accepts a contract to perform services in the future for \$4,000.
- b. Company Beta ships products worth \$6,000 to another company without an order from the other company but tells the company it can return the products if it does not sell them.
- c. Company Centric performs \$20,000 of services for a firm with financial problems.
- d. Company Radiant agrees to work out a price later for services that it performs for another company.

### LO 3 Adjusting Entry for Unearned Revenue

**E3A.** Stardust publishes a monthly magazine featuring local restaurant reviews and upcoming social, cultural, and sporting events. Subscribers pay for subscriptions either one year or two years in advance. Cash received from subscribers is credited to an account called Magazine Subscriptions Received in Advance. On December 31, 2014, the end of the company's fiscal year, the balance of this account is \$750,000. Expiration of subscriptions revenue is as follows.

During 2014	\$150,000
During 2015	375,000
During 2016	225,000

Prepare the adjusting entry for December 31, 2014.

### LO 3 Adjusting Entries for Prepaid Insurance

**E4A.** An examination of the Prepaid Insurance account shows a balance of \$10,280 at the end of an accounting period, before adjustment. Prepare journal entries to record the insurance expense for the period under the following independent assumptions:

1. An examination of the insurance policies shows unexpired insurance that cost \$4,935 at the end of the period.
2. An examination of the insurance policies shows insurance that cost \$1,735 has expired during the period.

**LO 3 Adjusting Entries for Supplies: Missing Data**

**E5A.** Each of the following columns represents a Supplies account:

	<b>a</b>	<b>b</b>	<b>c</b>	<b>d</b>
Supplies on hand at June 1	\$264	\$217	\$196	\$ ?
Supplies purchased during the month	52	?	174	1,928
Supplies consumed during the month	194	972	?	1,632
Supplies on hand at June 30	?	436	56	1,118

1. Determine the amounts indicated by the question marks.
2. Make the adjusting entry for column **a**, assuming supplies purchased are debited to an asset account.

**LO 3 Adjusting Entry for Accrued Salaries**

**E6A.** Kindle Company has a five-day workweek and pays salaries of \$70,000 each Friday.

1. Prepare the adjusting entry required on May 31, assuming that June 1 falls on a Wednesday.
2. Prepare the journal entry to pay the salaries on June 3, including the amount of salaries payable from requirement 1.

**LO 3 Revenue and Expense Recognition**

**E7A.** Lacoma Company produces computer software that Kozuch Company sells. Lacoma receives a royalty of 15 percent of sales. Kozuch pays royalties to Lacoma semi-annually—on May 1 for sales made in July through December of the previous year and on November 1 for sales made in January through June of the current year. Royalty expense for Kozuch and royalty income for Lacoma in the amount of \$12,000 were accrued on December 31, 2013. Cash in the amounts of \$12,000 and \$20,000 was paid and received on May 1 and November 1, 2014, respectively. Software sales during the July to December 2014 period totaled \$300,000.

1. Calculate the amount of royalty expense for Kozuch and royalty income for Lacoma during 2014.
2. Record the adjusting entry that each company made on December 31, 2014.

**LO 3 Accounting for Revenue Received in Advance**

**E8A.** Chris Gayle, a lawyer, received \$72,000 on October 1 to represent a client in real estate negotiations over the next 12 months.

1. Prepare the journal entries required in Gayle's records on October 1 and at the end of the fiscal year, December 31.
2. **ACCOUNTING CONNECTION** ► How would this transaction be reflected on the income statement and balance sheet on December 31?

**LO 3 Adjusting Entries**

**E9A.** Prepare year-end adjusting entries for each of the following:

1. Office Supplies has a balance of \$168 on January 1. Purchases debited to Office Supplies during the year amount to \$830. A year-end inventory reveals supplies of \$570 on hand.
2. Depreciation of office equipment is estimated to be \$4,260 for the year.
3. Property taxes for six months, estimated at \$1,750, have accrued but have not been recorded.
4. Unrecorded interest income on U.S. government bonds is \$1,700.
5. Unearned Revenue has a balance of \$1,800. Services for \$600 received in advance have now been performed.
6. Services totaling \$400 have been performed; the customer has not yet been billed.



**LO 4 Preparation of Financial Statements**

**E10A.** Prepare the monthly income statement, monthly statement of owner's equity, and the balance sheet at August 31, 2014, for Krishna Cleaning Company from the data provided in the adjusted trial balance that follows. The owner made no investments during the period.

**Krishna Cleaning Company**  
**Adjusted Trial Balance**  
**August 31, 2014**

Cash	4,590	
Accounts Receivable	2,592	
Prepaid Insurance	380	
Prepaid Rent	200	
Cleaning Supplies	152	
Cleaning Equipment	3,200	
Accumulated Depreciation—Cleaning Equipment		320
Truck	7,200	
Accumulated Depreciation—Truck		720
Accounts Payable		420
Wages Payable		80
Unearned Janitorial Revenue		920
A. Ambrose, Capital		15,034
A. Ambrose, Withdrawals	2,000	
Janitorial Revenue		14,620
Wages Expense	5,680	
Rent Expense	1,200	
Gas, Oil, and Other Truck Expenses	580	
Insurance Expense	380	
Supplies Expense	2,920	
Depreciation Expense—Cleaning Equipment	320	
Depreciation Expense—Truck	720	
	32,114	32,114

**LO 5 Determination of Cash Flows**

**E11A. BUSINESS APPLICATION** ► After adjusting entries had been made, Infosys Company's balance sheets showed the following asset and liability amounts at the end of 2013 and 2014:

	2014	2013
Prepaid insurance	\$1,200	\$1,450
Wages payable	600	1,100
Unearned fees	2,100	950

The following amounts were taken from the 2014 income statement:

Insurance expense	\$1,900
Wages expense	9,750
Fees earned	4,450

Calculate the amount of cash paid for insurance and wages and the amount of cash received for fees during 2014.

LO 5

**Relationship of Expenses to Cash Paid**

CASH FLOW

**E12A. BUSINESS APPLICATION** ► Wipro Company's income statement included the following expenses for 2014:

Rent expense	\$ 78,000
Interest expense	11,700
Salaries expense	124,500

The related balance sheet account balances at year end for last year and this year follow.

	Last Year	This Year
Prepaid rent	—	\$ 1,350
Interest payable	\$1,800	—
Salaries payable	7,500	18,000

1. Compute the cash paid for rent during the year.
2. Compute the cash paid for interest during the year.
3. Compute the cash paid for salaries during the year.

**EXERCISES: SET B**

Visit the textbook companion web site at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS**

LO 3

**Determining Adjustments**

✓ d: Revenue balance: \$9,150

**P1.** At the end of the first three months of operation, Kubose Answering Service's trial balance appears as follows. Dhaval Bose, Kubose's owner, has hired an accountant to prepare financial statements to determine how well the company is doing after three months. Upon examining the accounting records, the accountant finds the following items of interest:

- a. An inventory of office supplies reveals supplies on hand of \$133.
- b. The Prepaid Rent account includes the rent for the first three months plus a deposit for April's rent.
- c. Depreciation on the equipment for the first three months is \$208.
- d. The balance of the Unearned Answering Service Revenue account represents a 12-month service contract paid in advance on February 1.
- e. On March 31, accrued wages total \$80.

**Kubose Answering Service  
Trial Balance  
March 31, 2014**

Cash	3,482	
Accounts Receivable	4,236	
Office Supplies	903	
Prepaid Rent	800	
Equipment	4,700	
Accounts Payable		2,673
Unearned Answering Service Revenue		888
D. Bose, Capital		5,933
D. Bose, Withdrawals	2,130	
Answering Service Revenue		9,002
Wages Expense	1,900	
Office Cleaning Expense	345	
	<u>18,496</u>	<u>18,496</u>

*(Continued)*

**REQUIRED**

All adjustments affect one balance sheet account and one income statement account. For each of these situations, show the accounts affected, the amount of the adjustment (using a + or – to indicate an increase or decrease), and the balance of the account after the adjustment in the following format:

Balance Sheet Account	Amount of Adjustment (+ or –)	Balance After Adjustment	Income Statement Account	Amount of Adjustment (+ or –)	Balance After Adjustment
-----------------------	-------------------------------	--------------------------	--------------------------	-------------------------------	--------------------------

## LO 2, 3

## GENERAL LEDGER

✓ 1b: Debit to Insurance Expense: \$6,874

**Preparing Adjusting Entries**

**P2.** On November 30, the end of the current fiscal year, the following information is available to assist Allerton Company's accountants in making adjusting entries:

- Allerton's Supplies account shows a beginning balance of \$2,350. Purchases during the year were \$4,218. The end-of-year inventory reveals supplies on hand of \$1,397.
- The Prepaid Insurance account shows the following on November 30:

Beginning balance	\$4,720
July 1	4,200
October 1	7,272

The beginning balance represents the unexpired portion of a one-year policy purchased in September of the previous year. The July 1 entry represents a new one-year policy, and the October 1 entry represents additional coverage in the form of a three-year policy.

- The following table contains the cost and annual depreciation for buildings and equipment, all of which Allerton purchased before the current year:

Account	Cost	Annual Depreciation
Buildings	\$298,000	\$16,000
Equipment	374,000	40,000

- On October 1, the company completed negotiations with a client and accepted an advance of \$18,600 for services to be performed monthly for a year. The \$18,600 was credited to Unearned Services Revenue.
- The company calculated that, as of November 30, it had earned \$7,000 on an \$11,000 contract that would be completed and billed in January.
- Among the liabilities of the company is a note payable in the amount of \$300,000. On November 30, the accrued interest on this note amounted to \$18,000.
- On Saturday, December 2, the company, which is on a six-day workweek, will pay its regular employees their weekly wages of \$15,000.
- On November 29, the company completed negotiations and signed a contract to provide services to a new client at an annual rate of \$23,000.

**REQUIRED**

- Prepare adjusting entries for each item listed above.
- CONCEPT** ► Explain how the conditions for revenue recognition are applied to transactions e and h.

LO 3, 4

**Determining Adjusting Entries, Posting to T Accounts, and Preparing an Adjusted Trial Balance**

GENERAL LEDGER

✓ 3: Adjusted trial balance:  
\$106,167

P3. Kinokawa Consultants Company's trial balance on December 31, 2014, follows.

**Kinokawa Consultants Company  
Trial Balance  
December 31, 2014**

Cash	12,786	
Accounts Receivable	24,840	
Office Supplies	991	
Prepaid Rent	1,400	
Office Equipment	6,700	
Accumulated Depreciation—Office Equipment		1,600
Accounts Payable		1,820
Notes Payable		10,000
Unearned Service Revenue		2,860
K. Wah, Capital		29,387
K. Wah, Withdrawals	15,000	
Service Revenue		58,500
Salaries Expense	33,000	
Utilities Expense	1,750	
Rent Expense	7,700	
	<u>104,167</u>	<u>104,167</u>

The following information is also available:

- Ending inventory of office supplies, \$86
- Prepaid rent expired, \$700
- Depreciation of office equipment for the period, \$600
- Interest accrued on the note payable, \$600
- Salaries accrued at the end of the period, \$200
- Service revenue still unearned at the end of the period, \$1,410
- Service revenue earned but not billed, \$600

**REQUIRED**

- Open T accounts for the accounts in the trial balance plus the following: Interest Payable; Salaries Payable; Office Supplies Expense; Depreciation Expense—Office Equipment; and Interest Expense. Enter the account balances.
- Determine the adjusting entries and post them directly to the T accounts.
- Prepare an adjusted trial balance.
- ACCOUNTING CONNECTION** ► Which financial statements do each of the above adjustments affect? What financial statement is *not* affected by the adjustments?

## LO 3, 4

**Determining Adjusting Entries and Tracing Their Effects to Financial Statements**

SPREADSHEET

GENERAL LEDGER

✓ 4: Adjusted trial balance:  
\$633,209

**P4.** Hertz Limo Service was organized to provide limousine service between the airport and various suburban locations. It has just completed its second year of business. Its trial balance follows.

**Hertz Limo Service**  
**Trial Balance**  
**June 30, 2014**

Cash (111)	9,812	
Accounts Receivable (113)	14,227	
Prepaid Rent (117)	12,000	
Prepaid Insurance (118)	4,900	
Prepaid Maintenance (119)	12,000	
Spare Parts (140)	11,310	
Limousines (148)	200,000	
Accumulated Depreciation—Limousines (149)		25,000
Notes Payable (211)		45,000
Unearned Passenger Service Revenue (212)		30,000
A. Phylum, Capital (311)		78,211
A. Phylum, Withdrawals (313)	20,000	
Passenger Service Revenue (411)		428,498
Gas and Oil Expense (510)	89,300	
Salaries Expense (511)	206,360	
Advertising Expense (513)	26,800	
	<u>606,709</u>	<u>606,709</u>

The following information is also available:

- To obtain space at the airport, Hertz paid two years' rent in advance when it began the business.
- An examination of insurance policies reveals that \$2,800 expired during the year.
- To provide regular maintenance for the vehicles, Hertz deposited \$12,000 with a local garage. An examination of maintenance invoices reveals charges of \$10,944 against the deposit.
- An inventory of spare parts shows \$1,902 on hand.
- Hertz depreciates all of its limousines at the rate of 12.5 percent per year. No limousines were purchased during the year. (Round answer to the nearest dollar.)
- A payment of \$1,500 for one full year's interest on notes payable is now due.
- Unearned Passenger Service Revenue on June 30 includes \$17,815 for tickets that employers purchased for use by their executives but which have not yet been redeemed.

**REQUIRED**

- Determine the adjusting entries and enter them in the general journal (Page 14).
- Open ledger accounts for the accounts in the trial balance plus the following: Interest Payable (213); Rent Expense (514); Insurance Expense (515); Spare Parts Expense (516); Depreciation Expense—Limousines (517); Maintenance Expense (518); and Interest Expense (519). Record the balances shown in the trial balance.
- Post the adjusting entries from the general journal to the ledger accounts, showing proper references.
- Prepare an adjusted trial balance, an income statement, a statement of owner's equity, and a balance sheet. The owner made no investments during the period.
- ACCOUNTING CONNECTION** ► What effect do the adjusting entries have on the income statement?

LO 3 **Determining Adjustments**

✓ e: Unearned Cleaning Revenue  
balance: \$1,200

**P5.** At the end of its fiscal year, Berwyn Cleaners' trial balance is as follows.

<b>Berwyn Cleaners Trial Balance September 30, 2014</b>		
Cash	11,788	
Accounts Receivable	26,494	
Prepaid Insurance	3,400	
Cleaning Supplies	7,374	
Land	18,000	
Building	185,000	
Accumulated Depreciation—Building		45,600
Accounts Payable		20,400
Unearned Cleaning Revenue		1,600
Mortgage Payable		110,000
F. Berwyn, Capital		56,560
F. Berwyn, Withdrawals	10,000	
Cleaning Revenue		157,634
Wages Expense	101,330	
Cleaning Equipment Rental Expense	6,000	
Delivery Truck Expense	4,374	
Interest Expense	11,000	
Other Expenses	7,034	
	<u>391,794</u>	<u>391,794</u>

The following information is also available:

- a. A study of the company's insurance policies shows that \$680 is unexpired at the end of the year.
- b. An inventory of cleaning supplies shows \$1,244 on hand.
- c. Estimated depreciation on the building for the year is \$12,800.
- d. Accrued interest on the mortgage payable is \$1,000.
- e. On September 1, the company signed a contract, effective immediately, with Hope County Hospital to dry clean, for a fixed monthly charge of \$400, the uniforms used by doctors in surgery. The hospital paid for four months' service in advance.
- f. Sales and delivery wages are paid on Saturday. The weekly payroll is \$2,520. September 30 falls on a Thursday, and the company has a six-day pay week.

**REQUIRED**

All adjustments affect one balance sheet account and one income statement account. For each of the above situations, show the accounts affected, the amount of the adjustment (using a + or - to indicate an increase or decrease), and the balance of the account after the adjustment in the following format:

<b>Balance Sheet Account</b>	<b>Amount of Adjustment (+ or -)</b>	<b>Balance After Adjustment</b>	<b>Income Statement Account</b>	<b>Amount of Adjustment (+ or -)</b>	<b>Balance After Adjustment</b>
--------------------------------------	--	---	---	--	---

## LO 3, 4

**Determining Adjusting Entries, Posting to T Accounts, and Preparing an Adjusted Trial Balance****GENERAL LEDGER**

✓ 3: Adjusted trial balance:  
\$121,792

P6. Brave Advisors Service's trial balance on December 31, 2014, is as follows.

Cash	16,500	
Accounts Receivable	8,250	
Office Supplies	2,662	
Prepaid Rent	1,320	
Office Equipment	9,240	
Accumulated Depreciation—Office Equipment		1,540
Accounts Payable		5,940
Notes Payable		11,000
Unearned Service Revenue		2,970
B. Cooper, Capital		24,002
B. Cooper, Withdrawals	22,000	
Service Revenue		72,600
Salaries Expense	49,400	
Rent Expense	4,400	
Utilities Expense	4,280	
	<u>118,052</u>	<u>118,052</u>

The following information is also available:

- Ending inventory of office supplies, \$264
- Prepaid rent expired, \$440
- Depreciation of office equipment for the period, \$660
- Accrued interest expense at the end of the period, \$550
- Accrued salaries at the end of the period, \$330
- Service revenue still unearned at the end of the period, \$1,166
- Service revenue earned but unrecorded, \$2,200

**REQUIRED**

- Open T accounts for the accounts in the trial balance plus the following: Interest Payable; Salaries Payable; Office Supplies Expense; Depreciation Expense—Office Equipment; and Interest Expense. Enter the balances shown on the trial balance.
- Determine the adjusting entries and post them directly to the T accounts.
- Prepare an adjusted trial balance.
- ACCOUNTING CONNECTION** ► Which financial statements do each of the above adjustments affect? Which financial statement is not affected by the adjustments?

## LO 2, 3

**Preparing Adjusting Entries****GENERAL LEDGER**

✓ 1d: Debit to Supplies Expense:  
\$4,195

P7. On June 30, the end of the current fiscal year, the following information is available to BND Company's accountants for making adjusting entries:

- Among the liabilities of the company is a mortgage payable in the amount of \$240,000. On June 30, the accrued interest on this mortgage amounted to \$12,000.
- On Friday, July 2, the company, which is on a five-day workweek and pays employees weekly, will pay its regular salaried employees \$19,200.
- On June 29, the company completed negotiations and signed a contract to provide monthly services to a new client at an annual rate of \$3,600.
- The Supplies account shows a beginning balance of \$1,615 and purchases during the year of \$3,766. The end-of-year inventory reveals supplies on hand of \$1,186.



- e. The Prepaid Insurance account shows the following entries on June 30:

Beginning balance	\$1,530
January 1	2,900
May 1	3,366

The beginning balance represents the unexpired portion of a one-year policy purchased in April of the previous year. The January 1 entry represents a new one-year policy, and the May 1 entry represents the additional coverage of a three-year policy. (Round final answer to the nearest dollar.)

- f. The following table contains the cost and annual depreciation for buildings and equipment, all of which were purchased before the current year:

Account	Cost	Annual Depreciation
Buildings	\$185,000	\$ 7,300
Equipment	218,000	21,800

- g. On June 1, the company completed negotiations with another client and accepted an advance of \$21,000 for services to be performed for a year. The \$21,000 was credited to Unearned Service Revenue.
- h. The company calculates that, as of June 30, it had earned \$3,500 on a \$7,500 contract that will be completed and billed in August.

#### REQUIRED

- Prepare adjusting entries for each item listed above.
- CONCEPT** ► Explain how the conditions for revenue recognition are applied to transactions c and h.

LO 3, 4

### Determining Adjusting Entries and Tracing Their Effects to Financial Statements

SPREADSHEET

GENERAL LEDGER

✓ 3: Adjusted trial balance: \$29,778

**P8.** Kevin Steven opened a small tax-preparation service. Steven Tax Service's trial balance at the end of its second year of operation is as follows.

#### Steven Tax Service Trial Balance December 31, 2014

Cash	2,268	
Accounts Receivable	1,031	
Prepaid Insurance	240	
Office Supplies	782	
Office Equipment	7,100	
Accumulated Depreciation—Office Equipment		770
Accounts Payable		635
Unearned Tax Fees		219
K. Steven, Capital		5,439
K. Steven, Withdrawals	6,000	
Tax Fees Revenue		21,926
Office Salaries Expense	8,300	
Advertising Expense	650	
Rent Expense	2,400	
Telephone Expense	218	
	<u>28,989</u>	<u>28,989</u>

(Continued)

The following information is also available:

- Office supplies on hand, December 31, 2014, \$227
- Insurance still unexpired, \$120
- Estimated depreciation of office equipment, \$770
- Telephone expense for December, \$19; the bill was received but not recorded.
- The services for all unearned tax fees had been performed by the end of the year.

#### REQUIRED

- Open T accounts for the accounts in the trial balance plus the following: Office Supplies Expense; Insurance Expense; and Depreciation Expense—Office Equipment. Record the balances shown in the trial balance.
- Determine the adjusting entries and post them directly to the T accounts.
- Prepare an adjusted trial balance, an income statement, a statement of owner's equity, and a balance sheet. The owner made no investments during the period.
- ACCOUNTING CONNECTION** ► Why is it not necessary to show the effects of the above transactions on the statement of cash flows?

## ALTERNATE PROBLEMS

### LO 3 Determining Adjustments

✓ e: Wages Expense balance: \$3,748

**P9.** At the end of the first three months of operation, Evergreen Repair's trial balance is as follows.

<b>Evergreen Repair</b>	
<b>Trial Balance</b>	
<b>March 31, 2014</b>	
Cash	7,983
Accounts Receivable	5,872
Office Supplies	970
Prepaid Rent	1,500
Equipment	5,200
Accounts Payable	2,629
Unearned Repair Revenue	1,146
J. Kita, Capital	11,314
J. Kita, Withdrawals	1,800
Repair Revenue	12,236
Wages Expense	3,580
Office Cleaning Expense	420
	27,325
	27,325

Jonah Kita, Evergreen's owner, has hired an accountant to prepare financial statements to determine how well the company is doing after three months. Upon examining the accounting records, the accountant finds the following items of interest:

- An inventory of office supplies reveals supplies on hand of \$469.
- The Prepaid Rent account includes the rent for the first three months plus a deposit for April's rent.
- Depreciation on the equipment for the first three months is \$560.
- The balance of the Unearned Repair Revenue account represents a 12-month service contract paid in advance on February 1.
- On March 31, accrued wages total \$168.

**REQUIRED**

All adjustments affect one balance sheet account and one income statement account. For each of these situations, show the accounts affected, the amount of the adjustment (using a + or – to indicate an increase or decrease), and the balance of the account after the adjustment in the following format:

Balance Sheet Account	Amount of Adjustment (+ or –)	Balance After Adjustment	Income Statement Account	Amount of Adjustment (+ or –)	Balance After Adjustment
-----------------------	-------------------------------	--------------------------	--------------------------	-------------------------------	--------------------------

LO 2, 3

**GENERAL LEDGER**

✓ 1d: Debit to Unearned Service Revenue: \$10,667

**Preparing Adjusting Entries**

**P10.** On March 31, the end of the current fiscal year, the following information is available to assist Zun Cleaning Company's accountants in making adjusting entries:

- Zun's Supplies account shows a beginning balance of \$5,962. Purchases during the year were \$10,294. The end-of-year inventory reveals supplies on hand of \$3,105.
- The Prepaid Insurance account shows the following on March 31:

Beginning balance	\$ 5,990
September 1	6,480
January 1	10,080

The beginning balance represents the unexpired portion of a one-year policy purchased in January of the previous year. The September 1 entry represents a new one-year policy, and the January 1 entry represents additional coverage in the form of a three-year policy.

- The following table contains the cost and annual depreciation for buildings and equipment, all of which Zun purchased before the current year:

Account	Cost	Annual Depreciation
Buildings	\$ 804,000	\$34,000
Equipment	1,029,000	52,000

- On December 1, the company completed negotiations with a client and accepted an advance of \$32,000 for services to be performed monthly for a year. The \$32,000 was credited to Unearned Services Revenue. (Round to the nearest dollar.)
- The company calculated that, as of March 31, it had earned \$9,200 on a \$17,000 contract that would be completed and billed in January.
- Among the liabilities of the company is a note payable in the amount of \$600,000. On March 31, the accrued interest on this note amounted to \$17,470.
- On Saturday, April 3, the company, which is on a six-day workweek, will pay its regular employees their weekly wages of \$22,000. (Round to the nearest dollar.)
- On March 31, the company completed negotiations and signed a contract to provide services to a new client at an annual rate of \$19,000, beginning April 1.

**REQUIRED**

- Prepare adjusting entries for each item listed above.
- CONCEPT** ► Explain how the conditions for revenue recognition are applied to transactions e and h.

LO 3, 4 **Determining Adjusting Entries, Posting to T Accounts, and Preparing an Adjusted Trial Balance**

✓ 3: Adjusted trial balance: \$208,345

**P11.** Lee Technology Corporation's trial balance on December 31, 2014, is as follows.

<b>Lee Technology Corporation</b>		
<b>Trial Balance</b>		
<b>December 31, 2014</b>		
Cash	35,572	
Accounts Receivable	59,680	
Office Supplies	2,443	
Prepaid Rent	2,400	
Office Equipment	14,300	
Accumulated Depreciation—Office Equipment		3,200
Accounts Payable		2,640
Notes Payable		15,000
Unearned Service Revenue		5,650
E. Lee, Capital		88,705
E. Lee, Withdrawals	15,000	
Service Revenue		89,000
Salaries Expense	58,000	
Utilities Expense	3,600	
Rent Expense	13,200	
	<u>204,195</u>	<u>204,195</u>

The following information is also available:

- a. Ending inventory of office supplies, \$538
- b. Prepaid rent expired, \$1,200
- c. Depreciation of office equipment for the period, \$800
- d. Interest accrued on the note payable, \$750
- e. Salaries accrued at the end of the period, \$800
- f. Service revenue still unearned at the end of the period, \$3,675
- g. Service revenue earned but not billed, \$1,800

**REQUIRED**

1. Open T accounts for the accounts in the trial balance plus the following: Interest Payable; Salaries Payable; Office Supplies Expense; Depreciation Expense—Office Equipment; and Interest Expense. Enter the account balances.
2. Determine the adjusting entries and post them directly to the T accounts.
3. Prepare an adjusted trial balance.
4. **ACCOUNTING CONNECTION** ► Which financial statements do each of the above adjustments affect? What financial statement is not affected by the adjustments?

LO 3, 4

### Determining Adjusting Entries and Tracing Their Effects to Financial Statements

SPREADSHEET

GENERAL LEDGER

✓ 4: Adjusted trial balance: \$749,468

**P12.** USA Car Rental Service was organized to provide car rental service at the airport. It has just completed its second year of business. Its trial balance follows.

#### USA Car Rental Service Trial Balance June 30, 2014

Cash (111)	15,708	
Accounts Receivable (113)	19,830	
Prepaid Rent (117)	18,000	
Prepaid Insurance (118)	6,400	
Prepaid Maintenance (119)	13,620	
Spare Parts (140)	12,200	
Cars (148)	270,000	
Accumulated Depreciation—Car (149)		35,000
Notes Payable (211)		78,000
Unearned Rental Service Revenue (212)		42,000
S. Navarro, Capital (311)		66,567
S. Navarro, Withdrawals (313)	30,000	
Rental Service Revenue (411)		492,151
Gas and Oil Expense (510)	104,900	
Salaries Expense (511)	206,360	
Advertising Expense (513)	16,700	
	<u>713,718</u>	<u>713,718</u>

The following information is also available:

- To obtain space at the airport, USA paid two years' rent in advance when it began the business.
- An examination of insurance policies reveals that \$2,000 expired during the year.
- To provide regular maintenance for the vehicles, USA deposited \$13,620 with a local garage. An examination of maintenance invoices reveals charges of \$7,890 against the deposit.
- An inventory of spare parts shows \$2,170 on hand.
- USA depreciates all of its cars at the rate of 12.5 percent per year. No cars were purchased during the year.
- A payment of \$2,000 for one full year's interest on notes payable is now due.
- Unearned Rental Service Revenue on June 30 includes \$20,325 for cars that customers prepaid but have not yet been rented.

#### REQUIRED

- Determine the adjusting entries and enter them in the general journal (Page 14).
- Open ledger accounts for the accounts in the trial balance plus the following: Interest Payable (213); Rent Expense (514); Insurance Expense (515); Spare Parts Expense (516); Depreciation Expense—Cars (517); Maintenance Expense (518); and Interest Expense (519). Record the balances shown in the trial balance.
- Post the adjusting entries from the general journal to the ledger accounts, showing proper references.
- Prepare an adjusted trial balance, an income statement, a statement of owner's equity, and a balance sheet. The owner made no investments during the period.
- ACCOUNTING CONNECTION** ► What effect do the adjusting entries have on the income statement?

LO 2, 3 **Determining Adjustments**

✓ e: Upholstery Revenue  
balance: \$158,034

**P13.** Gonzales Upholstery's trial balance at the end of its fiscal year follows.

<b>Gonzales Upholstery Trial Balance September 30, 2014</b>	
Cash	16,288
Accounts Receivable	16,494
Prepaid Insurance	1,900
Upholstery Supplies	4,370
Land	18,000
Building	125,000
Accumulated Depreciation—Building	26,300
Accounts Payable	17,400
Unearned Upholstery Revenue	1,600
Mortgage Payable	90,000
C. Gonzales, Capital	7,756
C. Gonzales, Withdrawals	10,000
Upholstery Revenue	157,634
Wages Expense	81,930
Upholstery Equipment Rental Expense	6,000
Delivery Truck Expense	4,374
Interest Expense	9,300
Other Expenses	7,034
	300,690
	300,690

The following information is also available:

- a. A study of the company's insurance policies shows that \$380 is unexpired at the end of the year.
- b. An inventory of upholstery supplies shows \$1,040 on hand.
- c. Estimated depreciation on the building for the year is \$9,800.
- d. Accrued interest on the mortgage payable is \$960.
- e. On September 1, the company signed a contract, effective immediately, with County Community Bank to repair and reupholster office furniture, for a fixed monthly charge of \$400. The bank paid for four months' service in advance.
- f. Sales and delivery wages are paid on Saturday. The weekly payroll is \$1,530. September 30 falls on a Thursday, and the company has a six-day pay week.

**REQUIRED**

All adjustments affect one balance sheet account and one income statement account. For each of the above situations, show the accounts affected, the amount of the adjustment (using a + or – to indicate an increase or decrease), and the balance of the account after the adjustment in the following format:

Balance Sheet Account	Amount of Adjustment (+ or –)	Balance After Adjustment	Income Statement Account	Amount of Adjustment (+ or –)	Balance After Adjustment
-----------------------------	-------------------------------------	--------------------------------	--------------------------------	-------------------------------------	--------------------------------

LO 3, 4

### Determining Adjusting Entries, Posting to T Accounts, and Preparing an Adjusted Trial Balance

✓ 3: Adjusted trial balance: \$128,191

**P14.** Scoop Consulting Service's trial balance on December 31, 2014, is as follows.

**Scoop Consulting Service  
Trial Balance  
December 31, 2014**

Cash	19,250	
Accounts Receivable	7,360	
Office Supplies	2,861	
Prepaid Rent	1,820	
Office Equipment	9,240	
Accumulated Depreciation—Office Equipment		2,140
Accounts Payable		5,940
Notes Payable		11,000
Unearned Service Revenue		4,120
A. Chase, Capital		24,111
A. Chase, Withdrawals	22,000	
Service Revenue		76,200
Salaries Expense	51,300	
Rent Expense	5,400	
Utilities Expense	4,280	
	123,511	123,511

The following information is also available:

- Ending inventory of office supplies, \$564
- Prepaid rent expired, \$470
- Depreciation of office equipment for the period, \$820
- Accrued interest expense at the end of the period, \$730
- Accrued salaries at the end of the period, \$630
- Service revenue still unearned at the end of the period, \$2,722
- Service revenue earned but unrecorded, \$2,500

#### REQUIRED

- Open T accounts for the accounts in the trial balance plus the following: Interest Payable; Salaries Payable; Office Supplies Expense; Depreciation Expense—Office Equipment; and Interest Expense. Enter the balances shown on the trial balance.
- Determine the adjusting entries and post them directly to the T accounts.
- Prepare an adjusted trial balance.
- ACCOUNTING CONNECTION** ► Which financial statements do each of the above adjustments affect? Which financial statement is not affected by the adjustments?

LO 2, 3

GENERAL LEDGER

✓ 1e: Debit to Insurance Expense: \$2,781

### Preparing Adjusting Entries

**P15.** On June 30, the end of the current fiscal year, the following information is available to Axel Company's accountants for making adjusting entries:

- Among the liabilities of the company is a mortgage payable in the amount of \$280,000. On June 30, the accrued interest on this mortgage amounted to \$14,000.
- On Friday, July 2, the company, which is on a five-day workweek and pays employees weekly, will pay its regular salaried employees \$23,100.
- On June 29, the company completed negotiations and signed a contract to provide monthly services to a new client at an annual rate of \$6,645.
- The Supplies account shows a beginning balance of \$1,975 and purchases during the year of \$2,846. The end-of-year inventory reveals supplies on hand of \$1,984.

*(Continued)*



- e. The Prepaid Insurance account shows the following entries on June 30:

Beginning balance	\$1,333
January 1	2,544
May 1	3,168

The beginning balance represents the unexpired portion of a one-year policy purchased in April of the previous year. The January 1 entry represents a new one-year policy, and the May 1 entry represents the additional coverage of a three-year policy.

- f. The following table contains the cost and annual depreciation for buildings and equipment, all of which were purchased before the current year:

Account	Cost	Annual Depreciation
Buildings	\$235,000	\$ 6,301
Equipment	198,000	11,520

- g. On June 1, the company completed negotiations with another client and accepted an advance of \$31,080 for services to be performed for a year. The \$31,080 was credited to Unearned Service Revenue.
- h. The company calculates that, as of June 30, it had earned \$3,600 on a \$9,600 contract that will be completed and billed in August.

#### REQUIRED

1. Prepare adjusting entries for each item listed above.
2. **CONCEPT** ► Explain how the conditions for revenue recognition are applied to transactions c and h.

LO 3, 4

### Determining Adjusting Entries and Tracing Their Effects to Financial Statements

SPREADSHEET

✓ 3: Adjusted trial balance: \$45,198

**P16.** Simone Jacobs opened a small tax-preparation service. At the end of its second year of operation, Jacobs Financial Advisors Service had the following trial balance.

#### Jacobs Financial Advisors Service Trial Balance December 31, 2014

Cash	11,265	
Accounts Receivable	2,191	
Prepaid Insurance	520	
Office Supplies	682	
Office Equipment	7,980	
Accumulated Depreciation—Office Equipment		790
Accounts Payable		437
Unearned Tax Fees		519
S. Jacobs, Capital		5,474
S. Jacobs, Withdrawals	7,500	
Tax Fees Revenue		36,926
Office Salaries Expense	9,700	
Advertising Expense	650	
Rent Expense	3,200	
Telephone Expense	458	
	<u>44,146</u>	<u>44,146</u>

The following information is also available:

- a. Office supplies on hand, December 31, 2014, \$319
- b. Insurance still unexpired, \$180
- c. Estimated depreciation of office equipment, \$870
- d. Telephone expense for December, \$182; the bill was received but not recorded.
- e. The services for all unearned tax fees had been performed by the end of the year.

**REQUIRED**

1. Open T accounts for the accounts in the trial balance plus the following: Office Supplies Expense; Insurance Expense; and Depreciation Expense—Office Equipment. Record the balances shown in the trial balance.
2. Determine the adjusting entries and post them directly to the T accounts.
3. Prepare an adjusted trial balance, an income statement, a statement of owner's equity, and a balance sheet. The owner made no investments during the period.
4. **ACCOUNTING CONNECTION** ► Why is it not necessary to show the effects of the above transactions on the statement of cash flows?

**CASES**

LO 2, 3

**Conceptual Understanding: Importance of Adjustments**

**C1.** Never Flake Company provided a rust-prevention coating for the underside of new automobiles. The company advertised widely and offered its services through new-car dealers. When a dealer sold a new car, the salesperson attempted to sell the rust-prevention coating as an option. A key selling point was Never Flake's warranty, which stated that it would repair any damage due to rust at no charge for as long as the buyer owned the car.

For several years, Never Flake had been very successful, but in 2013, the company suddenly declared bankruptcy. Company officials said that the firm had only \$5.5 million in assets against liabilities of \$32.9 million. Most of the liabilities represented potential claims under the company's lifetime warranty. It seemed that owners were keeping their cars longer than they had previously. Therefore, more damage was being attributed to rust.

Discuss what accounting decisions could have helped Never Flake to survive under these circumstances.

LO 2, 3, 5

**Conceptual Understanding: Earnings Management and Fraudulent Financial Reporting**

**C2. BUSINESS APPLICATION** ► In recent years, the Securities and Exchange Commission (SEC) has been waging a public campaign against corporate accounting practices that manage or manipulate earnings to meet the expectations of Wall Street analysts. Corporations engage in such practices in the hope of avoiding shortfalls that might cause serious declines in their stock price.

For each of the following cases that the Securities and Exchange Commission challenged, explain why each was a violation of the accrual accounting:

- a. **Lucent Technologies** sold telecommunications equipment to companies from which there was no reasonable expectation of payment because of the companies' poor financial condition.
- b. **America Online (AOL)** recorded advertising as an asset rather than as an expense.
- c. **Eclipsys** recorded software contracts as revenue even though it had not yet rendered the services.
- d. **Xerox Corporation** recorded revenue from lease agreements at the time the leases were signed rather than over the lease term.
- e. **KnowledgeWare** recorded revenue from sales of software even though it told customers they did not have to pay until they had the software.

LO 2, 3

**Interpreting Financial Reports: Application of Accrual Accounting**

**C3.** The **Lyric Opera of Chicago** is one of the largest and best-managed opera companies in the United States. Managing opera productions requires advance planning, including the development of scenery, costumes, and stage properties and the sale of tickets. To measure how well the company is operating in any given year, management must apply accrual accounting to these and other transactions. At year-end, April 30, 2011, Lyric Opera's balance sheet showed deferred production costs and other assets of

\$1,978,322 and deferred ticket and other revenue of \$12,710,639.<sup>7</sup> What accounting policies and adjusting entries are applicable to these accounts? Why are they important to Lyric Opera's management?

**LO 2, 3 Interpreting Financial Reports: Analysis of an Asset Account**

**C4. The Walt Disney Company** is engaged in the financing, production, and distribution of motion pictures and television programming. In Disney's 2011 annual report, the balance sheet contains an asset called "film and television costs." Film and television costs, which consist of the costs associated with producing films and television programs less the amount expensed, were \$4,357 million. The notes reveal that the amount of film and television costs expensed (amortized) during the year was \$3,521 million. The amount spent for new film productions was \$3,184 million.<sup>8</sup>

1. **CONCEPT** ► What are film and television costs, and why would they be classified as an asset?
2. Prepare T accounts to record the amount the company spent on new film and television production during the year (assume all expenditures are paid for in cash).
3. Prepare an adjusting entry in T account form to record the expense for film and television productions.
4. **CONCEPT** ► Suggest a method by which The Walt Disney Company might have determined the amount of the expense in 3 in accordance with accrual accounting.

**LO 3 Annual Report Case: Analysis of Balance Sheet and Adjusting Entries**

**C5.** In the **CVS** annual report in the Supplement to Chapter 16, refer to the balance sheet and the Summary of Significant Accounting Policies in the notes to the financial statements.

1. Examine the accounts in the current assets, property and equipment, and current liabilities sections of CVS's balance sheet. Which are most likely to have had year-end adjusting entries? Describe the nature of the adjusting entries. For more information about the property and equipment section, refer to the notes to the financial statements.
2. Where is depreciation (and amortization) expense disclosed in CVS's financial statements?
3. CVS has a statement on the "Use of Estimates" in its Summary of Significant Accounting Policies. Read this statement, and tell how important estimates are in determining depreciation expense. What assumptions do accountants use in estimating depreciation?

**LO 5 Ethical Dilemma: Importance of Adjustments**

**C6. BUSINESS APPLICATION** ► Central Appliance Service Co., Inc., has achieved fast growth by selling service contracts on large appliances, such as washers, dryers, and refrigerators. For a fee, the company agrees to provide all parts and labor on an appliance after the regular warranty runs out. For example, by paying a fee of \$200, a person who buys a dishwasher can add two years to the regular one-year warranty on the appliance. In 2014, the company sold service contracts in the amount of \$1.8 million, all of which applied to future years. Management wanted all the sales recorded as revenues in 2014, contending that the amount of the contracts could be determined and the cash had been received. Do you agree with this logic? How would you record the cash receipts? What assumptions do you think Central Appliance should make? Would you consider it unethical to follow management's recommendation? Who might be hurt or helped by this action?

**Continuing Case: Annual Report Project**

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the current assets and current liabilities of your company. Identify accounts that would likely fall into one of the following two categories:

1. Deferral
2. Accrual

# CHAPTER 4

## Completing the Accounting Cycle

### BUSINESS INSIGHT

#### Speedy Movers

Speedy Movers provides moving and storage services for the local college and its students and employees. Speedy's busiest times are generally in the late spring and early fall. Thus, to keep an eye on fluctuations in earnings and cash flows, Speedy prepares financial statements each quarter.

As you know from Chapter 3, before a company prepares financial statements, it must make adjusting entries to the income statement and owner's equity accounts. After those entries have been made, an adjusted trial balance is prepared. Accounts from the adjusted trial balance are then used to prepare the financial statements. For example, in preparing its income statement, Speedy would use the revenue and expense accounts from its adjusted trial balance.

In addition, Speedy, like all other companies, must prepare its accounts for the next accounting period by making closing entries. Doing all this takes time and effort, but the results benefit both management and external users of the company's financial statements. To accomplish these tasks, Speedy needs to be able to answer the following questions.

- 1. CONCEPT** ► *Why are the concepts of permanent and temporary accounts important to making closing entries?*
- 2. ACCOUNTING APPLICATION** ► *What steps must a company follow to prepare its accounts for the next accounting period?*
- 3. BUSINESS APPLICATION** ► *Why are closing entries important to good financial reporting in the current accounting period and the next accounting period?*

### LEARNING OBJECTIVES

- LO 1** Describe the role of closing entries in the preparation of financial statements.
- LO 2** Prepare closing entries.
- LO 3** Prepare reversing entries.
- LO 4** Prepare a work sheet.
- LO 5** Explain the importance of the work sheet and closing entries when managing a business.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Periodicity
- Accrual accounting

RELEVANT  
LEARNING OBJECTIVE

- Lo 1** Describe the role of closing entries in the preparation of financial statements.

## Lo 1 Concepts Underlying Closing Entries

All companies prepare financial statements annually, but interim reports prepared quarterly or even monthly give management an ongoing view of a company's financial performance. Up this point, you have studied the first five steps of the accounting cycle. In this chapter, the final step, preparation of closing entries and the post-closing trial balance, is covered.

### Closing Entries

**Closing entries** are journal entries made at the end of an accounting period. They have two purposes:

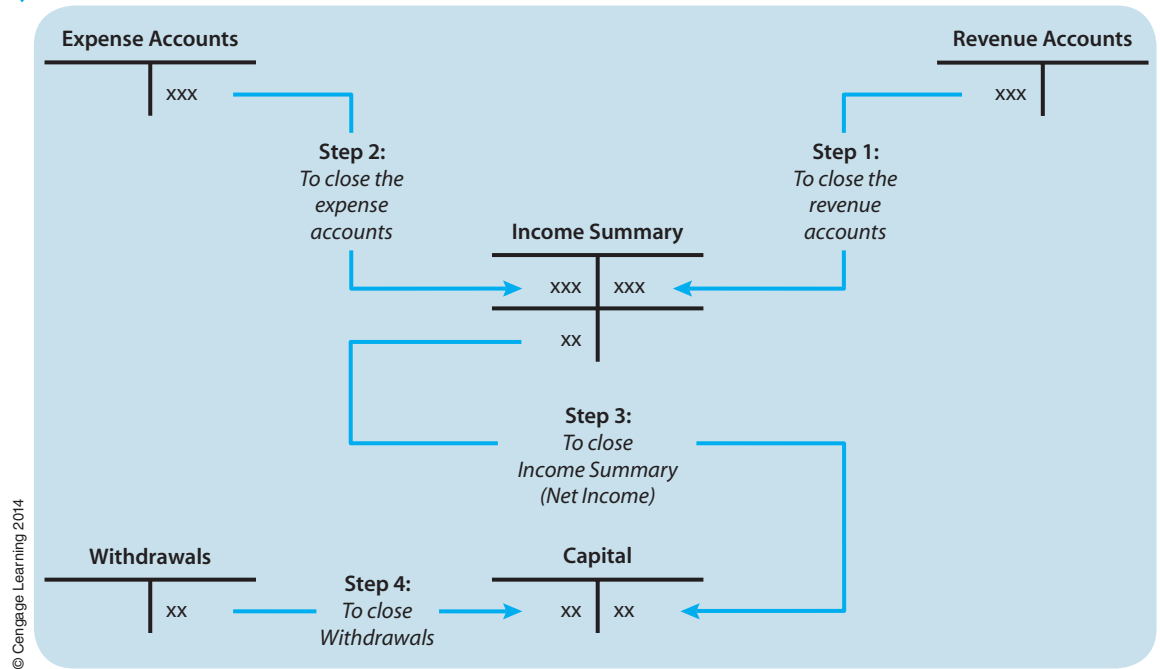
- **Setting the stage for the next accounting period:** Since the income statement reports net income (or loss) for a single accounting period and shows revenues and expenses for only that period, it is necessary to clear revenue and expense accounts and the withdrawals accounts of their balances. This step enables them to start over with a zero balance in the next accounting period.
- **Summarizing a period's revenues and expenses:** The **Income Summary account** is a temporary account that summarizes all revenues and expenses for the period. It is used only in the closing process, and its balance equals the net income or loss.

The preparation of closing entries is an important step in achieving two important concepts introduced in Chapter 3. Closing entries assist in achieving both *periodicity* and *accrual accounting* by being the process by which the life of the business is divided into equal time periods. Further, they summarize the effects of each accounting period on owner's equity and set the stage for the next accounting period.

To accomplish the closing process, it is important to understand the concepts of *permanent* and *temporary accounts*. Balance sheet accounts, such as Cash and Accounts Payable, are considered **permanent accounts** (or *real accounts*) because they carry their end-of-period balances into the next accounting period. In contrast, revenue and expense accounts, such as Revenues Earned and Wages Expense, are considered **temporary accounts** (or *nominal accounts*). Temporary accounts begin each accounting period with a zero balance, accumulate a balance during the period, and are then cleared by means of closing entries.

The net income or loss is transferred from the Income Summary account to the owner's Capital account because revenues and expenses represent increases and decreases in owner's equity. Exhibit 1 shows an overview of the closing process. For corporations, the net income or loss is transferred from the Income Summary account to the Retained Earnings account, which is part of the stockholders' (owner's) equity of a corporation.

**Exhibit 1**  
Overview of the Closing Process



**APPLY IT!**

Match the concepts that follow to the related statements.

- \_\_\_\_\_ 1. Important in assuring that owner's equity is affected properly by revenues and expenses.
- \_\_\_\_\_ 2. Usually begin the accounting period with a balance.
- \_\_\_\_\_ 3. Begin each period with a zero balance.
- \_\_\_\_\_ 4. Divides the life of the business into equal time periods.

- a. periodicity
- b. accrual accounting
- c. permanent accounts
- d. temporary accounts

**SOLUTION**

1. b; 2. c; 3. d; 4. a

**TRY IT! SE1**



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Prepare closing entries
- Prepare reversing entries
- Prepare a work sheet

RELEVANT  
LEARNING OBJECTIVES

**LO 2** Prepare closing entries.

**LO 3** Prepare reversing entries.

**LO 4** Prepare a work sheet.

## LO 2 Preparing Closing Entries

The steps involved in making closing entries are as follows.

- **Step 1.** Close the credit balances on the income statement accounts to the Income Summary account.
- **Step 2.** Close the debit balances on the income statement accounts to the Income Summary account.
- **Step 3.** Close the Income Summary account balance to the owner's Capital account. (Although it is not necessary to use the Income Summary account when preparing closing entries, it does simplify the procedure.)
- **Step 4.** Close the Withdrawals account balance to the owner's Capital account.

You will learn in later chapters that not all credit balance accounts are revenues and not all debit balance accounts are expenses. Therefore, we often use the term *credit balances* instead of *revenue accounts* and the term *debit balances* instead of *expense accounts*.

An adjusted trial balance provides all the data needed to record the closing entries. Exhibit 2 shows the relationships of the four kinds of closing entries to Blue Design Studio's adjusted trial balance.

### Exhibit 2 Preparing Closing Entries from the Adjusted Trial Balance

<b>Blue Design Studio Adjusted Trial Balance July 31, 2014</b>	
Cash	22,480
Accounts Receivable	5,000
Office Supplies	3,660
Prepaid Rent	1,600
Office Equipment	16,320
Accumulated Depreciation—Office Equipment	300
Accounts Payable	6,280
Unearned Design Revenue	600
Wages Payable	720
J. Blue, Capital	40,000
J. Blue, Withdrawals	2,800
Design Revenue	13,600
Wages Expense	5,520
Utilities Expense	680
Rent Expense	1,600
Office Supplies Expense	1,540
Depreciation Expense—Office Equipment	300
	61,500
	61,500



**Exhibit 2**  
**Preparing Closing Entries from**  
**the Adjusted Trial Balance**  
*(Continued)*

Entry 1				
July 31	Design Revenue	411	13,600	
	Income Summary	314		13,600
	To close the revenue account			

Entry 2				
July 31	Income Summary	314	9,640	
	Wages Expense	511		5,520
	Utilities Expense	512		680
	Rent Expense	514		1,600
	Office Supplies Expense	517		1,540
	Depreciation Expense—Office Equipment	520		300
	To close the expense accounts			

Income Summary				
		Dr.	Cr.	
July 31		9,640	July 31	13,600
July 31		3,960		
	<b>Bal.</b>			<b>—</b>

Entry 3				
July 31	Income Summary	314	3,960	
	J. Blue, Capital	311		3,960
	To close the Income Summary account (net income)			

Entry 4				
July 31	J. Blue, Capital	311	2,800	
	J. Blue, Withdrawals	313		2,800
	To close the Withdrawals account			

### Step 1: Closing the Credit Balances

In the adjusted trial balance in Exhibit 2, Design Revenue shows a credit balance of \$13,600 and is closed by debiting it for \$13,600 and crediting the Income Summary account for the same amount.

#### Closing the Revenue Account

**Accounts** On July 31, Design Revenue of \$13,600 credit balance is closed to Income Summary.

**Analysis** The journal entry to close Revenue

- ▼ *decreases* the owner’s equity account *Design Revenue* with a debit
- ▲ *increases* the owner’s equity account *Income Summary* with a credit

**Application of Double Entry**

Assets	=	Liabilities	+	Owner's Equity
				<b>Design Revenue</b>
				Dr.      Cr.
				July 31 13,600
				<b>Income Summary</b>
				July 31 13,600

**Journal Entry**

July 31	Design Revenue	411	Dr.	13,600	Cr.				
	Income Summary	314				13,600			
	To close the revenue account								

**Comment** Design Revenue now has a zero balance in preparation for the next accounting period and Income Summary reflects revenue for the period. Exhibit 3 shows Design Revenue and Income Summary ledger accounts at this point in the closing process.

**Exhibit 3**  
Posting the Closing Entry of a Credit Balance Account to the Income Summary Account

Design Revenue					Account No. 411		
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
July	10		J1		2,800		2,800
	15		J1		9,600		12,400
	31	Adj.	J3		800		13,200
	31	Adj.	J3		400		13,600
	31	Closing	J4	13,600			—

Income Summary					Account No. 314		
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
July	31	Closing	J4		13,600		13,600

© Cengage Learning 2014

**Step 2: Closing the Debit Balances**

Several expense accounts show balances in the adjusted trial balance in Exhibit 2. A compound entry is needed to credit each of these expense accounts for its balance and to debit the Income Summary account for the total, as follows.

**Closing the Expense Accounts**

**Accounts** On July 31, expenses accounts shown in the trial balance in Exhibit 2 are closed to Income Summary.

**Analysis** The journal entry to close the expense accounts

- ▼ *decreases* the owner's equity account *Income Summary* with a debit
- ▼ *decreases* the owner's equity expense accounts with a credit

Application of Double Entry

Assets	=	Liabilities	+	Owner's Equity
				<b>Income Summary</b>
				Dr.      Cr.
				July 31   9,640
				<b>Wages Expense</b>
				Dr.      Cr.
				July 31   5,520
				<b>Utilities Expense</b>
				Dr.      Cr.
				July 31   680
				<b>Rent Expense</b>
				Dr.      Cr.
				July 31   1,600
				<b>Office Supplies Expense</b>
				Dr.      Cr.
				July 31   1,540
				<b>Depreciation Expense— Office Equipment</b>
				Dr.      Cr.
				July 31   300

**STUDY NOTE:** The Income Summary account now reflects the account balance of the Design Revenue account before it was closed.

Journal Entry

		Dr.	Cr.
July 31	Income Summary	314	
	Wages Expense		5,520
	Utilities Expense		680
	Rent Expense		1,600
	Office Supplies Expense		1,540
	Depreciation Expense— Office Equipment		300
	To close the expense accounts	9,640	

**Comment** All expense accounts now have zero balances in preparation for the next accounting period and Income Summary reflects revenue and expenses for the period. Exhibit 4 shows all expense ledger accounts and the Income Summary ledger account at this point in the accounting cycle.

Closing entries bring the temporary account balances to zero, allowing a fresh start for the next accounting period.



Urbanmyth/Alamy

Wages Expense					Account No. 511	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
July	26		4,800		4,800	
	31	Adj.	720		5,520	
	31	Closing		5,520	—	

Office Supplies Expense					Account No. 517	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
July	31	Adj.	1,540		1,540	
	31	Closing		1,540	—	

Utilities Expense					Account No. 512	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
July	30		680		680	
	31	Closing		680	—	

Depreciation Expense— Office Equipment					Account No. 520	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
July	31	Adj.	300		300	
	31	Closing		300	—	

Rent Expense					Account No. 514	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
July	31	Adj.	1,600		1,600	
	31	Closing		1,600	—	

Income Summary					Account No. 314	
Date	Item	Post. Ref.	Debit	Credit	Balance	
					Debit	Credit
July	31	Closing		13,600		13,600
	31	Closing	9,640*			3,960

© Cengage Learning 2014

\*Total of all credit closing entries to expense accounts is debited to the Income Summary account.

**Exhibit 4**  
Posting the Closing Entry of  
Debit Balance Accounts to the  
Income Summary Account

### Step 3: Closing the Income Summary Account Balance

A credit balance in the Income Summary account represents a net income (i.e., revenues exceed expenses), and a debit balance represents a net loss (i.e., expenses exceed revenues). The balance, whatever its nature, is closed to the owner’s Capital account, as follows.

#### Closing the Income Summary Account

**Accounts** On July 31, Income Summary account balance of \$3,960 credit is closed to J. Blue, Capital.

**Analysis** The journal entry to close Income Summary

- ▼ decreases the owner’s equity account *Income Summary* with a debit
- ▲ increases the owner’s equity account *J. Blue, Capital* with a credit

#### Application of Double Entry

Assets	=	Liabilities	+	Owner’s Equity
				Income Summary
				Dr.      Cr.
				July 31   3,960
				J. Blue, Capital
				Dr.      Cr.
				July 31   3,960

#### Journal Entry

July 31	Income Summary		314	Dr.	3,960	Cr.	
	J. Blue, Capital		311				3,960
	To close the Income Summary account						

**STUDY NOTE:** At this point, the credit balance of the Income Summary account (\$3,960) represents net income—the key measure of performance. When a net loss occurs, debit the owner’s Capital account (to reduce it) and credit the Income Summary account (to close it).

**Exhibit 5**  
Posting the Closing Entry of the Income Summary Account Balance to the Owner’s Equity Account

Income Summary						Account No. 314	
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
July	31	Closing	J4		13,600		13,600
	31	Closing	J4	9,640			3,960
	31	Closing	J4	3,960			—

J. Blue, Capital						Account No. 311	
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
July	1		J1		40,000		40,000
	31	Closing	J4		3,960		43,960

© Cengage Learning 2014

### Step 4: Closing the Withdrawals Account Balance

The Withdrawals account shows the amount by which owner’s Capital decreased during an accounting period. The debit balance of the Withdrawals account is closed to the owner’s Capital account, as follows.

#### Closing the Withdrawals Account

**Account** On July 31, Withdrawals in the amount of \$2,800 debit is closed to J. Blue, Capital.

**Analysis** The journal entry to close Withdrawals

- ▼ decreases the owner’s equity account *J. Blue, Capital* with a debit
- ▼ decreases the owner’s equity account *Withdrawals* with a credit

#### Application of Double Entry

Assets	=	Liabilities	+	Owner’s Equity
				<b>J. Blue Capital</b>
				Dr.   Cr.
				July 31 2,800
				<b>Withdrawals</b>
				July 31 2,800

#### Journal Entry

			Dr.	Cr.
July 31	J. Blue, Capital	311	2,800	
	Withdrawals	313		2,800
	To close the Withdrawals account			

**Comment** Withdrawals now has a zero balance in preparation for the next accounting period and J. Blue, Capital reflects the income minus the withdrawals for the period. Exhibit 6 shows Income Summary and J. Blue, Capital ledger accounts at this point in the closing process.

**STUDY NOTE:** In a corporation, payments to owners are called dividends, and they are closed to the Retained Earnings account.

**STUDY NOTE:** Note that the Withdrawals account is closed to the owner’s Capital account, not to the Income Summary account.

**Exhibit 6**

Posting the Closing Entry of the Withdrawals Account Balance to the Owner's Capital Account

J. Blue, Withdrawals					Account No. 313		
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
July	31		J2	2,800		2,800	
	31	Closing	J4		2,800	—	

J. Blue, Capital					Account No. 311		
Date		Item	Post. Ref.	Debit	Credit	Balance	
						Debit	Credit
July	1		J1		40,000		40,000
	31	Closing	J4		3,960		43,960
	31	Closing	J4	2,800			41,160

© Cengage Learning 2014

## The Accounts After Closing

After all the steps in the closing process have been completed and all closing entries have been posted, everything is ready for the next accounting period. The revenue, expense, and withdrawals accounts (temporary accounts) have zero balances. The owner's Capital account has been increased or decreased to reflect net income or net loss (net income in our example) and has been decreased for withdrawals. The balance sheet accounts (permanent accounts) show the correct balances, which are carried forward to the next period, as shown in the **post-closing trial balance** in Exhibit 7.

**Exhibit 7**

Post-Closing Trial Balance

Blue Design Studio Post-Closing Trial Balance July 31, 2014		
Cash	22,480	
Accounts Receivable	5,000	
Office Supplies	3,660	
Prepaid Rent	1,600	
Office Equipment	16,320	
Accumulated Depreciation—Office Equipment		300
Accounts Payable		6,280
Unearned Design Revenue		600
Wages Payable		720
J. Blue, Capital		41,160
	<u>49,060</u>	<u>49,060</u>

© Cengage Learning 2014



## Business Perspective

### Closing Process in the Internet Age

Just a few years ago, it took companies eleven to fourteen days to close the accounts at the end of the year, but today the average is five to eight days. In fact, Cisco Systems, the big software company, is able to close its books in just one day. The company's CEO says this enables his managers to "spot problems and opportunities at any time" and that it has an important impact on a company's future success. The key to the success is for financial systems to work together seamlessly over the Internet so that companies have real-time transactions with real-time reporting.<sup>1</sup>

## APPLY IT!

Refer to the following partial adjusted trial balance for Fountas Recreational Park. (Except for K. Fountas, Capital, balance sheet accounts have been omitted.)

K. Fountas, Capital		93,070
K. Fountas, Withdrawals	36,000	
Campsite Rentals		88,200
Wages Expense	23,850	
Insurance Expense	3,784	
Utilities Expense	1,800	
Supplies Expense	1,320	
Depreciation Expense—Building	6,000	

1. Prepare the necessary closing entries.
2. Compute the ending balance of the owner's Capital account.

### SOLUTION

1.

June 30	Campsite Rentals	88,200	
	Income Summary		88,200
	To close the credit balance account		
30	Income Summary	36,754	
	Wages Expense		23,850
	Insurance Expense		3,784
	Utilities Expense		1,800
	Supplies Expense		1,320
	Depreciation Expense—Building		6,000
	To close the debit balance accounts		
30	Income Summary	51,446	
	K. Fountas, Capital		51,446
	To close the Income Summary account		
	$\$88,200 - \$36,754 = \$51,446$		
30	K. Fountas, Capital	36,000	
	K. Fountas, Withdrawals		36,000
	To close the Withdrawals account		

2.

	Dr.		Cr.
June 30	36,000	Beg. Bal.	93,070
		June 30	51,446
		End. Bal.	108,516

TRY IT! SE3, SE4, SE5, SE6, SE10, E1A, E3A, E1B, E3B

## LO 3 Reversing Entries: An Optional First Step

A **reversing entry** is an optional journal entry made on the first day of an accounting period. It has the opposite effect of an adjusting entry made at the end of the previous period—that is, it debits the credits and credits the debits of an earlier adjusting entry. The sole purpose of reversing entries is to simplify routine bookkeeping procedures, and they apply only to certain adjusting entries. As used in this text, reversing entries apply only to accruals (accrued revenues and expenses).

To see how reversing entries can be helpful, consider this adjusting entry to accrue wages expense made in Blue Design Studio's records.

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
			<b>Wages Payable</b>			<b>Wages Expense</b>	
			Dr.	Cr.		Dr.	Cr.
				July 31 720		July 31 720	

### Journal Entry

July 31	Wages Expense	Dr.	720	←	Cr.	720
	→ Wages Payable					
	Accrued unrecorded wages					



When the company pays its assistant on the next regular payday, its accountant would make the journal entry that follows.

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
Cash			Wages Payable			Wages Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	<b>Aug. 9 2,400</b>		<b>Aug. 9 720</b>			<b>Aug. 9 1,680</b>	

**Journal Entry**

Aug. 9	Wages Payable	720					
	Wages Expense		1,680				
	Cash			2,400			

Paid two weeks wages to assistant, \$720 of which accrued in the previous period

If no reversing entry is made at the time of payment, the accountant would have to find out how much of the \$2,400 applies to the current accounting period and how much applies to the previous period. That may seem easy in our example, but think how difficult and time-consuming it would be if a company had hundreds of employees working on different schedules. A reversing entry helps solve the problem of applying revenues and expenses to the correct accounting period.

For example, consider the following sequence of entries and their effects on the Wages Expense account:

<b>1. Adjusting Entry</b>		<b>Dr.</b>	<b>Cr.</b>				
July 31	Wages Expense	720					
	Wages Payable		720				
<b>2. Closing Entry</b>							
July 31	Income Summary	5,520					
	Wages Expense		5,520				
<b>3. Reversing Entry</b>							
Aug. 1	Wages Payable	720					
	Wages Expense		720				
<b>4. Payment Entry</b>							
Aug. 9	Wages Expense	2,400					
	Cash		2,400				

Wages Expense				Account No. 511	
Date	Post. Ref.	Debit	Credit	Balance	
				Debit	Credit
July 26	J1	4,800		4,800	
July 31	J3	720		5,520	
Aug. 1	J4		5,520	—	
Aug. 1	J5		720		720
Aug. 9	J6	2,400		1,680	

Here, you can see that

- Entry 1 adjusted Wages Expense to accrue \$720 in the July accounting period.
- Entry 2 closed the \$5,520 in Wages Expense for July to Income Summary, leaving a zero balance.
- Entry 3, the reversing entry, set up a credit balance of \$720 on August 1 in Wages Expense, which is the expense recognized through the adjusting entry in July (and also reduced the liability account Wages Payable to a zero balance). The reversing entry always sets up an abnormal balance in the income statement account and produces a zero balance in the balance sheet account.
- Entry 4 recorded the \$2,400 payment of wages as a debit to Wages Expense, automatically leaving a balance of \$1,680, which represents the correct wages expense to date in August. The reversing entry simplified the process of making the payment entry on August 9.

Reversing entries apply to any accrued expenses or revenues. Blue Design Studio's only accrued expense was wages expense. An adjusting entry for the company's accrued revenue (Design Revenue) would require the reversing entry that follows.

		<i>Dr.</i>	<i>Cr.</i>
Aug. 1	Design Revenue	400	
	Accounts Receivable		400
	Reversed the adjusting entry for accrued revenue earned		

## APPLY IT!

Which of the following accounts, after adjustment, will most likely require reversing entries?

- a. Salaries Payable
- b. Accumulated Depreciation
- c. Interest Payable
- d. Supplies
- e. Taxes Payable

### SOLUTION

a., c., and e.

**TRY IT! SE8, SE9, E2A, E6A, E2B, E6B**

## LO 4 The Work Sheet: An Accountant's Tool

To organize data and important information, accountants use **working papers**. Because working papers provide evidence of past work, they also enable accountants to retrace their steps when they need to verify information in the financial statements.

**STUDY NOTE:** *The work sheet is not a financial statement, it is not required, and it is not made public.*

A **work sheet** is a special kind of working paper. It serves as a preliminary step in preparing financial statements. Using a work sheet lessens the possibility of omitting an adjustment and helps the accountant check the arithmetical accuracy of the accounts. The work sheet is never published and is rarely seen by management.

Because preparing a work sheet is a mechanical process, many accountants use a computer for this purpose. Some accountants use a spreadsheet program to prepare the work sheet. Others use a general ledger system to prepare financial statements from the adjusted trial balance.

### Preparing the Work Sheet

A common form of work sheet has one column for account names and multiple columns with headings like the ones shown in Exhibit 8. A heading that includes the name of the company and the period of time covered (as on the income statement) identifies the work sheet. As Exhibit 8 shows, preparation of a work sheet involves five steps.

**STUDY NOTE:** *The Trial Balance columns of a work sheet take the place of a separate trial balance.*

**Step 1. Enter and Total the Account Balances in the Trial Balance Columns** The debit and credit balances of the accounts on the last day of an accounting period are copied from the ledger into the Trial Balance columns (the green columns in Exhibit 8). When accountants use a work sheet, they do not have to prepare a separate trial balance.

**Step 2. Enter and Total the Adjustments in the Adjustments Columns** The required adjustments are entered in the Adjustments columns of the work sheet (the purple columns in Exhibit 8). As each adjustment is entered, a letter is used to identify its debit and credit parts. For example, in Exhibit 8, the letter (a) identifies the adjustment made for the rent that Blue Design Studio prepaid on July 3, which results in a debit to Rent Expense and a credit to Prepaid Rent. These identifying letters may be used to reference supporting computations or documentation for the related adjusting entries.

**Blue Design Studio  
Work Sheet  
For the Month Ended July 31, 2014**

Account Name	Trial Balance		Adjustments		Adjusted Trial Balance		Income Statement		Balance Sheet	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	22,480				22,480				22,480	
Accounts Receivable	4,600		(f) 400		5,000				5,000	
Office Supplies	5,200			(b) 1,540	3,660				3,660	
Prepaid Rent	3,200			(a) 1,600	1,600				1,600	
Office Equipment	16,320				16,320				16,320	
Accumulated Depreciation—Office Equipment				(c) 300		300				300
Accounts Payable		6,280				6,280				6,280
Unearned Design Revenue		1,400	(e) 800			600				600
J. Blue, Capital		40,000				40,000				40,000
J. Blue, Withdrawals	2,800				2,800				2,800	
Design Revenue		12,400		(e) 800 (f) 400		13,600	13,600			
Wages Expense	4,800		(d) 720		5,520		5,520			
Utilities Expense	680				680		680			
	60,080	60,080								
Rent Expense			(a) 1,600		1,600		1,600			
Office Supplies Expense			(b) 1,540		1,540		1,540			
Depreciation Expense—Office Equipment			(c) 300		300		300			
Wages Payable				(d) 720		720				720
			5,360	5,360	61,500	61,500	9,640	13,600	51,860	47,900
Net Income							3,960			3,960
							13,600	13,600	51,860	51,860

Note: The columns of the work sheet are prepared in the following order. (1) Trial Balance, (2) Adjustments, (3) Adjusted Trial Balance, and (4) Income Statement and Balance Sheet columns. In the fifth step, the Income Statement and Balance Sheet columns are totaled.

© Cengage Learning 2014

**Exhibit 8**  
The Work Sheet

A trial balance includes only accounts that have balances. If an adjustment involves an account that does not appear in the trial balance, the new account is added below the accounts listed on the work sheet. For example, Rent Expense has been added to Exhibit 8. Accumulated depreciation accounts, which have a zero balance only in the initial period of operation, are the sole exception to this rule. They are listed immediately after their associated asset accounts.

When all the adjustments have been made, the two Adjustments columns must be totaled. This procedure proves that the debits and credits of the adjustments are equal, and it generally reduces errors in the work sheet.

**Step 3. Enter and Total the Adjusted Account Balances in the Adjusted Trial Balance Columns** The adjusted trial balance in the work sheet is prepared by combining the amount of each account in the Trial Balance columns with the corresponding amount in the Adjustments columns and entering each result in the Adjusted Trial Balance columns (the beige columns in Exhibit 8).

Exhibit 8 contains examples of **crossfooting**, or adding and subtracting a group of numbers horizontally.

- The first line shows Cash with a debit balance of \$22,480. Because there are no adjustments to the Cash account, \$22,480 is entered in the debit column of the Adjusted Trial Balance columns.
- On the second line, Accounts Receivable shows a debit of \$4,600 in the Trial Balance columns. Because there is a debit of \$400 in the Adjustments columns, it is added to the \$4,600 and carried over to the debit column of the Adjusted Trial Balance columns at \$5,000.
- On the next line, Office Supplies shows a debit of \$5,200 in the Trial Balance columns and a credit of \$1,540 in the Adjustments columns. Subtracting \$1,540 from \$5,200 results in a \$3,660 debit balance in the Adjusted Trial Balance columns.

This process is followed for all the accounts, including those added below the trial balance totals. The Adjusted Trial Balance columns are then *footed* (totaled) to check the accuracy of the crossfooting.

**Step 4. Extend the Account Balances from the Adjusted Trial Balance Columns to the Income Statement or Balance Sheet Columns** Each account in the adjusted trial balance is extended to its proper place as a debit or credit in either the Income Statement columns or the Balance Sheet columns (the blue columns in Exhibit 8). As shown in Exhibit 8, revenue and expense accounts are extended to the Income Statement columns, and asset, liability, Capital, and Withdrawals accounts are extended to the Balance Sheet columns.

To avoid overlooking an account, the accounts are extended line by line, beginning with the first line (Cash). For instance, the Cash debit balance of \$22,480 is extended to the debit column of the Balance Sheet columns; then, the Accounts Receivable debit balance of \$5,000 is extended to the debit column of the Balance Sheet columns; and so forth.

**Step 5. Total the Income Statement Columns and the Balance Sheet Columns. Enter the Net Income or Net Loss in Both Pairs of Columns as a Balancing Figure, and Recompute the Column Totals.** This last step, shown in the orange columns at the bottom of Exhibit 8, is necessary to compute net income or net loss and to prove the arithmetical accuracy of the work sheet.

Net income (or net loss) is equal to the difference between the total debits and credits of the Income Statement columns.

Revenues (Income Statement credit column total)	\$13,600
Expenses (Income Statement debit column total)	<u>(9,640)</u>
Net Income	<u>\$ 3,960</u>

In this case, revenues (credit column) exceed expenses (debit column). Thus, Blue Design Studio has a net income of \$3,960. The same difference occurs between the total debits and credits of the Balance Sheet columns.

The \$3,960 is entered in the debit side of the Income Statement columns and in the credit side of the Balance Sheet columns to balance the columns. Remember that the excess of revenues over expenses (net income) increases owner's equity and that increases in owner's equity are recorded by credits.

When a net loss occurs, the opposite rule applies. The excess of expenses over revenues—net loss—is placed in the credit side of the Income Statement columns as a

balancing figure. It is then placed in the debit side of the Balance Sheet columns because a net loss decreases owner's equity, and decreases in owner's equity are recorded by debits.

As a final check, the four columns are totaled again. If the Income Statement columns and the Balance Sheet columns do not balance, an account may have been extended or sorted to the wrong column, or an error may have been made in adding the columns. Of course, equal totals in the two pairs of columns are not absolute proof of accuracy. If an asset has been carried to the Income Statement debit column (or an expense has been carried to the Balance Sheet debit column) or a similar error with revenues or liabilities has been made, the work sheet will balance, but the net income figure will be wrong.

**Exhibit 9**  
Adjustments from the Work Sheet  
Entered in the General Journal

General Journal					Page 2
Date		Description	Post. Ref.	Debit	Credit
2014					
(a) July	31	Rent Expense	514	1,600	
		Prepaid Rent	117		1,600
		To recognize expiration of one month's rent			
(b)	31	Office Supplies Expense	517	1,540	
		Office Supplies	116		1,540
		To recognize office supplies used during the month			
(c)	31	Depreciation Expense—Office Equipment	520	300	
		Accumulated Depreciation—Office Equipment	147		300
		To record depreciation of office equipment for a month			
(d)	31	Wages Expense	511	720	
		Wages Payable	214		720
		To accrue unrecorded wages			
(e)	31	Unearned Design Revenue	213	800	
		Design Revenue	411		800
		To recognize payment for services not yet performed			
(f)	31	Accounts Receivable	113	400	
		Design Revenue	411		400
		To accrue design fees earned but unrecorded			

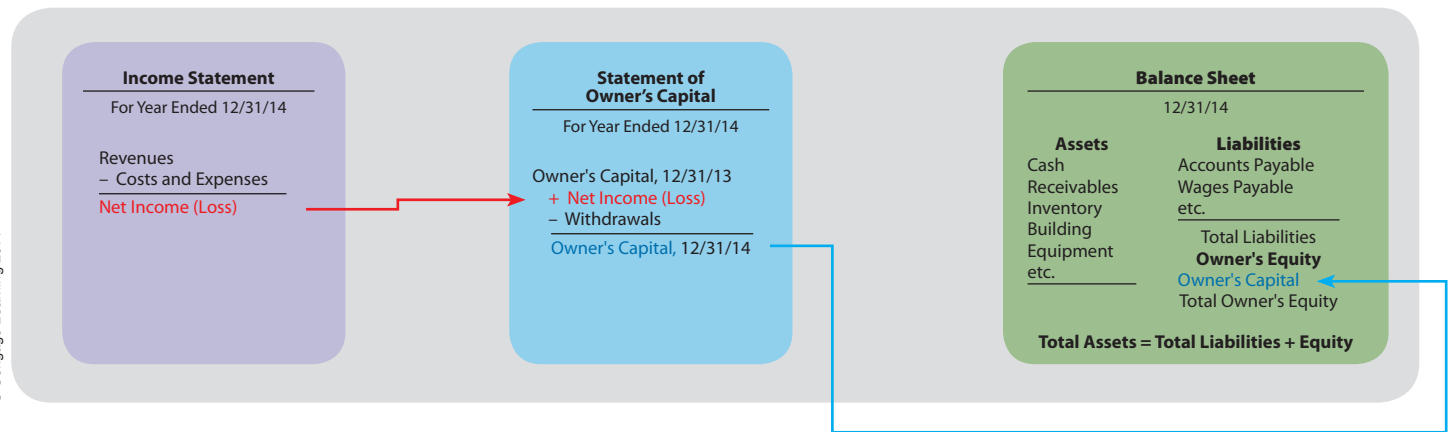
© Cengage Learning 2014

## Closing Entries and the Financial Statements

Closing entries set the accounts on the income statement to zero and transfer the resulting balance of net income or loss to the owner's Capital account on the balance sheet as depicted in Exhibit 10. Closing entries do not affect cash flows.

**Exhibit 10**  
The Effect of Closing Entries on the Financial Statements

© Cengage Learning 2014



**APPLY IT!**

Place the following columns of a work sheet in the proper order:

- a. Balance Sheet columns
- b. Trial Balance columns
- c. Income Statement columns
- d. Adjusted Trial Balance columns
- e. Adjustments columns

**SOLUTION**

b., e., d., c., a.

**TRY IT! SE 11, E4A, E6A, E7A, E8A, E4B, E6B, E7B, E8B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATION

- Using a work sheet

RELEVANT  
LEARNING OBJECTIVE

**LO 5** Explain the importance of the work sheet and closing entries when managing a business.

## **LO 5** The Importance of the Work Sheet and Closing Entries for Managers

Preparing the work sheet and recording closing entries may seem like technical accounting topics without much function, but in fact they are important steps that save money and prevent mistakes. They also help in understanding the business by providing the mechanism for dividing its financial life into accounting periods; thus, applying the concept of *periodicity*.

### Using the Work Sheet

Accountants use the completed work sheet in performing three principal tasks. These tasks are as follows.

- **Recording the adjusting entries in the general journal:** Because the information needed to record the adjusting entries can be copied from the work sheet, entering the adjustments in the journal is an easy step, as shown in Exhibit 9. The adjusting entries are then posted to the general ledger.
- **Recording the closing entries in the general journal:** The Income Statement columns of the work sheet show all the accounts that need to be closed, except for the Withdrawals account. Exhibits 2 through 6 show how the closing entries are entered in the journal and posted to the ledger.
- **Preparing the financial statements:** Once the work sheet has been completed, preparing the financial statements is simple because the account balances have been sorted into the Income Statement and Balance Sheet columns.

Closing entries are important to managing a business for the following reasons:

- The owners of the business expect periodic reports of the progress of the business.
- In planning a business' future operations, management needs to prepare budgets for future time periods.
- For management to evaluate a company's process in achieving its profitability goals, it is necessary to divide the life of the business into relatively short time periods.



## International Perspective

IFRS

### Why Are IFRS Important to Multinational Companies?

Many U.S. companies, both private and public, operate in different countries. If these companies were able to use IFRS for all their operations throughout the world (including in the United States), it would simplify the process of preparing combined or consolidated financial statements. Currently, these companies face a difficult task every time they need to prepare financial statements for combined or consolidated operations because the accounting records of the foreign divisions often follow the accounting standards of their respective countries or IFRS. In either case, their financial statements must be converted to U.S. GAAP before they can be combined with the accounts of the U.S. company. The use of IFRS for the entire company would save money and enable the company to report more timely results. This is one reason many U.S. multinational companies favor the adoption of IFRS in the United States.



# APPLY IT!

Indicate whether each of the following items is associated with a purpose of (a) the work sheet or (b) closing entries:

1. Preparing the financial statements.
2. Financial statements that are up to date for measuring financial progress.
3. Recording adjusting entries.
4. Recording closing entries.
5. Preparing budgets.

**SOLUTION**

1. a; 2. b; 3. a; 4. a; 5. b

**TRY IT! SE11, E5A, E6A, E7A, E8A, E5B, E6B, E7B, E8B**

## TriLevel Problem



**Speedy Movers**

mangostock/Shutterstock

The beginning of this chapter focused on Speedy Movers. At the end of an accounting period, Speedy Movers, like all other companies, must prepare its accounts for the next accounting period. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

**Section 1: Concepts**

*Why are the concepts of permanent and temporary accounts important to making closing entries?*

**Section 2: Accounting Applications**

*What steps must a company follow to prepare its accounts for the next accounting period? Refer to Speedy Movers' partial adjusted trial balance below.*

	A	B	C
1	<b>Speedy Movers</b>		
2	<b>Partial Adjusted Trial Balance</b>		
3	<b>June 30, 2014</b>		
4			
5	J. Thomas, Capital		24,740
6	J. Thomas, Withdrawals	18,000	
7	Moving Services Revenue		185,400
8	Driver Wages Expense	88,900	
9	Fuel Expense	19,000	
10	Other Wages Expense	14,400	
11	Packing Supplies Expense	6,200	
12	Office Equipment Rental Expense	3,000	
13	Utilities Expense	4,450	
14	Insurance Expense	4,200	
15	Interest Expense	5,100	
16	Depreciation Expense	10,040	
17			

1. Prepare the necessary closing entries. (Note that this adjusted trial balance is "partial" in that it omits all balance sheet accounts except the owner's equity accounts.)
2. Compute the ending balance of the owner's Capital account.

**Section 3: Business Applications**

*Why are closing entries important to good financial reporting in the current accounting period and the next accounting period?*

**SOLUTION****Section 1: Concepts**

Permanent accounts and temporary accounts are used in the process of achieving *periodicity* and *accrual accounting*. Permanent accounts (or real accounts) are accounts that carry forward their balances into the next accounting period. They are the balance sheet accounts. On the other hand, temporary accounts (or nominal accounts) are accounts that begin each accounting period with a zero balance, accumulate a balance during the period, and are then cleared by means of closing entries. Thus, temporary accounts show a company's revenues and expenses for a particular period of time. They are the income statement accounts and the owner's withdrawal accounts.

**Section 2: Accounting Applications**

1.

	A	B	C	D	E
1	June	30	Moving Services Revenue	185,400	
2			Income Summary		185,400
3			To close the credit balance account		
4		30	Income Summary	155,290	
5			Driver Wages Expense		88,900
6			Fuel Expense		19,000
7			Other Wages Expense		14,400
8			Packing Supplies Expense		6,200
9			Office Equipment Rental Expense		3,000
10			Utilities Expense		4,450
11			Insurance Expense		4,200
12			Interest Expense		5,100
13			Depreciation Expense		10,040
14			To close the debit balance accounts		
15		30	Income Summary	30,110	
16			J. Thomas, Capital		30,110
17			To close the Income Summary account		
18			$\$185,400 - \$155,290 = \$30,110$		
19		30	J. Thomas, Capital	18,000	
20			J. Thomas, Withdrawals		18,000
21			To close the Withdrawals account		
22					

2.

	A	B	C	D	E	F
1	<b>J. Thomas, Capital</b>					
2	June	30	18,000	Beg. Bal.		24,740
3				June	30	30,110
4				End. Bal.		36,850

**Section 3: Business Applications**

Closing entries are helpful for business owners who expect periodic reports of the progress of the business. These entries also help management to prepare budgets for future time periods in planning a business' future operation. Finally, closing entries help divide the life of the business into relatively short time periods so that management can evaluate a company's progress in achieving its profitability goals.

## Chapter Review

**Describe the role of closing entries in the preparation of financial statements.** **LO 1**

Closing entries have two purposes: (1) They clear the balances of all temporary accounts (revenue, expense, and Withdrawals accounts) so that they have zero balances at the beginning of the next accounting period, and (2) they summarize a period's revenues and expenses in the Income Summary account so that the net income or loss for the period can be transferred as a total to owner's Capital.

**Prepare closing entries.** **LO 2**

The first two steps in preparing closing entries are to transfer the balances of the revenue and expense accounts to the Income Summary account. The balance of the Income Summary account is then transferred to the owner's Capital account. Finally, the balance of the Withdrawals account is transferred to owner's Capital. After the closing entries have been posted to the ledger accounts, a post-closing trial balance is prepared as a final check on the balance of the ledger and to ensure that all temporary (nominal) accounts have been closed.

**Prepare reversing entries.** **LO 3**

Reversing entries are optional journal entries made on the first day of an accounting period. Reversing entries have the opposite effect of adjusting entries made at the end of the previous period—that is, a reversing entry debits the credits and credits the debits of an earlier adjusting entry. The sole purpose of reversing entries is to simplify routine bookkeeping procedures, and they apply only to accruals.

**Prepare a work sheet.** **LO 4**

The five steps in preparing a work sheet are (1) enter and total the account balances in the Trial Balance columns; (2) enter and total the adjustments in the Adjustments columns; (3) enter and total the adjusted account balances in the Adjusted Trial Balance columns; (4) extend the account balances from the Adjusted Trial Balance columns to the Income Statement or Balance Sheet columns; and (5) total the Income Statement and Balance Sheet columns, enter the net income or net loss in both pairs of columns as a balancing figure, and recompute the column totals.

**Explain the importance of the work sheet and closing entries when managing a business.** **LO 5**

A work sheet is useful in recording both adjusting and closing entries and in preparing the financial statements. The income statement and balance sheet can be prepared directly from the Income Statement and Balance Sheet columns of the completed work sheet. The statement of owner's equity is prepared using owner's Withdrawals, net income, additional investments, and the beginning balance of the owner's Capital account.

The work sheet assists in preparing adjusting and closing entries as well as the financial statements. Closing entries are useful for (1) owners of the business who expect periodic reports of the progress of the business, (2) management to prepare budgets for future time periods in planning a business' future operations, and (3) management to evaluate a company's progress in achieving its profitability goals.

## Key Terms

**closing entries** 132 (LO1)  
**crossfooting** 145 (LO4)  
**Income Summary account** 132 (LO1)

**permanent accounts** 132 (LO1)  
**post-closing trial balance** 140 (LO2)  
**reversing entry** 141 (LO3)  
**temporary accounts** 132 (LO1)

**work sheet** 143 (LO4)  
**working papers** 143 (LO4)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1.** Why is the accounting cycle called a “cycle”?
- LO 2 **DQ2.** Could closing entries be made without using the Income Summary account?
- LO 2 **DQ3.** Why does the post-closing trial balance contain only balance sheet accounts?
- LO 3 **DQ4.** Why are reversing entries helpful?
- LO 4 **DQ5.** Under what circumstances would the Income Statement and Balance Sheet columns on a work sheet balance when they are initially totaled?

### SHORT EXERCISES

#### LO 1 Concepts Underlying Closing Entries

**SE1. CONCEPT** ▶ Match the following concepts to the related statements:

- |                       |                       |
|-----------------------|-----------------------|
| a. periodicity        | c. permanent accounts |
| b. accrual accounting | d. temporary accounts |

1. Encompasses all the techniques that determine income for an accounting period.
2. Accumulate from zero each accounting period.
3. Concept that embodies assumption that life of business can be divided into accounting periods.
4. Have a balance that carries forwarded from one accounting period to another.

#### LO 1 Accounting Cycle

**SE2.** Resequence the following activities to indicate the usual order of the accounting cycle:

- |                                      |  |
|--------------------------------------|--|
| a. Close the accounts.               | f. Record the transactions in the journal. |
| b. Analyze the transactions.         | g. Prepare the post-closing trial balance. |
| c. Post the entries to the ledger.   | h. Prepare the initial trial balance.      |
| d. Prepare the financial statements. | i. Prepare the adjusted trial balance.     |
| e. Adjust the accounts.              |  |

#### LO 2 Closing Revenue Accounts

**SE3.** Assume that at the end of the accounting period there are credit balances of \$3,400 in Patient Services Revenues and \$1,800 in Laboratory Fees Revenues. Prepare the required closing entry. The accounting period ends December 31.

#### LO 2 Closing Expense Accounts

**SE4.** Assume that debit balances at the end of the accounting period are \$1,400 in Rent Expense, \$1,100 in Wages Expense, and \$500 in Other Expenses. Prepare the required closing entry. The accounting period ends December 31.

#### LO 2 Closing the Income Summary Account

**SE5.** Assuming that total revenues were \$5,200 and total expenses were \$3,000, prepare the journal entry to close the Income Summary account to the P. Mehta, Capital account. The accounting period ends December 31.

#### LO 2 Closing the Withdrawals Account

**SE6.** Assuming that withdrawals during the accounting period were \$800, prepare the journal entry to close the P. Mehta, Withdrawals account to the P. Mehta, Capital account. The accounting period ends December 31.

**LO 2 Posting Closing Entries**

**SE7.** Show the effects of the transactions in **SE3**, **SE4**, **SE5**, and **SE6** by entering beginning balances in appropriate T accounts and recording the transactions. Assume that the P. Mehta, Capital account had a beginning balance of \$1,300.

**LO 3 Preparation of Reversing Entries**

**SE8.** Below, indicated by letters, are the adjusting entries at the end of March.

Account Name	Debit	Credit
Prepaid Insurance		(a) 180
Accumulated Depreciation—Office Equipment		(b) 1,050
Salaries Expense	(c) 360	
Insurance Expense	(a) 180	
Depreciation Expense—Office Equipment	(b) 1,050	
Salaries Payable		(c) 360
	<u>1,590</u>	<u>1,590</u>

Prepare the required reversing entry or entries.

**LO 3 Effects of Reversing Entries**

**SE9.** Assume that prior to the adjustments in **SE8**, Salaries Expense had a debit balance of \$1,800 and Salaries Payable had a zero balance. Prepare a T account for each of these accounts. Enter the beginning balance. Post the adjustment for accrued salaries, the appropriate closing entry, and the reversing entry. Then, enter the transaction in the T accounts for a payment of \$480 for salaries on April 3.

**LO 2 Preparation of Closing Entries**

**SE10.** Katsu Company's adjusted trial balance on December 31, 2014, contains the following accounts and balances: F. Katsu, Capital, \$8,600; F. Katsu, Withdrawals, \$350; Service Revenue, \$2,600; Rent Expense, \$400; Wages Expense, \$900; Utilities Expense, \$200; and Telephone Expense, \$50. Prepare the closing entries.

**LO 2, 4, 5 Preparation of Closing Entries from a Work Sheet**

**SE11.** Prepare the required closing journal entries for the year ended December 31, using the items from the Income Statement columns of a work sheet that follow and assuming that withdrawals by the owner, A. Riley, were \$7,000.

Account Name	Debit	Credit
Repair Revenue		35,860
Wages Expense	13,260	
Rent Expense	2,800	
Supplies Expense	6,390	
Insurance Expense	1,370	
Depreciation Expense—Repair Equipment	3,020	
	<u>26,840</u>	<u>35,860</u>
Net Income	9,020	
	<u>35,860</u>	<u>35,860</u>

## EXERCISES: SET A

### LO 2 Preparation of Closing Entries

**E1A.** Hamilton Realty Company's income statement accounts at the end of its fiscal year, December 31, follow. Prepare the required closing entries. Lewis Hamilton is the owner.

Account Name	Debit	Credit
Commission Revenue		\$25,620
Wages Expense	\$8,110	
Rent Expense	1,200	
Supplies Expense	4,260	
Insurance Expense	915	
Depreciation Expense—Office Equipment	1,345	
Total Expenses		15,830
Net Income		<u>\$ 9,790</u>

### LO 3 Reversing Entries

**E2A.** Selected September T accounts for Kalgan Company follow.

Supplies				Supplies Expense			
Dr.		Cr.		Dr.		Cr.	
9/1 Bal.	1,720	9/30 Adj.	2,560	9/30 Adj.	2,560	9/30 Closing	2,560
Sept. purchases	1,880						
<b>Bal.</b>	<b>1,040</b>			<b>Bal.</b>	—		

Wages Payable				Wages Expense			
Dr.		Cr.		Dr.		Cr.	
		9/30 Adj.	1,280	Sept. wages	7,880	9/30 Closing	9,160
				9/30 Adj.	1,280		
		<b>Bal.</b>	<b>1,280</b>	<b>Bal.</b>	—		

- ACCOUNTING CONNECTION** ▶ In which of the accounts would a reversing entry be helpful? Why?
- Prepare the appropriate reversing entry.
- Prepare the journal entry to record a payment on October 25 for wages totaling \$6,280. How much of this amount represents wages expense for October?

### LO 2 Preparation of a Trial Balance

**E3A.** An alphabetical list presenting the accounts and balances for Ken's Cleaners on June 30, 2014, follows. All the accounts have normal balances.

Accounts Payable	\$ 30,840
Accounts Receivable	15,300
Accumulated Depreciation—Office Equipment	2,700
Advertising Expense	3,600
Cash	15,270
Office Equipment	31,020
Prepaid Insurance	3,360
Rent Expense	14,400
Revenue from Cleaning	115,800
I. Bell, Capital	61,260
I. Bell, Withdrawals	54,000
Supplies	1,650
Wages Expense	72,000

Prepare the trial balance by listing the accounts in the correct order, with the balances in the appropriate debit or credit column.

**LO 4 Completion of a Work Sheet**

**E4A.** A highly simplified alphabetical list of trial balance accounts and their normal balances for the month ended March 31, 2014, follows.

Accounts Payable	8
Accounts Receivable	14
Accumulated Depreciation—Office Equipment	2
Cash	8
K. Pollard, Capital	24
K. Pollard, Withdrawals	12
Office Equipment	16
Prepaid Insurance	4
Service Revenue	46
Supplies	8
Unearned Revenues	6
Utilities Expense	4
Wages Expense	20

1. Prepare a work sheet, entering the trial balance accounts in the order in which they would normally appear and entering the balances in the correct debit or credit column.
2. Complete the work sheet using the following information: expired insurance, \$2; estimated depreciation on office equipment, \$2; accrued wages, \$2; and unused supplies on hand, \$2. In addition, \$4 of the unearned revenues balance had been earned by the end of the month.

**LO 5 Preparation of Statement of Owner's Equity**

**E5A.** The Capital, Withdrawals, and Income Summary accounts for Strauss's Hair Salon are shown in the T accounts that follow. The closing entries have been recorded for the year ended December 31, 2014.

<b>B. Strauss, Capital</b>			
<i>Dr.</i>		<i>Cr.</i>	
12/31/14	9,000	12/31/13	26,000
		12/31/14	19,000
		<b>Bal.</b>	<b>36,000</b>

<b>Income Summary</b>			
<i>Dr.</i>		<i>Cr.</i>	
12/31/14	43,000	12/31/14	62,000
12/31/14	19,000		
<b>Bal.</b>	—		

<b>B. Strauss, Withdrawals</b>			
<i>Dr.</i>		<i>Cr.</i>	
4/1/14	3,000	12/31/14	9,000
7/1/14	3,000		
10/1/14	3,000		
<b>Bal.</b>	—		

Prepare a statement of owner's equity for Strauss's Hair Salon.



LO 3, 4, 5 **Preparation of Adjusting and Reversing Entries from Work Sheet Columns**

**E6A.** The items that follow are from the Adjustments columns of a work sheet dated June 30, 2014.

Account Name	Adjustments	
	Debit	Credit
Prepaid Insurance		(a) 480
Office Supplies		(b) 1,260
Accumulated Depreciation—Office Equipment		(c) 2,800
Accumulated Depreciation—Store Equipment		(d) 4,400
Office Salaries Expense	(e) 480	
Store Salaries Expense	(e) 960	
Insurance Expense	(a) 480	
Office Supplies Expense	(b) 1,260	
Depreciation Expense—Office Equipment	(c) 2,800	
Depreciation Expense—Store Equipment	(d) 4,400	
Salaries Payable		(e) 1,440
	<u>10,380</u>	<u>10,380</u>

1. Prepare the adjusting entries.
2. Where required, prepare appropriate reversing entries.

LO 2, 4, 5 **Preparation of Closing Entries from the Work Sheet**

**E7A.** The items that follow are from the Income Statement columns of Winter's Repair Shop's work sheet for the year ended December 31, 2014. Prepare journal entries to close the revenue, expense, Income Summary, and Withdrawals accounts. The owner, A. Winter, withdrew \$2,500 during the year.

Account Name	Income Statement	
	Debit	Credit
Repair Revenue		12,810
Wages Expense	4,055	
Rent Expense	600	
Supplies Expense	2,130	
Insurance Expense	458	
Depreciation Expense—Repair Equipment	672	
	<u>7,915</u>	<u>12,810</u>
Net Income	4,895	
	<u>12,810</u>	<u>12,810</u>

LO 4, 5 **Adjusting Entries and Preparation of a Balance Sheet**

**E8A.** In the partial work sheet for K. Joe Company that follows, the Trial Balance and Income Statement columns have been completed. All amounts are in dollars.

Account Name	Trial Balance		Income Statement	
	Debit	Credit	Debit	Credit
Cash	28			
Accounts Receivable	48			
Supplies	44			
Prepaid Insurance	32			
Building	100			
Accumulated Depreciation—Building		32		
Accounts Payable		16		
Unearned Revenues		8		
K. Joe, Capital		128		
Revenues		176		184
Wages Expense	108		120	
	<u>360</u>	<u>360</u>		

Account Name	Trial Balance		Income Statement	
	Debit	Credit	Debit	Credit
Insurance Expense			16	
Supplies Expense			32	
Depreciation Expense—Building			8	
Wages Payable				
			<u>176</u>	<u>184</u>
Net Income			8	
			<u>184</u>	<u>184</u>

1. Show the adjusting entries without giving an explanation.
2. Prepare a balance sheet for December 31, 2014.

## EXERCISES: SET B

Visit the textbook companion web site at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 1, 2 Preparation of Closing Entries

**P1.** Salinas Trailer Rental rents small trailers by the day for local moving jobs. Its adjusted trial balance at the end of the current fiscal year follows.

Salinas Trailer Rental Adjusted Trial Balance June 30, 2014			
Cash	1,384		
Accounts Receivable	1,944		
Supplies	238		
Prepaid Insurance	720		
Trailers	24,000		
Accumulated Depreciation—Trailers			14,400
Accounts Payable			542
Wages Payable			400
D. Anatole, Capital			11,388
D. Anatole, Withdrawals	14,400		
Trailer Rentals Revenue			91,092
Wages Expense	46,800		
Insurance Expense	1,440		
Supplies Expense	532		
Depreciation Expense—Trailers	4,800		
Other Expenses	21,564		
	<u>117,822</u>		<u>117,822</u>

### REQUIRED

1. From the information given, record closing entries.
2. **CONCEPT** ► If closing entries were not prepared at the end of the accounting period, what problems would result in the next accounting period?

## LO 1, 2 Closing Entries Using T Accounts and Preparation of Financial Statements

- ✓ 3: Net income: \$103,150
- ✓ 3: Total assets: \$627,800

**P2.** Carlton Tennis Club's adjusted trial balance at the end of its fiscal year follows.

<b>Carlton Tennis Club Adjusted Trial Balance June 30, 2014</b>		
Cash	26,200	
Prepaid Advertising	9,600	
Supplies	1,200	
Land	100,000	
Building	645,200	
Accumulated Depreciation—Building		260,000
Equipment	156,000	
Accumulated Depreciation—Equipment		50,400
Accounts Payable		73,000
Wages Payable		9,000
Property Taxes Payable		22,500
Unearned Revenue—Locker Fees		3,000
J. Kojas, Capital		471,150
J. Kojas, Withdrawals	54,000	
Revenue from Court Fees		678,100
Revenue from Locker Fees		9,600
Wages Expense	351,000	
Maintenance Expense	51,600	
Advertising Expense	39,750	
Utilities Expense	64,800	
Supplies Expense	6,000	
Depreciation Expense—Building	30,000	
Depreciation Expense—Equipment	12,000	
Property Taxes Expense	22,500	
Miscellaneous Expense	6,900	
	<u>1,576,750</u>	<u>1,576,750</u>

### REQUIRED

1. Prepare T accounts and enter the balances for J. Kojas, Capital; J. Kojas, Withdrawals; Income Summary, and all revenue and expense accounts.
2. Enter the four required closing entries in the T accounts, labeling the components *a* (credit balances), *b* (debit balances), *c* (Income Summary), and *d* (withdrawals), as appropriate.
3. Prepare an income statement, a statement of owner's equity, and a balance sheet for Carlton Tennis Club.
4. **CONCEPT** ► Explain why it is necessary to make closing entries at the end of an accounting period.

## LO 2 Preparation of Closing Entries

**P3.** Primorsk is a global specialized staffing firm. Information adapted from the statement of earnings (in thousands, without earnings per share information) in its annual report for the year ended December 31, 2014, follows. The firm reported distributing cash (dividends) in the amount of \$95,562,000 to the owners in 2014.

**Revenues**

Service revenues	\$6,676,878
Interest income	21,896
Total revenues	<u>\$6,698,774</u>

**Expenses**

Employee compensation and benefits	\$3,930,780
Selling, general, and administrative expenses	1,983,646
Income taxes	308,608
Total expenses	<u>\$6,223,034</u>
Net income	<u>\$ 475,740</u>

**REQUIRED**

1. Prepare the closing entries Primorsk would have made on December 31, 2014. Treat income taxes as an expense and cash distributions to owners as withdrawals.
2. **ACCOUNTING CONNECTION** ► Based on your handling of requirement 1 and the effect of expenses and cash distributions on owner's capital, what theoretical reason can you give for not including expenses and cash distributions in the same closing entry?

LO 2, 3, 4, 5

**Preparation of a Work Sheet, Financial Statements, and Adjusting, Closing, and Reversing Entries**

SPREADSHEET

- ✓ 2: Net income: \$62,392
- ✓ 2: Total assets: \$247,148

- P4.** At the end of the fiscal year, Siglo Delivery Service's trial balance appeared as follows.

**Siglo Delivery Service**  
**Trial Balance**  
**August 31, 2014**

Cash	10,072	
Accounts Receivable	29,314	
Prepaid Insurance	5,340	
Delivery Supplies	14,700	
Office Supplies	2,460	
Land	15,000	
Building	196,000	
Accumulated Depreciation—Building		53,400
Trucks	103,800	
Accumulated Depreciation—Trucks		30,900
Office Equipment	15,900	
Accumulated Depreciation—Office Equipment		10,800
Accounts Payable		9,396
Unearned Lockbox Fees		8,340
Mortgage Payable		72,000
R. Siglo, Capital		128,730
R. Siglo, Withdrawals	30,000	
Delivery Service Revenue		283,470
Lockbox Fees Earned		28,800
Truck Drivers' Wages Expense	120,600	
Office Salaries Expense	44,400	
Gas, Oil, and Truck Repairs Expense	31,050	
Interest Expense	7,200	
	<u>625,836</u>	<u>625,836</u>

(Continued)

**REQUIRED**

1. Enter the trial balance amounts in the Trial Balance columns of a work sheet and complete the work sheet using the information that follows.
  - a. Expired insurance, \$3060
  - b. Inventory of unused delivery supplies, \$1,430
  - c. Inventory of unused office supplies, \$186
  - d. Estimated depreciation on the building, \$14,400
  - e. Estimated depreciation on the trucks, \$15,450
  - f. Estimated depreciation on the office equipment, \$2,700
  - g. The company credits the lockbox fees of customers who pay in advance to the Unearned Lockbox Fees account. Of the amount credited to this account during the year, \$5,630 had been earned by August 31.
  - h. Lockbox fees earned but unrecorded and uncollected at the end of the accounting period, \$816
  - i. Accrued but unpaid truck drivers' wages at the end of the year, \$1,920
2. Prepare an income statement, a statement of owner's equity, and a balance sheet for the company. Assume the owner, Raul Siglo, made no additional investments.
3. Prepare adjusting, closing, and, when necessary, reversing entries from the work sheet.
4. **BUSINESS APPLICATION** ► Can the work sheet be used as a substitute for the financial statements? Explain your answer.

LO 1, 2

**The Complete Accounting Cycle Without a Work Sheet:  
Two Months (second month optional)**

SPREADSHEET

GENERAL LEDGER

**P5.** On May 1, 2014, Leon Stoker opened Stoker's Repair Service. During the month, he completed the following transactions for the company:

- May 1 Began business by depositing \$10,000 in a bank account in the name of the company.
- 1 Paid the rent for the store for current month, \$850.
  - 1 Paid the premium on a one-year insurance policy, \$960.
  - 2 Purchased repair equipment from Latin Company, \$8,400. Terms were \$1,200 down and \$600 per month for one year. First payment is due June 1.
  - 5 Purchased repair supplies from Tanaka Company on credit, \$936.
  - 8 Paid cash for an advertisement in a local newspaper, \$120.
  - 15 Received cash repair revenue for the first half of the month, \$800.
  - 21 Paid Tanaka Company on account, \$450.
  - 31 Received cash repair revenue for the last half of May, \$1,950.
  - 31 Made a withdrawal, \$600.

**REQUIRED FOR MAY**

1. Prepare journal entries to record the May transactions. Include the Post. Ref. column and fill in using the account numbers listed in requirement 2.
2. Open the following accounts: Cash (111); Prepaid Insurance (117); Repair Supplies (119); Repair Equipment (144); Accumulated Depreciation—Repair Equipment (145); Accounts Payable (212); L. Stoker, Capital (311); L. Stoker, Withdrawals (313); Income Summary (314); Repair Revenue (411); Store Rent Expense (511); Advertising Expense (512); Insurance Expense (513); Repair Supplies Expense (514); and Depreciation Expense—Repair Equipment (515). Post the May journal entries to the ledger accounts.
3. Using the following information, record adjusting entries in the general journal and post to the ledger accounts:
  - a. One month's insurance has expired.
  - b. The remaining inventory of unused repair supplies is \$338.
  - c. The estimated depreciation on repair equipment is \$140.
4. From the accounts in the ledger, prepare an adjusted trial balance.  
(*Note:* Normally, a trial balance is prepared before adjustments but is omitted here to save time.)

- ✓5: May 31, 2014, net income: \$962
- ✓5: May 31, 2014, total assets: \$18,048
- ✓11: June 30, 2014, net income: \$1,034
- ✓11: June 30, 2014, total assets: \$18,408

5. From the adjusted trial balance, prepare an income statement, a statement of owner's equity, and a balance sheet for May.
6. Prepare and post closing entries.
7. Prepare a post-closing trial balance.

*(Optional)*

During June, Leon Stoker completed these transactions for Stoker's Repair Service.

- |      |    |  |
|------|----|--|
| June | 1  | Paid the monthly rent, \$850.  |
|      | 1  | Made the monthly payment to Latin Company, \$600.                            |
|      | 6  | Purchased additional repair supplies on credit from Tanaka Company, \$1,726. |
|      | 15 | Received cash repair revenue for the first half of the month, \$1,828.       |
|      | 20 | Paid cash for an advertisement in the local newspaper, \$120.                |
|      | 23 | Paid Tanaka Company on account, \$1,200.                                     |
|      | 30 | Received cash repair revenue for the last half of the month, \$1,634.        |
|      | 30 | Recorded a withdrawal by owner, \$600.                                       |

8. Prepare and post journal entries to record the June transactions.
9. Using the following information, record adjusting entries in the general journal and post to the ledger accounts.
  - a. One month's insurance has expired.
  - b. The inventory of unused repair supplies is \$826.
  - c. The estimated depreciation on repair equipment is \$140.
10. From the accounts in the ledger, prepare an adjusted trial balance.
11. From the adjusted trial balance, prepare the June income statement, statement of owner's equity, and balance sheet.
12. Prepare and post closing entries.
13. Prepare a post-closing trial balance.

## ALTERNATE PROBLEMS

LO 1, 2

### Preparation of Closing Entries

**P6.** Villa Consultant Company's adjusted trial balance at the end of its fiscal year follows.

**Villa Consultant Company**  
**Adjusted Trial Balance**  
**December 31, 2014**

Cash	14,550	
Accounts Receivable	4,650	
Prepaid Insurance	1,170	
Office Supplies	880	
Office Equipment	12,600	
Accumulated Depreciation—Office Equipment		1,530
Automobile	13,500	
Accumulated Depreciation—Automobile		1,500
Accounts Payable		3,400
Unearned Consulting Fees		3,000
J. Villa, Capital		29,070
J. Villa, Withdrawals	14,000	
Consulting Fees Earned		66,430
Office Salaries Expense	27,000	
Advertising Expense	5,050	
Rent Expense	5,300	
Telephone Expense	3,200	
Depreciation Expense—Office Equipment	1,530	
Depreciation Expense—Automobile	1,500	
	104,930	104,930

*(Continued)*

**REQUIRED**

1. Prepare the required closing entries.
2. **CONCEPT** ► Explain why closing entries are necessary at the end of the accounting period.

LO 1, 2

- ✓ 3: Net income: \$206,300
- ✓ 3: Total assets: \$1,255,600

**Closing Entries Using T Accounts and Preparation of Financial Statements**

**P7.** Kilda Recreational Club's adjusted trial balance at the end of its fiscal year follows.

**Kilda Recreational Club  
Adjusted Trial Balance  
June 30, 2014**

Cash	52,400	
Prepaid Advertising	19,200	
Supplies	2,400	
Land	200,000	
Building	1,290,400	
Accumulated Depreciation—Building		520,000
Equipment	312,000	
Accumulated Depreciation—Equipment		100,800
Accounts Payable		146,000
Wages Payable		18,000
Property Taxes Payable		45,000
Unearned Revenue—Locker Fees		6,000
M. Kilda, Capital		942,300
M. Kilda, Withdrawals	108,000	
Revenue from Court Fees		1,356,200
Revenue from Locker Fees		19,200
Wages Expense	702,000	
Maintenance Expense	103,200	
Advertising Expense	79,500	
Utilities Expense	129,600	
Supplies Expense	12,000	
Depreciation Expense—Building	60,000	
Depreciation Expense—Equipment	24,000	
Property Taxes Expense	45,000	
Miscellaneous Expense	13,800	
	3,153,500	3,153,500

**REQUIRED**

1. Prepare T accounts and enter the balances for M. Kilda, Capital; M. Kilda, Withdrawals; Income Summary, and all revenue and expense accounts.
2. Enter the four required closing entries in the T accounts, labeling the components *a* (credit balances), *b* (debit balances), *c* (Income Summary), and *d* (withdrawals), as appropriate.



3. Prepare an income statement, a statement of owner's equity, and a balance sheet for Kilda Recreational Club.
4. **CONCEPT** ► Explain why it is necessary to make closing entries at the end of an accounting period.

**LO 2 Preparation of Closing Entries**

**P8.** Change Painting Company's adjusted trial balance at December 31, 2014, follows. The owner made no investments during the period.

<b>Change Painting Company</b>		
<b>Adjusted Trial Balance</b>		
<b>December 31, 2014</b>		
Cash	9,500	
Accounts Receivable	5,184	
Prepaid Insurance	760	
Prepaid Rent	400	
Painting Supplies	304	
Painting Equipment	7,750	
Accumulated Depreciation—Painting Equipment		640
Truck	14,400	
Accumulated Depreciation—Truck		1,440
Accounts Payable		840
Wages Payable		590
Unearned Painting Revenue		3,380
G. Ranke, Capital		30,068
G. Ranke, Withdrawals	4,000	
Painting Revenue		29,240
Wages Expense	11,360	
Rent Expense	2,700	
Gas, Oil, and Other Truck Expenses	1,160	
Insurance Expense	760	
Supplies Expense	5,840	
Depreciation Expense—Painting Equipment	640	
Depreciation Expense—Truck	1,440	
	<u>66,198</u>	<u>66,198</u>

**REQUIRED**

Prepare the required closing entries.

LO 2, 3, 4, 5

### Preparation of a Work Sheet, Financial Statements, and Adjusting, Closing, and Reversing Entries

SPREADSHEET

GENERAL LEDGER

✓ 2: June 30, 2014, net income: \$197,244

✓ 2: June 30, 2014, total assets: \$1,403,472

P9. Julio Theater Company's trial balance at the end of its current fiscal year follows.

#### Julio Theater Company Trial Balance June 30, 2014

Cash	63,600	
Accounts Receivable	37,088	
Prepaid Insurance	39,200	
Office Supplies	1,560	
Cleaning Supplies	7,180	
Land	40,000	
Building	800,000	
Accumulated Depreciation—Building		78,800
Theater Furnishings	740,000	
Accumulated Depreciation—Theater Furnishings		130,000
Office Equipment	63,200	
Accumulated Depreciation—Office Equipment		31,120
Accounts Payable		91,012
Gift Books Liability		83,800
Mortgage Payable		600,000
P. Julio, Capital		625,296
P. Julio, Withdrawals	120,000	
Ticket Sales Revenue		822,800
Theater Rental Revenue		90,400
Usher Wages Expense	314,000	
Office Wages Expense	48,000	
Utilities Expense	225,400	
Interest Expense	54,000	
	<u>2,553,228</u>	<u>2,553,228</u>

#### REQUIRED

- Enter Julio Theater's trial balance amounts in the Trial Balance columns of a work sheet and complete the work sheet using the following information:
  - Expired insurance, \$34,800.
  - Inventory of unused office supplies, \$488.
  - Inventory of unused cleaning supplies, \$936.
  - Estimated depreciation on the building, \$28,000.
  - Estimated depreciation on the theater furnishings, \$72,000.
  - Estimated depreciation on the office equipment, \$6,320.
  - The company credits all gift books sold during the year to the Gift Books Liability account. A gift book is a booklet of ticket coupons that is purchased in advance as a gift. The recipient redeems the coupons at some point in the future. On June 30 it was estimated that \$75,600 worth of the gift books had been redeemed.
  - Accrued but unpaid usher wages at the end of the accounting period, \$1,720.
- Prepare an income statement, a statement of owner's equity, and a balance sheet. Assume no additional investments by the owner, P. Julio.
- Prepare adjusting, closing, and, when necessary, reversing entries from the work sheet.
- BUSINESS APPLICATION** ► Can the work sheet be used as a substitute for the financial statements? Explain your answer.

LO 1, 2

### The Complete Accounting Cycle Without a Work Sheet: Two Months (*second month optional*)

SPREADSHEET

GENERAL LEDGER

- ✓ 5: June 30, 2014, net income: \$1,924
- ✓ 5: June 30, 2014, total assets: \$36,096
- ✓ 10: July 31, 2014, net income: \$2,068
- ✓ 10: July 31, 2014, total assets: \$36,816

**P10.** On June 1, 2014, Bob Lutz opened Lutz Repair Service. During the month, he completed the following transactions for the company:

- |      |   |
|------|---|
| June | <ul style="list-style-type: none"> <li>1 Began business by depositing \$20,000 in a bank account in the name of the company.</li> <li>1 Paid the rent for the store for current month, \$1,700.</li> <li>1 Paid the premium on a one-year insurance policy, \$1,920.</li> <li>2 Purchased repair equipment from Bilbao Company, \$16,800. Terms were \$2,400 down and \$1,200 per month for one year. First payment is due June 1.</li> <li>5 Purchased repair supplies from Rusin Company on credit, \$1,872.</li> <li>8 Paid cash for an advertisement in a local newspaper, \$240.</li> <li>15 Received cash repair revenue for the first half of the month, \$1,600.</li> <li>21 Paid Rusin Company on account, \$900.</li> <li>30 Received cash repair revenue for the last half of May, \$3,900.</li> <li>30 Made a withdrawal, \$1,200.</li> </ul> |
|------|---|

#### REQUIRED FOR JUNE

1. Prepare journal entries to record the June transactions. Include the Post. Ref. column and fill in using the account numbers listed in requirement 2.
2. Open the following accounts: Cash (111); Prepaid Insurance (117); Repair Supplies (119); Repair Equipment (144); Accumulated Depreciation—Repair Equipment (145); Accounts Payable (212); B. Lutz, Capital (311); B. Lutz, Withdrawals (313); Income Summary (314); Repair Revenue (411); Store Rent Expense (511); Advertising Expense (512); Insurance Expense (513); Repair Supplies Expense (514); and Depreciation Expense—Repair Equipment (515). Post the May journal entries to the ledger accounts.
3. Using the following information, record adjusting entries in the general journal and post to the ledger accounts:
  - d. One month's insurance has expired.
  - e. The remaining inventory of unused repair supplies is \$676.
  - f. The estimated depreciation on repair equipment is \$280.
4. From the accounts in the ledger, prepare an adjusted trial balance.  
(*Note:* Normally, a trial balance is prepared before adjustments but is omitted here to save time.)
5. From the adjusted trial balance, prepare an income statement, a statement of owner's equity, and a balance sheet for June.
6. Prepare and post closing entries.
7. Prepare a post-closing trial balance.

#### (Optional)

During July, Bob Lutz completed these transactions for Lutz Repair Service:

- |      |  |
|------|--|
| July | <ul style="list-style-type: none"> <li>1 Paid the monthly rent, \$1,700.</li> <li>1 Made the monthly payment to Bilbao Company, \$1,200.</li> <li>6 Purchased additional repair supplies on credit from Rusin Company, \$3,452.</li> <li>15 Received cash repair revenue for the first half of the month, \$3,656.</li> <li>20 Paid cash for an advertisement in the local newspaper, \$240.</li> <li>23 Paid Rusin Company on account, \$2,400.</li> <li>30 Received cash repair revenue for the last half of the month, \$3,268.</li> <li>30 Recorded a withdrawal by owner, \$1,200.</li> </ul> |
|------|--|

(Continued)

8. Prepare and post journal entries to record the July transactions.
9. Using the following information, record adjusting entries in the general journal and post to the ledger accounts.
  - d. One month's insurance has expired.
  - e. The inventory of unused repair supplies is \$1,652.
  - f. The estimated depreciation on repair equipment is \$280.
10. From the accounts in the ledger, prepare an adjusted trial balance.
11. From the adjusted trial balance, prepare the July income statement, statement of owner's equity, and balance sheet.
12. Prepare and post closing entries.
13. Prepare a post-closing trial balance.

## CASES

### LO 1 Conceptual Understanding: Interim Financial Statements

**C1.** Gulf Coast Drilling Company provides services for drilling operations off the coast of Louisiana. The company has a significant amount of debt to National Bank of New Orleans. The bank requires the company to provide it with quarterly financial statements. Explain what is involved in preparing financial statements every quarter.

### LO 1 Conceptual Understanding: Purpose of Closing Entries

**C2.** Pamela Turnbow, owner of Turnbow Fashions Company, notices the amount of time it takes the company's accountant to prepare closing entries. She suggests that the company could save time and money by not doing closing entries. She argues that only adjusting entries are needed to determine the company's earnings. Explain the purposes of closing entries and why they are worth doing.

### LO 1 Conceptual Understanding: Accounting Efficiency

**C3.** Turner Cabinets Company manufactures storage cabinets used in industry. It sells its cabinets to some customers on credit with generous terms specifying payment six months after purchase and an interest rate based on current bank rates. Because the interest on the loans accrues a little every day but is not paid until the note's due date, an adjusting entry must be made at the end of each accounting period to debit Interest Receivable and credit Interest Income for the amount of the interest accrued but not received to date. The company prepares financial statements every month. Keeping track of what has been accrued in the past is time-consuming because the notes carry different dates and interest rates.

Form in-class groups to determine what the accountant can do to simplify the process of making the adjusting entry for accrued interest each month. Compare the groups' solutions in a class discussion.

### LO 1 Ethical Dilemma: Ethics and Time Pressure

**C4.** Thomas Odzer, an accountant for Mennix Company, has made adjusting entries and is preparing the adjusted trial balance for the first six months of the year. Financial statements must be delivered to the bank by 5 P.M. to support a critical loan agreement. By noon, Odzer has been unable to balance the adjusted trial balance. The figures are off by \$1,320, so he increases the balance of the owner's Capital account by \$1,320. He closes the accounts, prepares the statements, and sends them to the bank on time. He hopes that no one will notice the problem and believes that he can find the error and correct it by the end of next month. Are Odzer's actions ethical? Why or why not? Did he have other alternatives?

**LO 1 Annual Report Case: Fiscal Year, Closing Process, and Interim Reports**

**C5.** Refer to the notes to the financial statements in the **CVS** annual report in the Supplement to Chapter 16. When does CVS end its fiscal year? For what reasons might it have chosen this date? From the standpoint of completing the accounting cycle, what advantage does this date have? Does CVS prepare interim financial statements? What are the implications of interim financial statements for the accounting cycle?

**LO 1 Comparison Analysis: Interim Financial Reporting and Seasonality**

**C6.** Both **CVS** and **Southwest Airlines** provide quarterly financial information in their financial statements. Quarterly financial reports provide important information about the “seasonality” of a company’s operations. *Seasonality* refers to how dependent a company is on sales during different seasons of the year, and how that affects a company’s need to plan for cash flows and inventory. From the quarterly financial information for CVS in the Supplement to Chapter 16, determine the effects of seasons on CVS’s net revenues and net earnings by calculating for the most recent year the percentage of quarterly net sales and net earnings to annual net sales and net earnings. Discuss the results. How do you think the effect of seasons might differ for Southwest’s operating revenues and income?

**Continuing Case: Annual Report Project**

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company’s website, examine all four of the financial statements. Identify the accounts in these statements that would be affected by closing entries. Describe how they would be affected.





# CHAPTER 5

## Foundations of Financial Reporting and the Classified Balance Sheet

### BUSINESS INSIGHT

#### Surf-With-Park Company

Surf-With-Park Company is a retailer of casual beach wear for college students. It has two stores, and the owner, Alan Park, now wants to open a third. To obtain a loan, he will have to present a balance sheet to his bank. In the past, he has simply provided a list of the post-closing account balances at the end of the year and not prepared a balance sheet. In other words, he is looking for answers to the questions that appear below.

- 1. CONCEPT** ▶ *Why are relevance and faithful representation as well as enhancing qualitative characteristics important to understanding financial statements?*
- 2. ACCOUNTING APPLICATION** ▶ *How should the balance sheet be organized to provide the best information?*
- 3. BUSINESS APPLICATION** ▶ *What key measures best capture a company's financial performance?*

### LEARNING OBJECTIVES

- LO 1** Describe the objective of financial reporting, and identify the conceptual framework underlying accounting information.
- LO 2** Identify and define the basic components of financial reporting, and prepare a classified balance sheet.
- LO 3** Use classified financial statements to evaluate liquidity and profitability.



Tim Mantoani/Masterfile



## SECTION 1

## CONCEPTS

## CONCEPTS

- Relevance
  - Predictive value
  - Confirmative value
  - Materiality
- Faithful representation
  - Completeness
  - Neutrality
  - Free from material error
- Enhancing qualitative characteristics
  - Comparability
  - Verifiability
  - Timeliness
  - Understandability
  - Cost constraint
- Accounting conventions
  - Consistency
  - Full disclosure
  - Conservatism

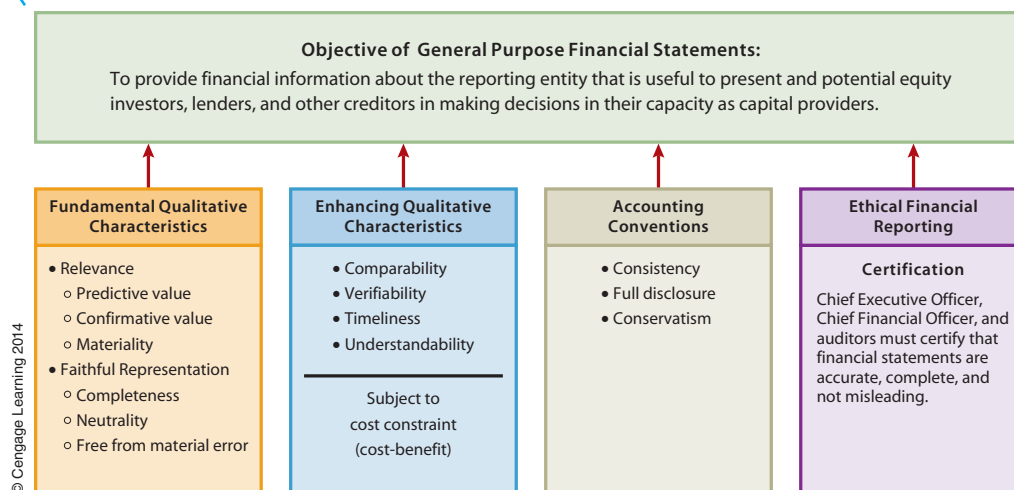
RELEVANT  
LEARNING OBJECTIVE

**LO 1** Describe the objective of financial reporting, and identify the conceptual framework underlying accounting information.

## LO 1 Concepts Underlying Financial Reporting

The FASB and the IASB are working toward convergence of U.S. generally accepted accounting principles (GAAP) with international financial reporting standards (IFRS). Their goal is “to increase the international comparability and the quality of standards used in the United States [which] is consistent with the FASB’s obligation to its domestic constituents, who benefit from comparability across national borders.”<sup>1</sup> An important part of this convergence project is agreement on the objective of financial reporting and conceptual framework underlying it. Exhibit 1 illustrates these factors, which we discuss in this section.

### Exhibit 1 Concepts Underlying Financial Reporting



## Objective of Financial Reporting

The Financial Accounting Standards Board (FASB) emphasizes the needs of current and potential investors (owners) and creditors while recognizing the needs of other users when it defines the objective of financial reporting as follows.<sup>2</sup>

*To provide financial information about the reporting entity that is useful to present and potential equity investors, lenders, and other creditors in making decisions in their capacity as capital providers. Information that is decision-useful to capital providers may also be useful to other users of financial reporting who are not capital providers.*

To be useful for decision making, financial reporting must enable the user to:

- **Assess cash flow prospects.** The ultimate value of a business and its ability to pay dividends, interest, or otherwise provide returns to capital providers depends on its ability to generate future cash flows. Capital providers and other users therefore need information about the business’s ability to generate cash flows.
- **Assess management’s stewardship.** Capital providers and others need information about the business’s resources (assets), claims against them (liabilities and owner’s [stockholders’] equity), and changes in these resources and claims resulting from transactions (earnings and cash flows) and other economic events.

Financial reporting includes the financial statements (balance sheet, income statement, statement of owner's equity, and statement of cash flows) that are periodically presented to parties outside the business. Management's underlying assumptions and methods and estimates used in the financial statements are also important components of financial reporting. Because of a potential conflict of interest between managers, who must prepare the statements, and investors or creditors, who invest in or lend money to the business, financial statements usually are audited by outside accountants.

## Qualitative Characteristics of Accounting Information

Introductory textbooks simplify basic accounting concepts to help students. All the problems can be solved, and all the numbers add up. In practice, however, accounting information is neither simple nor precise. The FASB emphasizes this fact in the following statement:

*The information provided by financial reporting often results from approximate, rather than exact, measures. The measures commonly involve numerous estimates, classifications, summarizations, judgments, and allocations. The outcome of economic activity in a dynamic economy is uncertain and results from combinations of many factors. Thus, despite the aura of precision that may seem to surround financial reporting in general and financial statements in particular, with few exceptions the measures are approximations, which may be based on rules and conventions, rather than exact amounts.<sup>3</sup>*

The goal of generating accounting information is to provide data that different users need to make informed decisions for their unique situations. How this goal is achieved provides much of the interest and controversy in accounting. To facilitate interpretation of accounting information, the FASB has established standards, or **qualitative characteristics**, by which to judge the information.<sup>4</sup> The most fundamental of these characteristics are *relevance* and *faithful representation*. *Comparability, verifiability, timeliness, and understandability* are enhancing characteristics that assist in interpreting accounting information.

**Relevance** means that the information has a direct bearing on a decision. In other words, if the information were not available, a different decision would be made. To be relevant, information must have *predictive value*, *confirmative value*, or both. Further, it is subject to *materiality*.

- **Predictive value:** Information has **predictive value** if it helps capital providers make decisions about future actions. For example, the statement of cash flows can provide information as to whether the company has sufficient funds to expand or if it will need to raise funds from capital providers.
- **Confirmative value:** Information has **confirmative value** if it confirms or changes previous evaluations. For example, the income statement provides information as to whether or not a company met earnings expectations.
- **Materiality:** Information is **material** if its omission or misstatement could influence the user's economic decisions taken on the basis of the specific entity's financial statements. **Materiality** is related to both the nature of an item and its size or misstatement. Immaterial items are not relevant to the economic decision. The materiality of an item normally is determined by relating its dollar value to an element of the financial statements, such as net income or total assets. As a rule, when an item is worth 5 percent or more of net income, accountants treat it as material. However, materiality depends not only on the value of an item but also on its nature. For example, in a multimillion-dollar company, a mistake of \$5,000 in recording an item may not be important, but the discovery of even a small bribe or theft can be very important. Moreover, many small errors can add up to a material amount.

The financial statements may provide information that is both predictive and confirmative. For example, the statement of cash flows not only helps to project future cash flows but also confirms expectations about various prior actions.



## Business Perspective

### How Much Is Material?

© Allija / iStockphoto.com

The materiality issue was long a pet peeve of the SEC, which contended that companies were increasingly abusing the convention to protect their stocks from taking a pounding when earnings did not reach their targets. Thus, the SEC issued a rule that includes both quantitative and qualitative guides. The traditional rule of thumb of 5 percent or more of net income is acceptable as an initial screening. However, companies cannot decline to book items in the interest of meeting earnings estimates, preserving a growing earnings trend, converting a loss to a profit, increasing management compensation, or hiding an illegal transaction, such as a bribe.<sup>5</sup>

**Faithful Representation** **Faithful representation** means that the financial information is *complete, neutral, and free from material error*.

- **Completeness: Complete information** provides all information necessary for a reliable decision.
- **Neutrality: Neutral information** is free from bias intended to achieve a certain result or to bring about a particular behavior.
- **Free from material error:** To be **free from material error** means information meets a minimum level of accuracy so it does not distort what is being reported. Free from material error does not mean that information is absolutely accurate because most financial information is based on estimates and judgments.

If major uncertainties about faithful representation exist, they should be *disclosed* in a note to the financial statements.

**Enhancing Qualitative Characteristics** Other qualitative characteristics that the FASB has established for interpreting accounting information include:

- **Comparability: Comparability** is the quality that enables users to identify similarities and differences between two sets of financial data.
- **Verifiability: Verifiability** is the quality that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation.
- **Timeliness: Timeliness** is the quality that enables users to receive information in time to influence their decisions.
- **Understandability: Understandability** is the quality that enables users to comprehend the meaning of the information.

These enhancing characteristics are subject to the **cost constraint** (or **cost-benefit**), which holds that the benefits to be gained from providing accounting information should be greater than the costs of providing it. Of course, minimum levels of relevance and faithful representation must be reached if accounting information is to be useful. Beyond the minimum levels, however, it is up to the FASB and the SEC, which stipulate the information that must be reported, and the accountant, who provides the information, to judge the costs and benefits in each case.

## Accounting Conventions

For accounting information to be understandable, accountants must prepare financial statements in accordance with accepted practices, which include some concepts that are not formally part of the agreed-upon conceptual framework and which may conflict with it at times. Familiarity with the **accounting conventions**, or *constraints*, used in preparing financial statements enables the user to better understand accounting information. Among these accounting conventions are *consistency, full disclosure, and conservatism*.

**Consistency** **Consistency** requires that once a company has adopted an accounting procedure, it must use it from one period to the next unless a note to the financial statements informs users of a change. Generally accepted accounting principles specify what the note must contain:

**STUDY NOTE:** Theoretically, a \$10 stapler is a long-term asset and should therefore be capitalized and depreciated over its useful life. However, the concepts of materiality and cost constraint allow the stapler to be expensed entirely in the year of purchase.

*The nature of and justification for a change in accounting principle and its effect on income should be disclosed in the financial statements of the period in which the change is made. The justification for the change should explain clearly why the newly adopted accounting principle is preferable.<sup>6</sup>*

For example, in the notes to its financial statements, **Goodyear Tire & Rubber Company** disclosed that it had changed its method of accounting for inventories because management felt it improved the matching of revenues and costs. Without such an acknowledgment, users of financial statements can assume that the treatment of a particular transaction, account, or item has not changed since the last period.

**Full Disclosure (Transparency)** Full disclosure (or transparency) requires that financial statements present all the information relevant to users' understanding of the statements. The statements must include any explanation needed to keep them from being misleading. For instance, the notes should disclose any change that a company has made in its accounting procedures.

A company must also disclose significant events arising after the balance sheet date. For example, suppose that a firm has purchased a piece of land for a future subdivision. Shortly after the end of its fiscal year, the firm is ordered to halt construction because the Environmental Protection Agency asserts that the land was once a toxic waste dump. This information, which obviously affects the users of the financial statements, must be disclosed in the statements for the fiscal year just ended.

Additional disclosures required by the FASB and other official bodies include the accounting procedures used in preparing the financial statements and important terms of a company's debt and commitments. Beyond the required disclosures, the application of the full-disclosure convention is based on the judgment of management and of the accountants who prepare the financial statements.

In recent years, independent auditors, the stock exchanges, and the SEC have made more demands for disclosure by publicly owned companies. As a result, more and better information about corporations is now available to investors and creditors than ever before.

**STUDY NOTE:** The purpose of conservatism is not to produce the lowest net income and lowest asset value. It is a guideline for choosing among GAAP alternatives, and it should be used with care.

**Conservatism** When accountants are uncertain about the judgments or estimates they must make, they look to the convention of **conservatism**. This convention holds that, when faced with choosing between two equally acceptable procedures or estimates, accountants should choose the one that is least likely to overstate assets and income. One of the most common applications of conservatism is the use of the *lower-of-cost-or-market method* in accounting for inventories. Under this method, if an item's market value is greater than its original cost, the more conservative cost figure is used. If the market value is below the original cost, the more conservative market value is used. The latter situation often occurs in the computer industry.

Conservatism can be a useful tool, but if abused, it can lead to incorrect and misleading financial statements. For example, there is no uncertainty about how a long-term asset of material cost should be treated. As explained in Chapter 3, the cost of such



## Business Perspective

### When Is "Full Disclosure" Too Much?

**Ernst & Young**, a large accounting firm, reported that over a 20-year period, the total number of pages in the annual reports of 25 large, well-known companies increased an average of 84 percent, and the number of pages of notes increased 325 percent—from 4 to 17 pages. Management's discussion and analysis increased 300 percent, from 3 pages to 12.<sup>7</sup> Because some people feel that "these documents are so daunting that people don't read them at all," the SEC allows companies to issue to the public "summary reports" in which the bulk of the notes can be reduced.

Summary reports are controversial because many analysts feel that the notes provide the detailed information necessary to understand complex business operations. One analyst remarked, "To banish the notes for fear they will turn off readers would be like eliminating fractions from math books on the theory that the average student prefers to work with whole numbers."<sup>8</sup> Detailed reports still must be filed with the SEC, but more and more companies are providing summary reports to the public.

an asset should be spread over the asset's useful life. When conservatism is used to justify expensing a long-term asset in the period of purchase, income and assets for the current period will be understated, and income in future periods will be overstated. Accountants therefore apply the conservatism convention only when they are uncertain about which accounting procedure or estimate to use.

## Ethical Financial Reporting

As noted earlier, under the Sarbanes-Oxley Act, chief executive officers and chief financial officers of all publicly traded companies must certify that, to their knowledge, their quarterly and annual statements are accurate and complete. After this legislation passed, an investigation by the audit committee of **Dell's** board of directors and management disclosed weaknesses in the company's controls and led to restatements of the financial statements for the prior four years. After extensive improvements in control and the restatements, the company's chief executive officer, Michael S. Dell, made the following certifying statement in the company's annual report to the SEC:

*Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows . . . for the periods represented in this report.<sup>9</sup>*

Fraudulent financial reporting can have high costs for investors, lenders, employees, and customers. It can also have high costs for the people who condone, authorize, or prepare misleading reports—even those at the highest corporate levels. In March 2005, Bernard J. Ebbers, former CEO of **WorldCom**, was convicted of seven counts of filing false reports with the SEC and one count each of securities fraud and conspiracy.<sup>10</sup> In 2006, both Kenneth Lay, **Enron Corporation's** former chairman, and Jeffrey Skilling, Enron's former CEO, were convicted on charges similar to the ones of which Ebbers was convicted.



## International Perspective

IFRS

### What Is the Future of the Conservatism Convention?

Conservatism, which has been the bedrock of U.S. accounting practice for many decades, clearly conflicts with the agreed upon concept of *neutrality* in the conceptual framework. The practice under IFRS, for example, of writing up the value of an asset, such as inventory or equipment, that has increased in fair value and recording the increase as income violates the conservatism convention under U.S. GAAP. Thus, the convergence of IFRS with GAAP may well influence the way accountants in the United States prepare financial statements, but it will likely take a generation for this to change.

© loops7 / iStockphoto.com

© Cengage Learning 2014

## APPLY IT!

Match each concept that follows with the category in which it belongs.

- |   |  |
|---|--|
| a. Objective of accounting information      | 5. Neutrality  |
| b. Underlies relevant financial information | 6. Conservatism  |
| c. Underlies faithful representation        | 7. Comparability   |
| d. Enhancing qualitative characteristics    | 8. Completeness  |
| e. Accounting convention                    | 9. Materiality   |
| 1. Consistency                              | 10. Confirmative value   |
| 2. Verifiability                            | 11. Understandability  |
| 3. Predictive value                         | 12. Furnishing information that is useful to capital providers |
| 4. Timeliness                               |  |

### SOLUTION

1. e; 2. d; 3. b; 4. d; 5. c; 6. e; 7. d; 8. c; 9. b; 10. b; 11. d; 12. a

**TRY IT! SE1, SE2, E1A, E2A, E1B, E2B**



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Identify components of a classified balance sheet
- Prepare a classified balance sheet

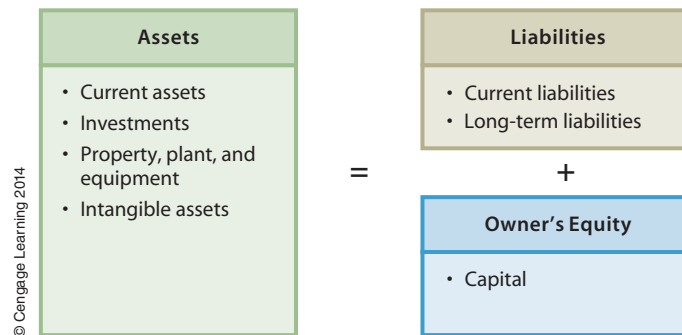
## RELEVANT LEARNING OBJECTIVE

**LO 2** Identify and define the basic components of financial reporting, and prepare a classified balance sheet.

## LO 2 Classified Balance Sheet

As you know, a balance sheet presents a company's financial position at a particular time. The balance sheets presented thus far categorize accounts as assets, liabilities, and owner's equity. Because even a fairly small company can have hundreds of accounts, subcategories within the major categories can make financial statements much more useful. General-purpose external financial statements that are divided into subcategories are called **classified financial statements**. Exhibit 2 depicts the subcategories into which the principal elements of assets, liabilities, and owner's equity are broken down. This format enables owners and creditors to study and evaluate relationships among the subcategories.

**Exhibit 2**  
Classified Balance Sheet



The subcategories of Bonali Company's classified balance sheet, shown in Exhibit 3, are those used by most U.S. corporations. The subcategories under owner's equity would, of course, be different if Bonali were a corporation or partnership rather than a sole proprietorship.

### Assets

As shown in Exhibit 3, the classified balance sheet of a U.S. company typically divides assets into four categories: current assets; investments; property, plant, and equipment; and intangible assets. These categories are listed in the order of how easily they can be converted into cash. For example, current assets are usually more easily converted to cash than are property, plant, and equipment. For simplicity, some companies group investments, intangible assets, and other miscellaneous assets into a category called **other assets**.

**Current Assets** **Current assets** include cash and other assets that a company can reasonably expect to convert to cash, sell, or consume within one year or its normal operating cycle, whichever is longer. A company's **normal operating cycle** is the average time it needs to go from spending cash to receiving cash. For example, suppose a company uses cash to buy inventory and sells the inventory to a customer on credit. To classify the resulting receivable as a current asset, there must be a reasonable expectation that it will be collected in cash before the normal operating cycle ends.

As discussed, cash is a current asset. Short-term investments, notes and accounts receivable, and inventory that a company expects to convert to cash (by selling it) within

**Exhibit 3**  
Classified Balance Sheet  
for Bonali Company

<b>Bonali Company</b>		
<b>Balance Sheet</b>		
<b>December 31, 2014</b>		
<b>Assets</b>		
<b>Current assets:</b>		
Cash	\$ 41,440	
Short-term investments	28,000	
Notes receivable	32,000	
Accounts receivable	141,200	
Merchandise inventory	191,600	
Prepaid insurance	26,400	
Supplies	<u>6,784</u>	
Total current assets		\$467,424
<b>Investments:</b>		
Land held for future use		50,000
<b>Property, plant, and equipment:</b>		
Land	\$ 18,000	
Building	\$ 82,600	
Less accumulated depreciation	<u>34,560</u>	48,040
Equipment	\$108,000	
Less accumulated depreciation	<u>57,800</u>	<u>50,200</u>
Total property, plant, and equipment		116,240
<b>Intangible assets:</b>		
Trademark		<u>2,000</u>
Total assets		<u>\$635,664</u>
<b>Liabilities</b>		
<b>Current liabilities:</b>		
Notes payable	\$ 60,000	
Accounts payable	102,732	
Salaries payable	<u>8,000</u>	
Total current liabilities		\$170,732
<b>Long-term liabilities:</b>		
Mortgage payable		<u>71,200</u>
Total liabilities		\$241,932
<b>Owner's Equity</b>		
J. Bonali, capital	\$393,732	
Total owner's equity		<u>393,732</u>
Total liabilities and owner's equity		<u>\$635,664</u>

© Cengage Learning 2014



## Business Perspective

### Normal Operating Cycles Can Be Long

The normal operating cycle for most companies is less than one year, but there are exceptions. For example, because of the length of time it takes **The Boeing Company** to build aircraft, its normal operating cycle exceeds one year. The inventory used in building the planes is nonetheless considered a current asset because the planes will be sold within the normal operating cycle. Another example is a company that sells on an installment basis. The payments for a television set or a refrigerator can extend over 24 or 36 months, but these receivables are still considered current assets.

© Cengage Learning 2014



the next year or the normal operating cycle are also current assets. On the balance sheet, they are listed in order of how easily they can be converted to cash.

Prepaid expenses, such as rent and insurance paid in advance, and supplies bought for use rather than for sale should be classified as current assets. These assets are current in the sense that if they had not been paid for earlier, they would require a current outlay of cash.

**STUDY NOTE:** Investments classified as current must be readily marketable—i.e., management must expect to sell them within the next year or within the current operating cycle.

**Investments** Investments include assets, usually long-term, that are not used in normal business operations and that management does not plan to convert to cash within the next year. Examples of items in this category include the following:

- Securities held for long-term investment
- Long-term notes receivable
- Land held for future use
- Plant or equipment not used in the business
- Special funds established to pay off a debt or buy a building
- Large permanent investments (those a company does not intend to sell) made in another company for the purpose of controlling that company

**Property, Plant, and Equipment** Property, plant, and equipment (also called *operating assets*, *fixed assets*, *tangible assets*, *long-lived assets*, or *plant assets*) include tangible long-term assets used in a business's day-to-day operations. They represent a place to operate (land and buildings) and the equipment used to produce, sell, and deliver goods or services. Through depreciation, the costs of these assets (except the cost of land) are spread over the periods they benefit. Past depreciation is recorded in the Accumulated Depreciation accounts and deducted from their related asset accounts on the balance sheet.

To reduce clutter on the balance sheet, property, plant, and equipment accounts and related accumulated depreciation accounts are often combined—for example:

Property, plant, and equipment (net)	\$116,240
--------------------------------------	-----------

The company provides the details in a note to the financial statements.

The property, plant, and equipment category also includes natural resources owned by the company, such as forest lands, oil and gas properties, and coal mines, if they are used in the regular course of business. If they are not, they are listed in the investments category.

**Intangible Assets** Intangible assets are long-term assets with no physical substance. Their value stems from the rights or privileges accruing to their owners. Examples include patents, copyrights, franchises, and trademarks. These assets are recorded at cost, which is spread over the expected life of the right or privilege. **Goodwill**, which arises in an acquisition of another company, is another intangible asset that is recorded at cost, but the cost is not allocated (amortized) over future periods. Goodwill is reviewed each year for possible loss of value, or impairment.

Intangible assets can be worth an enormous amount for some companies. Consider the value of Coca-Cola's trademark, which over the years has become a familiar and easily recognizable symbol worldwide.



STR/AFP/GETTY IMAGES/Newscom

## Liabilities

Liabilities are divided into two categories: current liabilities and long-term liabilities.

**Current Liabilities** Current liabilities are obligations that must be satisfied within one year or within the company's normal operating cycle, whichever is longer. These liabilities are typically paid out of current assets or by incurring new short-term liabilities. Examples include:

- Notes payable
- Accounts payable
- The current portion of long-term debt
- Salaries and wages payable
- Customer advances (unearned revenues)

**STUDY NOTE:** The portion of a mortgage due during the next year or the current operating cycle is classified as a current liability. The portion due after the next year or the current operating cycle is classified as a long-term liability.

**Long-Term Liabilities** Long-term liabilities are debts that fall due more than one year in the future or beyond the normal operating cycle and thus will be paid out of noncurrent assets. Examples include:

- Mortgages payable
- Long-term notes
- Bonds payable
- Employee pension obligations
- Long-term lease liabilities

## Owner's Equity

The terms *owner's equity*, *proprietorship*, *owner's capital*, and *net worth* are used to refer to the owner's interest, or equity, in a company. However, the first three terms are preferred to *net worth* because many assets are recorded at their original cost rather than at their current value.

Although the form of business organization does not usually affect the accounting treatment of assets and liabilities, the equity section of the balance sheet differs depending on whether the business is a sole proprietorship, a partnership, or a corporation.

**Sole Proprietorship** The owner's equity section of a sole proprietorship would be similar to the one shown for Bonali Company in Exhibit 3:

<b>Owner's Equity</b>	
J. Bonali, capital	<u>\$393,732</u>

**STUDY NOTE:** Equity in a sole proprietorship and a partnership differs only in the number of Capital accounts.

**Partnership** The equity section of a partnership's balance sheet is called **partners' equity**. It is much like that in a sole proprietorship's balance sheet. It might appear as follows.

<b>Partners' Equity</b>	
R. Hay, capital	\$168,750
J. Bonali, capital	<u>224,982</u>
Total partners' equity	<u>\$393,732</u>

**Corporation** Corporations are by law separate, legal entities that are owned by their stockholders. The equity section of a balance sheet for a corporation is called **stockholders' equity** (or *shareholders' equity*) and has two parts: *contributed capital* and *retained earnings*. It might appear as follows.

<b>Stockholders' Equity</b>	
<b>Contributed capital:</b>	
Common stock, \$10 par value, 20,000 shares authorized, issued, and outstanding	\$200,000
Additional paid-in capital	<u>40,000</u>
Total contributed capital	\$240,000
Retained earnings	<u>153,732</u>
Total stockholders' equity	<u>\$393,732</u>

Remember that owner's equity accounts show the sources of and claims on assets. These claims are not on any particular asset but on the assets as a whole. It follows, then, that a corporation's contributed and earned capital accounts measure its stockholders' claims on assets and also indicate the sources of the assets. The **Contributed Capital** (or *Paid-in Capital*) accounts reflect the amounts of assets invested by stockholders. Generally, contributed capital is shown on corporate balance sheets by two amounts: (1) the face, or par, value of issued stock and (2) the amounts paid in, or contributed, in excess



## Business Perspective

### Terminology In Financial Statements Is Not Consistent

Although balance sheets generally resemble the one shown in Exhibit 3 for Bonali Company, no two companies have financial statements that are exactly alike. **CVS's** balance sheet is a good example of some of the variations. As shown in the Supplement to Chapter 16, it provides data for two years (three years for the income statement) so that users can evaluate changes from one year to the next. Note that its major classifications are similar but not identical to those of Bonali. For instance, Bonali has asset categories for investments, and CVS has an asset category called "other assets," which is a small amount of its total assets. Also note that CVS has various accounts listed in the liabilities under "Total Current Liabilities." Because these accounts are listed after current liabilities, they represent longer-term liabilities, due more than one year after the balance sheet date.

© Allija / Stockphoto.com

© Cengage Learning 2014

of the par value per share. In the previous illustration, stockholders invested amounts equal to the par value of the outstanding stock of \$200,000 plus \$40,000 in additional paid-in capital for a total of \$240,000.

The **Retained Earnings** account is sometimes called *Earned Capital* because it represents the stockholders' claim to the assets that are earned from operations and reinvested in corporate operations. Distributions of assets to shareholders, which are called **dividends**, reduce the Retained Earnings account just as withdrawals of assets by the owner of a business reduce the Capital account. Thus, the Retained Earnings balance represents the earnings of the corporation less dividends paid to stockholders over the life of the business.

## Overview of Classified Balance Sheet Accounts

Like accounts on the balance sheet and income statement can be grouped, as shown in Exhibit 4. Such groupings aid in analysis of the statements.

**Exhibit 4**  
Classified Balance Sheet Groups  
Accounts into Useful Categories

<b>Balance Sheet</b>	
<b>December 31, 2014</b>	
<b>Assets</b>	<b>Liabilities</b>
Current assets	Current liabilities
Investments	Long-term liabilities
Property, plant, and equipment	Total liabilities
Intangible assets	
	<b>Owner's Equity</b>
	Owner's capital
	Total owner's equity
<b>Total Assets</b>	<b>Total Liabilities + Owner's Equity</b>

© Cengage Learning 2014

## APPLY IT!

Match each account title that follows with the category that appears on a balance sheet or indicate that it does not appear on the balance sheet.

- |                                   |                               |
|-----------------------------------|-------------------------------|
| a. Current assets                 | 3. Land Held for Future Use   |
| b. Investments                    | 4. Property Taxes Payable     |
| c. Property, plant, and equipment | 5. Note Payable in Five Years |
| d. Intangible assets              | 6. Investment by Owner        |
| e. Current liabilities            | 7. Land Used in Operations    |
| f. Long-term liabilities          | 8. Accumulated Depreciation   |
| g. Owner's capital                | 9. Accounts Receivable        |
| h. Not on balance sheet           | 10. Interest Expense          |
| 1. Trademark                      | 11. Unearned Revenue          |
| 2. Supplies                       | 12. Prepaid Rent              |

### SOLUTION

1. d; 2. a; 3. b; 4. e; 5. f; 6. g;  
7. c; 8. c; 9. a; 10. h; 11. e; 12. a

**TRY IT! SE3, SE4, E3A, E4A, E3B, E4B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Liquidity
  - Working capital
  - Current ratio
- Profitability
  - Profit margin
  - Asset turnover
  - Return on assets
  - Debt to equity ratio
  - Return on equity

RELEVANT  
LEARNING OBJECTIVE

- LO 3** Use classified financial statements to evaluate liquidity and profitability.

**LO 3** Using Classified Financial Statements

Owners and creditors base decisions largely on their assessments of a firm's potential liquidity and profitability, often relying on ratios. Ratios use the components of classified financial statements to reflect how well a firm has performed in terms of maintaining liquidity and achieving profitability. Accounts must be classified correctly before the ratios are computed. Otherwise, the ratios will be incorrect.

**Evaluation of Liquidity**

**Liquidity** means having enough money on hand to pay bills when they are due and to take care of unexpected needs for cash. Two measures of liquidity are working capital and current ratio.

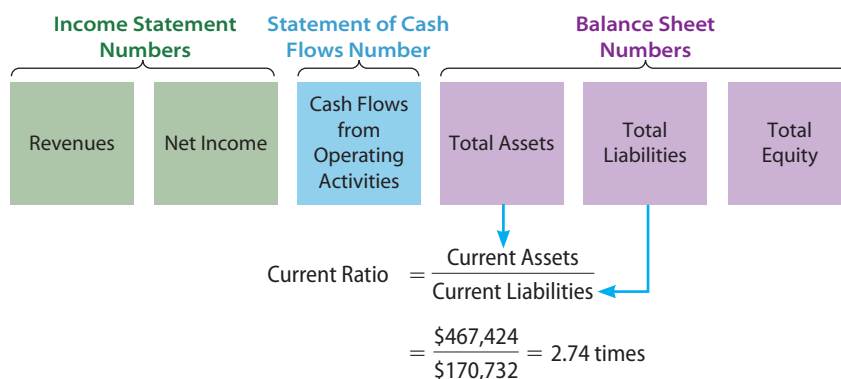
**Working Capital** **Working capital**, which uses two elements of the classified balance sheet, is the amount by which current assets exceed current liabilities. It is an important measure of liquidity because current liabilities must be satisfied within one year or one operating cycle, whichever is longer, and current assets are used to pay the current liabilities. Thus, the working capital is what is on hand to continue business operations.

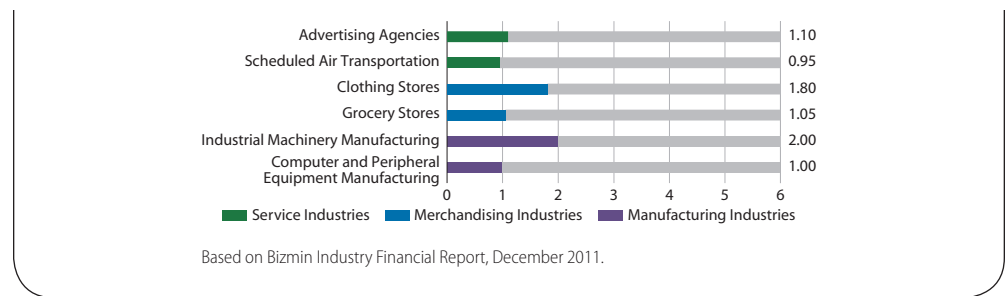
For Bonali Company, working capital is computed as follows.

Current assets	\$467,424
Less current liabilities	<u>170,732</u>
Working capital	<u>\$296,692</u>

Working capital can be used to buy inventory, obtain credit, and finance expanded sales. Lack of working capital can lead to a company's failure.

**Current Ratio** The current ratio is closely related to working capital. Many bankers and other creditors believe it is a good indicator of a company's ability to pay its debts on time. The **current ratio** is the ratio of current assets to current liabilities. For Bonali Company, it is computed as follows.

**RATIO****Current Ratio: How Did Current Assets Compare to Current Liabilities?**



Thus, Bonali has \$2.74 of current assets for each \$1.00 of current liabilities. Is this good or bad? The answer requires a comparison of this year's current ratio with ratios for earlier years and with similar measures for companies in the same industry, which for Bonali is clothing. The average current ratio varies from industry to industry. For the advertising industry, which has large receivables, the current ratio is 1.10. The industrial machinery manufacturing industry, in which companies carry large merchandise inventories, has an average current ratio of 2.00. The current ratio for Bonali, 2.74, exceeds the average for its industry, 1.80.

A very low current ratio can be unfavorable, indicating that a company will not be able to pay its debts on time. But that is not always the case. For example, **McDonald's** and various other successful companies have low current ratios because they carefully plan their cash flows. A very high current ratio may indicate that a company is not using its assets to the best advantage. In other words, it could probably use its excess funds more effectively to increase its overall profit.

## Evaluation of Profitability

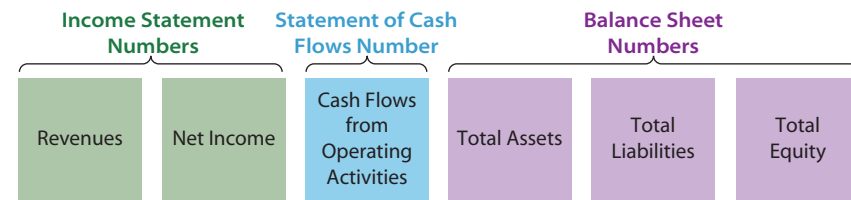
Just as important as paying bills on time is **profitability**—the ability to earn a satisfactory income. As a goal, profitability competes with liquidity for attention because liquid assets are not the best profit-producing resources. Cash means purchasing power; but a satisfactory profit can be made only if purchasing power is used to buy profit-producing (and less liquid) assets, such as inventory and long-term assets.

To evaluate a company's profitability, you must relate its current performance to its past performance and prospects for the future, as well as to the averages of other companies in the same industry. The following are the ratios commonly used to evaluate a company's ability to earn income:

- Profit margin
- Asset turnover
- Return on assets
- Debt to equity ratio
- Return on equity

**Profit Margin** The **profit margin** shows the percentage of each sales dollar that results in net income. It is an indication of how well a company is controlling its costs: the lower its costs, the higher its profit margin. The profit margin uses two elements of the income statements: net income and revenues (often called *net sales* or *net revenues*). If Bonali Company had \$71,524 of net income and \$1,248,624 of revenues, its profit margin would be computed as follows.

## RATIO

**Profit Margin: How Much Income Does Each Dollar of Sales Generate?**

$$\text{Profit Margin} = \frac{\text{Net Income}}{\text{Revenues}}$$

$$= \frac{\$71,524}{\$1,248,624}$$

$$= 0.057, \text{ or } 5.7\%$$



Based on Bizmin Industry Financial Report, December 2011.

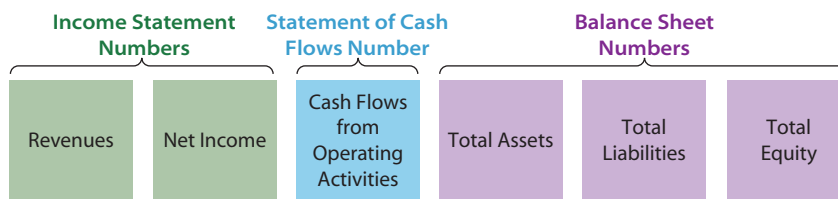
Thus, on each dollar of revenue, Bonali makes 5.7 cents. Is this a satisfactory profit? The answer requires a comparison with the profit margin ratios of other companies in the clothing industry, which is 4.2. A difference of 1 or 2 percent in a company's profit margin can be the difference between a fair year and a very profitable one.

**Asset Turnover** The **asset turnover** ratio measures how efficiently assets are used to produce sales. In other words, how much revenue is generated by each dollar of assets? A company with a high asset turnover uses its assets more productively than one with a low asset turnover.

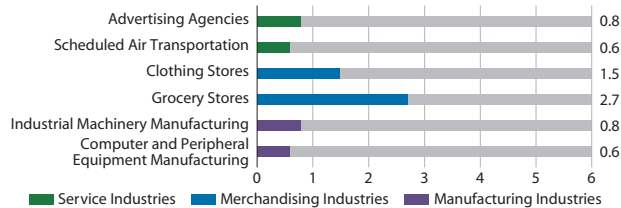
The asset turnover ratio uses revenues from the income statement and total assets from the balance sheet. It is computed by dividing revenues by average total assets. Since revenues take place over the year, they are compared with average total assets, which is intended to represent the usual level of assets over the year. Average total assets are the sum of assets at the beginning and end of the period divided by 2. If Bonali Company had \$1,248,624 of revenues, and \$594,480 of assets at the beginning of the year, its asset turnover would be computed as follows.



## RATIO

**Asset Turnover:** How Much Revenue Is Generated by Each Dollar of Assets?

$$\begin{aligned} \text{Asset Turnover} &= \frac{\text{Revenues}}{\text{Average Total Assets}} \\ &= \frac{\$1,248,624}{(\$635,664 + \$594,480) \div 2} \\ &= \frac{\$1,248,624}{\$615,072} = 2.03 \text{ Times} \end{aligned}$$



Based on Bizmin Industry Financial Report, December 2011.

Thus, Bonali produces \$2.03 in sales for each dollar invested in assets. Its asset turnover of 2.03 times is greater than the industry average of 1.5 times. In other words, the company is more productive in producing revenue than other companies in the clothing industry.

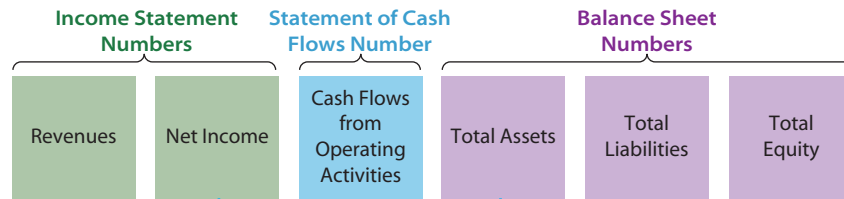
**STUDY NOTE:** Return on assets is a widely used measure of profitability. It is a combination of the profit margin and the asset turnover.

**Return on Assets** The profit margin and asset turnover ratios are important measures, but they have limitations. For example, the profit margin ratio does not consider the assets necessary to produce income, and the asset turnover ratio does not take into account the amount of income produced. The **return on assets** ratio overcomes these deficiencies by relating net income to average total assets. If Bonali Company had \$71,524 of net income, its return on assets would be computed as follows.

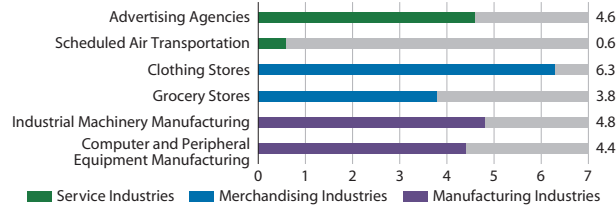


## RATIO

## Return on Assets: How Much Income Did Each Dollar of Assets Generate?



$$\begin{aligned} \text{Return on Assets} &= \frac{\text{Net Income}}{\text{Average Total Assets}} \\ &= \frac{\$71,524}{(\$635,664 + \$594,480) \div 2} \\ &= \frac{\$71,524}{\$615,072} = 0.116, \text{ or } 11.6\% \end{aligned}$$



Based on Bizmin Industry Financial Report, December 2011.

For each dollar of invested assets, Bonali earned 11.6 cents of net income. This ratio combines the firm's income-generating strength (profit margin) and its revenue-generating effectiveness (asset turnover):

$$\begin{aligned} \frac{\text{Net Income}}{\text{Net Sales}} \times \frac{\text{Net Sales}}{\text{Average Total Assets}} &= \frac{\text{Net Income}}{\text{Average Total Assets}} \\ \text{Profit Margin} \times \text{Asset Turnover} &= \text{Return on Assets} \\ 5.7\% \times 2.03 \text{ Times} &= 11.6\% \end{aligned}$$

A company's management can improve overall profitability by increasing the profit margin, the asset turnover, or both. A financial statement user must consider how these two ratios interact to produce return on assets.

Bonali's profit margin of 5.7 percent is above the clothing industry's average of 4.2 percent. Its asset turnover of 2.03 times is greater than the industry average of 1.5 percent. Bonali is able to achieve a higher profit margin than the industry norm without sacrificing asset turnover. Clearly, its strategy is working because the company's return on assets of 11.6 percent is also greater than the industry average of 6.3 percent.

You can see the different ways in which various industries combine profit margin and asset turnover to produce return on assets. For instance, by comparing the return on assets for grocery stores and computer companies, you can see how they achieve that return in very different ways. The grocery store industry has a profit margin of 1.4 percent, which when multiplied by an asset turnover of 2.7 times gives a return on assets of 3.8 percent. The computer industry has a higher profit margin, 7.4 percent, and a lower asset turnover, 0.6 time, and produces a return on assets of 4.4 percent.



## Business Perspective

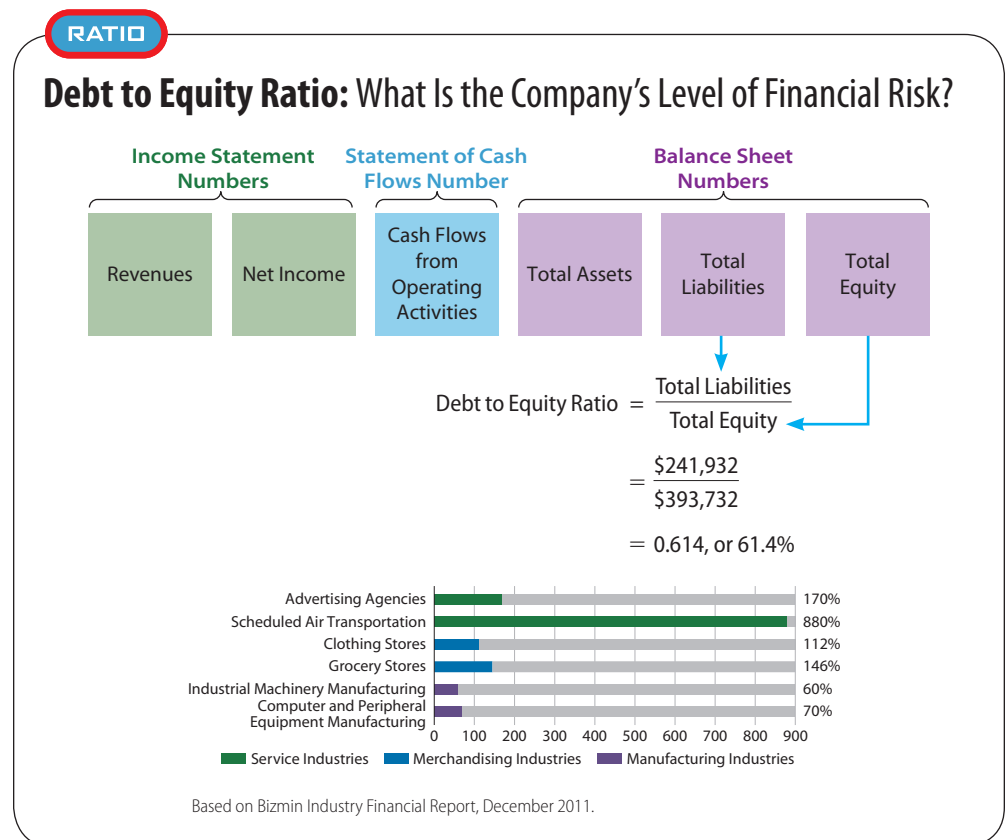
### What Performance Measures Do Top Companies Use to Compensate Executives?

The boards of directors of public companies often use financial ratios to judge the performance of their top executives and to determine annual bonuses. Public companies must disclose the ratios or performance measures they use in creating these compensation plans. Studies show that the most successful companies use earnings goals combined with sales growth 61 percent of the time compared to 43 percent for less successful companies. Among the most common earnings goals are return on assets and return on equity. Clearly, successful companies set objectives that will provide management with performance incentives.<sup>11</sup>

© Allija / iStockphoto.com

**Debt to Equity Ratio** The **debt to equity ratio** reflects a company's strategy for financing its operations. It shows the proportion of a company's assets financed by creditors and the proportion financed by the owner. It is thus a measure of financial risk; the more debt a company has in relation to its owner's equity, the greater its financial risk. Creditors and interest on debt must be paid on time regardless of how well or poorly a company is performing. Owner's equity, on the other hand, does not have to be repaid, and withdrawals can be deferred when a company's performance is poor.

The debt to equity ratio uses two elements of the balance sheet: total liabilities and total equity. Since the balance sheets of most companies do not show total liabilities, a short way of determining them is to deduct the total owner's equity from total assets. For Bonali Company, it is computed as follows.



A debt to equity ratio of 1.0 means that equal amounts of liabilities and owner's equity are used to finance a company's assets. A ratio of 0.5 means that if a company has 50 cents of liabilities for every dollar of equity, one-third of a company's total assets are

financed by creditors. Bonali's debt to equity ratio of 61.4 percent means that Bonali relied more on owners than on creditors to finance its assets.

The debt to equity ratio does not fit neatly into either the liquidity or profitability category. It is clearly very important to liquidity analysis because it relates to debt and its repayment. It is also relevant to profitability for two reasons:

- Creditors are interested in the proportion of the business that is debt-financed because the more debt a company has, the more profit it must earn to ensure the payment of interest to creditors.
- Owners are interested in the proportion of the business that is debt-financed because the amount of interest paid on debt affects the amount of profit left to provide a return on the owner's investment.

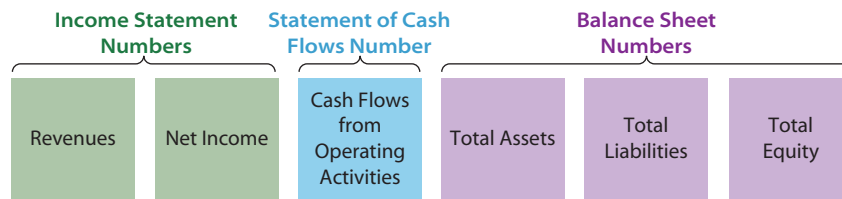
The debt to equity ratio also shows how much expansion is possible through borrowing additional long-term funds.

**Return on Equity** Return on equity is the ratio of net income to average owner's equity. It indicates whether a company has earned a favorable return for the owner. Return on equity will always be greater than return on assets because total equity will always be less than total assets. While greater return on assets is an advantage, the more debt a company has, the greater its financial risk. A company must, therefore, carefully balance the amount of financial risk it assumes with its desire to increase its return to the owner.

Using the ending owner's equity from Bonali Company's balance sheet and assuming that the beginning owner's equity was \$402,212, and that the company had net income of \$71,524, Bonali's return on equity is computed as follows.

### RATIO

## Return on Equity: How Much Net Income Does a Company Make for Each Dollar Invested by the Owner?



$$\begin{aligned} \text{Return on Equity} &= \frac{\text{Net Income}}{\text{Average Owner's Equity}} \\ &= \frac{\$71,524}{(\$393,732 + \$402,212) \div 2} \\ &= \frac{\$71,524}{\$397,972} = 0.180, \text{ or } 18.0\% \end{aligned}$$



Based on Bizmin Industry Financial Report, December 2011.



## International Perspective

### IFRS How Has the Goal of Convergence of U.S. GAAP and IFRS Made Financial Analysis More Difficult?

Although the SEC believes that the ideal outcome of an international standard-setting process would be worldwide use of a single set of accounting standards for both domestic and international financial reporting, the reality is that such consistency does not now exist and will be a challenge to implement.<sup>12</sup> For a period of time, financial statement users will have difficulty comparing companies' performance. Profitability measures of foreign firms that file in the United States using IFRS will not be comparable to profitability measures of companies that file using U.S. GAAP. For instance, consider the reporting earnings of the following European companies under both standards in a recent year (earnings in millions of euros):

	IFRS Earnings	GAAP Earnings	% Diff.
<b>Bayer AG</b>	1,695	269	530.1%
<b>Reed Elsevier</b>	625	399	56.6
<b>Benetton Group</b>	125	100	25.0

Given that assets and equity for these companies are also likely to differ as well as the use of fair value in valuing assets and liabilities, all profitability ratios—profit margin, asset turnover, return on assets, debt to equity ratio, and return on equity—will be affected.

© loops7 / iStockphoto.com

Bonali earned 18.0 cents for every dollar invested by the owner. Is this an acceptable return? Bonali's average return on equity of 18.0 percent is better than the average of 14.4 percent for the clothing industry. Although the air transportation industry's return on equity of 8.6 percent is one of the lowest of the selected industries, it also has the highest debt to equity ratio (880 percent).

## APPLY IT!

Roth Company is considering applying for a bank loan. Various data from Roth's classified financial statements follows.

	2014	2013		2014	2013
Current assets	\$200,000	\$170,000	Owner's equity	\$ 640,000	\$ 610,000
Total assets	880,000	710,000	Sales	1,200,000	1,050,000
Current liabilities	90,000	50,000	Net income	60,000	80,000
Long-term liabilities	150,000	50,000			

Its total assets and owner's equity at the beginning of 2013 were \$690,000 and \$590,000, respectively.

- Use (a) liquidity analysis and (b) profitability analysis to document Roth's financial position.
- Discuss Roth's profitability and liquidity. Do you think it will qualify for a bank loan?

### SOLUTION

- (a) Liquidity analysis

	Current Assets	Current Liabilities	Working Capital	Current Ratio
2013	\$170,000	\$50,000	\$120,000	3.40
2014	200,000	90,000	110,000	2.22
Decrease in working capital			<u>\$ 10,000</u>	
Decrease in current ratio				<u>1.18</u>

(b) Profitability analysis

	Net Income	Sales	Profit Margin	Average Total Assets	Assets Turnover	Return on Assets	Average Owner's Equity	Return on Equity
2013	\$80,000	\$1,050,000	7.6%	\$700,000 <sup>a</sup>	1.50	11.4%	\$600,000 <sup>c</sup>	13.3%
2014	60,000	1,200,000	5.0%	795,000 <sup>b</sup>	1.51	7.5%	625,000 <sup>d</sup>	9.6%
Increase (decrease)	<u>(\$20,000)</u>	<u>\$ 150,000</u>	<u>(2.6)%</u>	<u>\$ 95,000</u>	<u>0.01</u>	<u>(3.9)%</u>	<u>\$ 25,000</u>	<u>(3.7)%</u>

<sup>a</sup> $(\$710,000 + \$690,000) \div 2$ <sup>b</sup> $(\$880,000 + \$710,000) \div 2$ <sup>c</sup> $(\$610,000 + \$590,000) \div 2$ <sup>d</sup> $(\$640,000 + \$610,000) \div 2$ 

2. Both working capital and the current ratio declined between 2013 and 2014 because the \$40,000 increase in current liabilities (\$90,000 – \$50,000) was greater than the \$30,000 increase in current assets.

Net income decreased by \$20,000 despite an increase in sales of \$150,000 and an increase in average total assets of \$95,000. Thus, the profit margin fell from 7.6 percent to 5.0 percent, and return on assets fell from 11.4 percent to 7.5 percent. Asset turnover showed almost no change and so did not contribute to the decline in profitability. The decrease in return on equity, from 13.3 percent to 9.6 percent, was not as great as the decrease in return on assets because the growth in total assets was financed mainly by debt, as shown in the capital structure analysis below.

	Total Liabilities	Owner's Equity	Debt to Equity Ratio
2013	\$100,000	\$610,000	16.4%
2014	<u>240,000</u>	<u>640,000</u>	<u>37.5%</u>
Increase	<u>\$140,000</u>	<u>\$ 30,000</u>	<u>21.1%</u>

Total liabilities increased by \$140,000, while owner's equity increased by \$30,000. Thus, the amount of the business financed by debt increased between 2013 and 2014.

Both liquidity and profitability have declined. Roth will probably have to focus on improving current operations before expanding or getting a bank loan.

**TRY IT! SE5, SE6, SE7, E5A, E6A, E7A, E8A, E5B, E6B, E7B, E8B**

## TriLevel Problem



Tim Mantoani/Masterfile

### Surf-With-Park Company

The beginning of this chapter focused on Alan Park, who was considering expanding Surf-With-Park Company. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*Why are relevance and faithful representation as well as enhancing qualitative characteristics important to understanding financial statements?*

#### Section 2: Accounting Applications

*How should the balance sheet be organized to provide the best information? From the information provided, prepare a classified balance sheet for Surf-With-Park Company.*

	A	B	C
1	<b>Surf-With-Park Company</b>		
2	<b>Post-Closing Trial Balance</b>		
3	<b>December 31, 2014</b>		
4	<b>Account Name</b>	<b>Debit</b>	<b>Credit</b>
5	Cash	16,000	
6	Short-Term Investments	16,500	
7	Notes Receivable	5,000	
8	Accounts Receivable	138,000	
9	Merchandise Inventory	72,500	
10	Prepaid Rent	800	
11	Prepaid Insurance	2,400	
12	Sales Supplies	640	
13	Office Supplies	220	
14	Deposit for Future Advertising	1,840	
15	Building, Not in Use	24,800	
16	Land	11,700	
17	Delivery Equipment	20,600	
18	Accumulated Depreciation—Delivery Equipment		14,200
19	Trademark	2,000	
20	Accounts Payable		57,300
21	Salaries Payable		2,600
22	Interest Payable		420
23	Long-Term Notes Payable		40,000
24	A. Park, Capital		198,480
25		313,000	313,000
26			

### Section 3: Business Applications

What key measures best capture a company's financial performance? To answer this question, complete the following requirements:

1. Compute Surf-With-Park's: (a) current ratio, and (b) debt to equity ratio.
2. As a user of the classified balance sheet, why would you want to know the current ratio or the debt to equity ratio?

## SOLUTION

### Section 1: Concepts

Understanding of the conceptual framework helps accountants prepare financial statements that users can understand and use to make decisions. *Relevance* means that the information has a direct bearing on a decision and includes the concepts of *predictive value* and *confirmative value*, and *materiality*, subject to the *cost constraint*. *Faithful representation* means that the financial information is *complete*, *neutral*, and *free from material error*. Enhancing qualitative characteristics include *comparability* to enable users to identify similarities and differences between two sets of financial data, *verifiability* to assure users that information as presented can be substantiated, *timeliness* to enable users to receive information in time to influence their decisions, and *understandability* to enable users to comprehend the meaning of the information. Further, the benefits of information must exceed the costs of providing it. The accounting conventions of *consistency*, *full disclosure*, and *conservatism* help accountants to decide what information to present when uncertainties exist.

## Section 2: Accounting Applications

	A	B	C	D	E
1	<b>Surf-With-Park Company</b>				
2	<b>Balance Sheet</b>				
3	<b>June 30, 2014</b>				
4	<b>Assets</b>				
5	<b>Current assets:</b>				
6	Cash		\$ 16,000		
7	Short-term investments		16,500		
8	Notes receivable		5,000		
9	Accounts receivable		138,000		
10	Merchandise inventory		72,500		
11	Prepaid rent		800		
12	Prepaid insurance		2,400		
13	Sales supplies		640		
14	Office supplies		220		
15	Deposit for future advertising		1,840		
16	Total current assets			\$253,900	
17	<b>Investments:</b>				
18	Building, not in use			24,800	
19	<b>Property, plant, and equipment:</b>				
20	Land		\$ 11,700		
21	Delivery equipment	\$ 20,600			
22	Less accumulated depreciation	14,200	6,400		
23	Total property, plant, and equipment			18,100	
24	<b>Intangible assets:</b>				
25	Trademark			2,000	
26	<b>Total assets</b>			<b>\$298,800</b>	
27	<b>Liabilities</b>				
28	<b>Current liabilities:</b>				
29	Accounts payable		\$ 57,300		
30	Salaries payable		2,600		
31	Interest payable		420		
32	Total current liabilities			\$ 60,320	
33	<b>Long-term liabilities:</b>				
34	Long-term notes payable			40,000	
35	<b>Total liabilities</b>			<b>\$100,320</b>	
36	<b>Owner's Equity</b>				
37	A. Park, capital		\$198,480		
38	Total owner's equity			198,480	
39	Total liabilities and owner's equity			<b>\$298,800</b>	

## Section 3: Business Applications

$$1. \quad a. \quad \text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$= \frac{\$253,900}{\$60,320} = 4.2$$

$$b. \quad \text{Debit to Equity Ratio} = \frac{\text{Total Liabilities}}{\text{Owner's Equity}}$$

$$= \frac{\$100,320}{\$198,480} = 50.5\%$$



2. A user of the classified balance sheet would want to know the current ratio because it is a good indicator of a company's ability to pay its bills and to repay outstanding loans. The other measure, the debt to equity ratio, shows the proportion of the company financed by creditors in comparison with that financed by owners. That measure is very important to liquidity analysis because it is related to debt and its repayment. It is also relevant to profitability analysis because the amount of debt affects the amount of interest expense and the owner's return on investment.

## Chapter Review

**Describe the objective of financial reporting, and identify the conceptual framework underlying accounting information.** **LO 1**

The objective of financial reporting is to provide financial information about the reporting entity to present and potential equity investors, lenders, and other creditors in their capacity as capital providers. Financial information must enable the reader to assess cash flow prospects and management's stewardship. Financial information must exhibit the concepts of relevance and faithful representation. To be relevant, it must have predictive value, confirmative value, or both, subject to materiality. To be faithfully represented, it must be complete, neutral, and free from error. Enhancing qualitative characteristics are comparability, verifiability, timeliness, and understandability, all subject to the cost constraint. Because accountants' measurements are not exact, certain conventions are applied to help users interpret financial statements. Consistency requires the use of the same accounting procedures from period to period and enhances the comparability of financial statements. Full disclosure means including all relevant information in the financial statements. Conservatism entails using the procedure that is least likely to overstate assets and income. Since the passage of the Sarbanes-Oxley Act, CEOs and CFOs have been required to certify that their companies' financial statements are accurate and complete.

**Identify and define the basic components of financial reporting, and prepare a classified balance sheet.** **LO 2**

The basic components of a classified balance sheet are as follows.

<u>Assets</u>	<u>Liabilities</u>	<u>Owner's Equity</u>
Current assets	Current liabilities	Owner's capital
Investments	Long-term liabilities	
Property, plant, and equipment		
Intangible assets		

Current assets are cash and other assets that a firm can reasonably expect to convert to cash or use up during the next year or the normal operating cycle, whichever is longer. Investments are assets, usually long-term, that are not used in the normal operation of a business. Property, plant, and equipment are tangible long-term assets used in day-to-day operations. Intangible assets are long-term assets with no physical substance whose value stems from the rights or privileges they are accruing to their owners.

A current liability is an obligation that must be satisfied within the next year or the normal operating cycle, whichever is longer. Long-term liabilities are debts that fall due more than one year in the future or beyond the normal operating cycle.

The equity section of a sole proprietorship's balance sheet differs from the equity section of a partnership's or corporation's balance sheet in that it does not have subcategories for contributed capital (the assets invested by stockholders) and retained earnings (stockholders' claim to assets earned from operations and reinvested in operations).

Use classified financial statements to evaluate liquidity and profitability. **LO 3**

In evaluating a company's performance, investors (owners) and creditors rely on the data provided in financial statements. Two measures of liquidity are working capital and the current ratio. Five measures of profitability are profit margin, asset turnover, return on assets, debt to equity ratio, and return on equity. Data from multiple years and industry averages are useful in interpreting these ratios.

## Key Terms and Ratios

**accounting conventions** 172 (LO1)  
**classified financial statements** 175 (LO2)  
**comparability** 172 (LO1)  
**complete information** 172 (LO1)  
**confirmative value** 171 (LO1)  
**conservatism** 173 (LO1)  
**consistency** 172 (LO1)  
**Contributed Capital** 178 (LO2)  
**cost-benefit** 172 (LO1)  
**cost constraint** 172 (LO1)  
**current assets** 175 (LO2)  
**current liabilities** 177 (LO2)  
**dividends** 179 (LO2)  
**faithful representation** 172 (LO1)  
**free from material error** 172 (LO1)  
**full disclosure** 173 (LO1)

**goodwill** 177 (LO2)  
**intangible assets** 177 (LO2)  
**investments** 177 (LO2)  
**liquidity** 180 (LO3)  
**long-term liabilities** 178 (LO2)  
**material** 171 (LO1)  
**materiality** 171 (LO1)  
**neutral information** 172 (LO1)  
**normal operating cycle** 175 (LO2)  
**other assets** 175 (LO2)  
**partners' equity** 178 (LO2)  
**predictive value** 171 (LO1)  
**profitability** 181 (LO3)  
**property, plant, and equipment** 177 (LO2)  
**qualitative characteristics** 171 (LO1)  
**relevance** 171 (LO1)

**Retained Earnings** 179 (LO2)  
**stockholders' equity** 178 (LO2)  
**timeliness** 172 (LO1)  
**transparency** 173 (LO1)  
**understandability** 172 (LO1)  
**verifiability** 172 (LO1)

### RATIOS

**asset turnover** 182 (LO3)  
**current ratio** 180 (LO3)  
**debt to equity ratio** 185 (LO3)  
**profit margin** 181 (LO3)  
**return on assets** 183 (LO3)  
**return on equity** 186 (LO3)  
**working capital** 180 (LO3)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 DQ1. CONCEPT** ► How do the four basic financial statements meet the stewardship objective of financial reporting?
- LO 1 DQ2. CONCEPT** ► What are some areas that require estimates to record transactions under the matching rule?
- LO 1 DQ3. CONCEPT** ► How can financial information be consistent but not comparable?
- LO 1 DQ4. CONCEPT** ► When might an amount be material to management but not to the CPA auditing the financial statements?
- LO 2 DQ5.** Why is it that land held for future use and equipment not currently used in the business are classified as investments rather than as property, plant, and equipment?
- LO 3 DQ6. BUSINESS APPLICATION** ► Why is it important to compare a company's financial performance with industry standards?
- LO 3 DQ7. BUSINESS APPLICATION** ► Is the statement "Return on assets is a better measure of profitability than profit margin" true or false and why?

## SHORT EXERCISES

### LO 1 Objectives and Qualitative Characteristics

**SE1. CONCEPT** ► Identify each of the following statements as related to either an objective (O) of financial information or as a qualitative (Q) characteristic of accounting information:

- Information about business resources, claims to those resources, and changes in them should be provided.
- Decision makers must be able to interpret accounting information.
- Information that is useful in making investment and credit decisions should be furnished.
- Accounting information must exhibit relevance and faithful representation.
- Information useful in assessing cash flow prospects should be provided.

### LO 1 Enhancing Qualitative Characteristics and Accounting Conventions

**SE2. CONCEPT** ► State which of these selected enhancing qualitative characteristics and accounting conventions—comparability, verifiability, timeliness, cost constraint, consistency, full disclosure, materiality, or conservatism—is being followed in each case that follows.

- Management provides detailed information about the company's long-term debt in the notes to the financial statements.
- A company does not account separately for discounts received for prompt payment of accounts payable because few of these transactions occur and the total amount of the discounts is small.
- Management eliminates a weekly report on property, plant, and equipment acquisitions and disposals because no one finds it useful.
- A company follows the policy of recognizing a loss on inventory when the market value of an item falls below its cost but does nothing if the market value rises.
- When several accounting methods are acceptable, management chooses a single method and follows that method from year to year.
- The internal audit department comes up with similar estimates to management's determination of fair value of investments.
- The company makes every effort to complete its financial statements within one week after the end of the accounting period.

### LO 2 Classification of Accounts: Balance Sheet

**SE3.** Tell whether each of the following accounts is a current asset; an investment; property, plant, and equipment; an intangible asset; a current liability; a long-term liability; owner's equity; or not on the balance sheet:

- |                                  |                                     |
|----------------------------------|-------------------------------------|
| 1. Delivery Trucks               | 6. Prepaid Insurance                |
| 2. Accounts Payable              | 7. Trademark                        |
| 3. Note Payable (due in 90 days) | 8. Investment to Be Held Six Months |
| 4. Delivery Expense              | 9. Factory Not Used in Business     |
| 5. Owner's Capital               |                                     |

### LO 2 Classified Balance Sheet

**SE4.** Using the following accounts, prepare a classified balance sheet at year end, May 31, 2014: Accounts Payable, \$1,600; Accounts Receivable, \$2,200; Accumulated Depreciation—Equipment, \$1,400; Cash, \$400; Owner's Investment, \$2,000; Equipment, \$6,000; Franchise, \$400; Investments (long-term), \$1,000; Merchandise Inventory, \$1,200; Notes Payable (long-term), \$800; Owner's Capital, \$?; Wages Payable, \$200. Assume that this is the company's first year of operations.

LO 3 **Liquidity Ratios**

RATIO

**SE5. BUSINESS APPLICATION** ► Using the following accounts and balances taken from a year-end balance sheet, compute working capital and the current ratio:

Accounts Payable	\$3,500	Merchandise Inventory	\$ 6,000
Accounts Receivable	5,000	Notes Payable in Three Years	6,500
Cash	2,000	Owner's Capital	24,000
Marketable Securities	1,000	Property, Plant, and Equipment	20,000

LO 3 **Profitability Ratios**

RATIO

**SE6. BUSINESS APPLICATION** ► Using the following information from a balance sheet and an income statement, compute the (1) profit margin, (2) asset turnover, (3) return on assets, (4) debt to equity ratio, and (5) return on equity. The previous year's total assets were \$200,000, and owner's equity was \$140,000. (Round to one decimal place.)

Total Assets	\$240,000	Net Sales	\$260,000
Total Liabilities	60,000	Cost of Goods Sold	140,000
Total Owner's Equity	180,000	Operating Expenses	80,000

LO 3 **Profitability Ratios**

RATIO

**SE7. BUSINESS APPLICATION** ► Assume that a company has a profit margin of 12.0 percent, an asset turnover of 6.4 times, and a debt to equity ratio of 50 percent. What are the company's return on assets and return on equity? (Round to one decimal place.)

**EXERCISES: SET A**LO 1 **Financial Accounting Concepts**

**E1A. CONCEPT** ► The lettered items that follow represent a classification scheme for the concepts of financial accounting. Match each numbered term in the list that follows with the letter of the category in which it belongs.

- |   |  |
|---|--|
| a. Qualitative characteristics  | 7. Cost-benefit  |
| b. Financial statements   | 8. Predictive value  |
| c. Objective of accounting information                                | 9. Business transactions   |
| d. Accounting measurement considerations                              | 10. Consistency  |
| e. Accounting processing considerations                               | 11. Full disclosure  |
| f. Decision makers (users of accounting information)                  | 12. Furnishing information that is useful to investors and creditors       |
| g. Accounting conventions   | 13. Specific business entities   |
| h. Business activities or entities relevant to accounting measurement | 14. Classification   |
|   | 15. Management   |
|   | 16. Neutrality   |
|   | 17. Internal accounting control  |
| 1. Conservatism   | 18. Valuation  |
| 2. Verifiability  | 19. Investors  |
| 3. Statement of cash flows  | 20. Completeness   |
| 4. Materiality  | 21. Relevance  |
| 5. Faithful representation  | 22. Furnishing information that is useful in assessing cash flow prospects |
| 6. Recognition  |  |

### LO 1 Qualitative Characteristics and Accounting Conventions

**E2A. CONCEPT** ▶ Each of the statements that follow violates one or more accounting concepts. State which of these selected qualitative characteristics and accounting conventions—relevance, faithful representation, comparability, verifiability, timeliness, understandability, cost constraint, consistency, materiality, conservatism, or full disclosure—is (are) violated.

1. A company changes its method of accounting for depreciation.
2. The asset account for a pickup truck still used in the business is written down to what the truck could be sold for, even though the carrying value under conventional depreciation methods is higher.
3. A series of reports that are time-consuming and expensive to prepare are presented to the owner each month, even though they are never used.
4. The company in 1 does not indicate in the financial statements that the method of depreciation was changed, nor does it specify the effect of the change on net income.
5. A company's new office building, which is built next to the company's existing factory, is debited to the factory account because it represents a fairly small dollar amount in relation to the factory.
6. Information is presented in a way that is not useful to users.
7. A transaction is recorded that does not represent the substance of the economic event.
8. Information is presented in a way that is confusing to users.
9. Similar transactions are recorded using different accounting principles.
10. Information is reported long after the economic events they represent.
11. Various experts come up with widely different estimates of an amount.

### LO 2 Classification of Accounts: Balance Sheet

**E3A.** The lettered items that follow represent a classification scheme for a balance sheet, and the numbered items in the list are account titles. Match each account with the letter of the category in which it belongs.

- |                                   |  |
|-----------------------------------|--|
| a. Current liabilities            | 5. Note Payable in Five Years          |
| b. Owner's equity                 | 6. Building Used in Operations         |
| c. Current assets                 | 7. Fund Held to Pay Off Long-Term Debt |
| d. Intangible assets              | 8. Inventory                           |
| e. Property, plant, and equipment | 9. Prepaid Insurance                   |
| f. Investments                    | 10. Depreciation Expense               |
| g. Long-term liabilities          | 11. Accounts Receivable                |
| h. Not on balance sheet           | 12. Interest Expense                   |
| 1. Patent                         | 13. Unearned Revenue                   |
| 2. Building Held for Sale         | 14. Short-Term Investments             |
| 3. Prepaid Rent                   | 15. Accumulated Depreciation           |
| 4. Wages Payable                  | 16. Owner's Capital                    |

### LO 2 Classified Balance Sheet Preparation

**E4A.** The following data pertain to Wagoner Company: Accounts Payable, \$20,400; Accounts Receivable, \$15,200; Accumulated Depreciation—Building, \$5,600; Accumulated Depreciation—Equipment, \$6,800; Bonds Payable, \$24,000; Building, \$28,000; Cash, \$12,480; Copyright, \$2,480; Equipment, \$60,800; Inventory, \$16,000; Investment in Corporate Securities (long-term), \$8,000; Investment in Six-Month Government Securities, \$6,560; Y. Wagoner, Capital, \$95,280; Land, \$3,200; Prepaid Rent, \$480; and Revenue Received in Advance, \$1,120. Prepare a classified balance sheet at December 31, 2014. Assume that this is Wagoner's first year of operations.

LO 3 **Liquidity Ratios**

RATIO

**E5A. BUSINESS APPLICATION** ► The accounts and balances that follow are from Kellman Company's general ledger. Compute the (1) working capital and (2) current ratio. (Round to one decimal place.)

Accounts Payable	\$13,280
Accounts Receivable	8,160
Cash	1,200
Current Portion of Long-Term Debt	8,000
K. Kellman, Capital	22,640
Long-Term Investments	8,320
Marketable Securities	10,080
Merchandise Inventory	20,320
Notes Payable (90 days)	12,000
Notes Payable (2 years)	16,000
Notes Receivable (90 days)	20,800
Notes Receivable (2 years)	8,000
Prepaid Insurance	320
Property, Plant, and Equipment	48,000
Property Taxes Payable	1,000
Salaries Payable	680
Supplies	280
Unearned Revenue	600

LO 3 **Profitability Ratios**

RATIO

**E6A. BUSINESS APPLICATION** ► The following amounts are from Shimura Company's financial statements at the end of the current year: total assets, \$426,000; total liabilities, \$172,000; owner's equity, \$254,000; net sales, \$782,000; cost of goods sold, \$486,000; operating expenses, \$178,000; and withdrawals, \$40,000. During the current year, total assets increased by \$75,000. Total owner's equity was affected only by net income and withdrawals. Compute the (1) profit margin, (2) asset turnover, (3) return on assets, (4) debt to equity ratio, and (5) return on equity. (Round to one decimal place.)

LO 3 **Liquidity and Profitability Ratios**

RATIO

**E7A. BUSINESS APPLICATION** ► A company's simplified balance sheet and income statement follow.

**Balance Sheet**  
**December 31, 2014**

Assets		Liabilities	
Current assets	\$ 50,000	Current liabilities	\$ 20,000
Investments	10,000	Long-term liabilities	30,000
Property, plant, and equipment	146,500	Total liabilities	<u>\$ 50,000</u>
Intangible assets	13,500	<b>Owner's Equity</b>	
		Owner's capital	170,000
Total assets	<u>\$220,000</u>	Total liabilities and owner's equity	<u>\$220,000</u>

**Income Statement**  
**For the Year Ended December 31, 2014**

Net sales	\$410,000
Cost of goods sold	<u>250,000</u>
Gross margin	\$160,000
Operating expenses	<u>135,000</u>
Net income	<u>\$ 25,000</u>



Total assets and owner's equity at the beginning of 2014 were \$180,000 and \$140,000, respectively. The owner made no investments or withdrawals during the year.

1. Compute the following liquidity measures: (a) working capital and (b) current ratio. (Round to one decimal place.)
2. Compute the following profitability measures: (a) profit margin, (b) asset turnover, (c) return on assets, (d) debt to equity ratio, and (e) return on equity. (Round to one decimal place.)

LO 3

### Liquidity and Profitability Ratios

RATIO

**E8A. BUSINESS APPLICATION** ► Villegas Company is considering applying for a bank loan. Various data from Villegas's classified financial statements follow.

	2014	2013
Current assets	\$100,000	\$ 85,000
Total assets	440,000	355,000
Current liabilities	45,000	25,000
Long-term liabilities	75,000	25,000
Owner's equity	320,000	305,000
Sales	600,000	525,000
Net income	30,000	40,000

Its total assets and owner's equity at the beginning of 2013 were \$345,000 and \$295,000, respectively.

1. Use (a) liquidity analysis and (b) profitability analysis to document Villegas's financial position. (Round to two decimal places.)
2. Discuss Villegas's profitability and liquidity. Do you think it will qualify for a bank loan?

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

LO 1

### Qualitative Characteristics and Accounting Conventions

**P1. CONCEPT** ► In each case that follows, qualitative characteristics and accounting conventions may have been violated.

1. After careful study, Schuss Company, which has offices in 40 states, has determined that its method of depreciating office furniture should be changed. The new method is adopted for the current year, and the change is noted in the financial statements.
2. In the past, Waldemar Company has recorded operating expenses in general accounts (e.g., Salaries Expense and Utilities Expense). Management has determined that despite the additional recordkeeping costs, the company's income statement should break down each operating expense into its components of selling expense and administrative expense.
3. Leon Company's auditor discovered that a company official had authorized the payment of a \$1,200 bribe to a local official. Management argued that because the item was so small in relation to the size of the company (\$1,700,000 in sales), the illegal payment should not be disclosed.
4. J&J Bookstore built a small addition to its main building to house a new computer games section. Because no one could be sure that the computer games section would succeed, the accountant took a conservative approach and recorded the addition as an expense.

(Continued)



5. Since it began operations ten years ago, Reed Company has used the same generally accepted inventory method. The company does not disclose in its financial statements what inventory method it uses.
6. Go-Fast Gas has a number of aged service stations around the local community. The company has not included the buildings at these locations on its financial statements because it does not plan on selling them.
7. Social Internet Company is planning to ask the bank for a loan. It asks its accountants to make its financial prospects look as attractive as possible.
8. Acre Company's auditors are having difficulty reproducing estimates in Acre's financial statements due to estimates that cannot be substantiated.

**REQUIRED**

In each of these cases, identify the qualitative characteristic or accounting convention that applies, state whether or not the treatment is in accord with the accounting concept and generally accepted accounting principles, and briefly explain why.

LO 2, 3

RATIO

SPREADSHEET

✓ 1: Total assets: \$597,600

**Classified Balance Sheet**

**P2.** The information that follows is from Jason's Hardware Company's June 30, 2014, post-closing trial balance.

Account Name	Debit	Credit
Cash	32,000	
Short-Term Investments	33,000	
Notes Receivable	10,000	
Accounts Receivable	276,000	
Merchandise Inventory	145,000	
Prepaid Rent	1,600	
Prepaid Insurance	4,800	
Sales Supplies	1,280	
Office Supplies	440	
Deposit for Future Advertising	3,680	
Building, Not in Use	49,600	
Land	23,400	
Delivery Equipment	41,200	
Accumulated Depreciation—Delivery Equipment		28,400
Trademark	4,000	
Accounts Payable		114,600
Salaries Payable		5,200
Interest Payable		840
Long-Term Notes Payable		80,000
J. Smith, Capital		396,960
	<u>626,000</u>	<u>626,000</u>

**REQUIRED**

1. Prepare a classified balance sheet for Jason's Hardware Company.
2. **BUSINESS APPLICATION** ► Compute Jason's Hardware's current ratio and debt to equity ratio. (Round to one decimal place.)
3. **BUSINESS APPLICATION** ► As a user of the classified balance sheet, why would you want to know the current ratio or the debt to equity ratio?

LO 3

RATIO

SPREADSHEET

✓ 1b: 2014 current ratio: 2.3  
 ✓ 2e: 2014 return on equity: 15.6%

**Liquidity and Profitability Ratios**

**P3. BUSINESS APPLICATION** ► Julio Company has had poor operating results for the past two years. As Julio's accountant, you have the following information available to you:

	2014	2013
Current assets	\$ 45,000	\$ 35,000
Total assets	145,000	110,000
Current liabilities	20,000	10,000
Long-term liabilities	20,000	—
Owner's equity	105,000	100,000
Net sales	262,000	200,000
Net income	16,000	11,000

Total assets and owner's equity at the beginning of 2013 were \$90,000 and \$80,000, respectively. The owner made no investments in 2013 or 2014.

#### REQUIRED

1. Compute the following measures of liquidity for 2013 and 2014: (a) working capital and (b) current ratio. Comment on the differences between the years. (Round to one decimal place.)
2. Compute the following measures of profitability for 2013 and 2014: (a) profit margin, (b) asset turnover, (c) return on assets, (d) debt to equity ratio, and (e) return on equity. Comment on the change in performance from 2013 to 2014. (Round to one decimal place.)

LO 2, 3

RATIO

✓ 1: Total assets: \$625,800

#### Classified Balance Sheet

**P4.** The information that follows is from Cullen's Hardware Company's June 30, 2014, post-closing trial balance.

Account Name	Debit	Credit
Cash	42,800	
Short-Term Investments	34,300	
Sales Supplies	1,280	
Merchandise Inventory	145,000	
Prepaid Rent	2,100	
Prepaid Insurance	4,800	
Accounts Receivable	287,000	
Office Supplies	440	
E. Cullen, Capital		412,660
Notes Receivable	10,000	
Land	31,400	
Delivery Equipment	43,200	
Accumulated Depreciation—Delivery Equipment		28,400
Trademark	4,000	
Accounts Payable		124,600
Salaries Payable		7,700
Deposit for Future Advertising	3,680	
Interest Payable		840
Long-Term Notes Payable		80,000
Building, Not in Use	44,200	
	<u>654,200</u>	<u>654,200</u>

#### REQUIRED

1. Prepare a classified balance sheet for Cullen's Hardware Company.
2. **BUSINESS APPLICATION** ▶ Compute Cullen's Hardware's current ratio and debt to equity ratio. (Round to one decimal place.)
3. **BUSINESS APPLICATION** ▶ As a user of the classified balance sheet, why would you want to know the current ratio or the debt to equity ratio?

## ALTERNATE PROBLEMS

### LO 1 Accounting Conventions

**P5. CONCEPT** ▶ In each case that follows, qualitative characteristics and accounting conventions may have been violated.

- Elite Manufacturing Company uses the cost method for computing the balance sheet amount of inventory unless the market value of the inventory is less than the cost, in which case the market value is used. At the end of the current year, the market value is \$302,000 and the cost is \$324,000. The company uses the \$302,000 figure to compute the value of inventory because management believes it is the more cautious approach.
- Livery Service Company has annual sales of \$20,000,000. It follows the practice of recording any items costing less than \$500 as expenses in the year purchased. During the current year, it purchased several chairs for the executive conference room at \$490 each, including freight. Although the chairs were expected to last for at least ten years, they were recorded as an expense in accordance with company policy.
- Stardust Company closed its books on October 31, 2013, before preparing its annual report. On November 3, 2013, a fire destroyed one of the company's two factories. Although the company had fire insurance and would not suffer a loss on the building, it seemed likely that it would suffer a significant decrease in sales in 2014 because of the fire. It did not report the fire damage in its 2013 financial statements because the fire had not affected its operations during that year.
- Primal Drug Company spends a substantial portion of its profits on research and development. The company had been reporting its \$12,000,000 expenditure for research and development as a lump sum, but management recently decided to begin classifying the expenditures by project, even though its recordkeeping costs will increase.
- During the current year, Ziegler Company changed from one generally accepted method of accounting for inventories to another method, without disclosing the change.
- Due to pressing business issues, Judson Products is consistently behind schedule in preparing its financial statements.
- Thomas Electronics is a complex global business whose financial statements use many technical terms not known by the typical investor.
- Siro Company produces financial statements that are not helpful in assessing the company's prospects in the future.

### REQUIRED

For each of these cases, identify the accounting concept that applies, state whether or not the treatment is in accord with the concept, and briefly explain why.

### LO 2, 3

RATIO

SPREADSHEET

✓ 1: Total assets: \$595,600

### Classified Balance Sheet

**P6.** The information that follows is from Matt's Hardware Company's April 30, 2014, post-closing trial balance.

Account Name	Debit	Credit
Cash	31,000	
Short-Term Investments	33,000	
Notes Receivable	10,000	
Accounts Receivable	276,000	
Merchandise Inventory	145,000	
Prepaid Rent	1,600	
Prepaid Insurance	4,800	

Sales Supplies	1,280	
Office Supplies	440	
Deposit for Future Advertising	3,680	
Building, Not in Use	49,600	
Land	22,400	
Delivery Equipment	41,200	
Accumulated Depreciation—Delivery Equipment		28,400
Trademark	4,000	
Accounts Payable		114,600
Salaries Payable		5,200
Interest Payable		840
Long-Term Notes Payable		80,000
M. Shah, Capital		394,960

**REQUIRED**

1. Prepare a classified balance sheet for Matt's Hardware.
2. **BUSINESS APPLICATION** ▶ Compute Matt's Hardware's current ratio and debt to equity ratio. (Round to one decimal place.)
3. **BUSINESS APPLICATION** ▶ As a user of the classified balance sheet, why would you want to know the current ratio or the debt to equity ratio?

LO 3

**Liquidity and Profitability Ratios**

RATIO

SPREADSHEET

- ✓ 1b: 2014 current ratio: 2.0
- ✓ 2c: 2014 return on assets: 14.8%

**P7. BUSINESS APPLICATION** ▶ A summary of data from Pinder Construction Supply Company's income statements and balance sheets for 2014 and 2013 follows.

	2014	2013
Current assets	\$ 366,000	\$ 310,000
Total assets	2,320,000	1,740,000
Current liabilities	180,000	120,000
Long-term liabilities	800,000	580,000
Owner's equity	1,340,000	1,040,000
Net sales	4,600,000	3,480,000
Net income	300,000	204,000

Total assets and owner's equity at the beginning of 2013 were \$1,360,000 and \$840,000, respectively.

**REQUIRED**

1. Compute the following liquidity measures for 2013 and 2014: (a) working capital and (b) current ratio. Comment on the differences between the years. (Round to one decimal place.)
2. Compute the following measures of profitability for 2013 and 2014: (a) profit margin, (b) asset turnover, (c) return on assets, (d) debt to equity ratio, and (e) return on equity. Comment on the change in performance from 2013 to 2014. (Round to one decimal place.)

LO 2, 3

**Classified Balance Sheet**

RATIO

- ✓ 1: Total assets: \$571,470

**P8.** The information that follows is from Rodriguez's Tools Company's April 30, 2014, post-closing trial balance.

*(Continued)*

Account Name	Debit	Credit
Cash	31,000	
Short-Term Investments	43,500	
Accounts Receivable	239,000	
Merchandise Inventory	113,000	
Notes Receivable	10,000	
Interest Payable		930
Sales Supplies	1,280	
Office Supplies	540	
Deposit for Future Advertising	3,120	
Long-Term Notes Payable		99,000
Land	34,700	
Delivery Equipment	42,230	
Accumulated Depreciation—Delivery Equipment		28,400
Building, Not in Use	72,100	
Accounts Payable		129,600
Salaries Payable		4,600
Prepaid Rent	1,800	
Prepaid Insurance	3,600	
C. Rodriguez, Capital		337,340
Trademark	4,000	

**REQUIRED**

1. Prepare a classified balance sheet for Rodriguez's Tools.
2. **BUSINESS APPLICATION** ► Compute Rodriguez's Tools' current ratio and debt to equity ratio. (Round to one decimal place.)
3. **BUSINESS APPLICATION** ► As a user of the classified balance sheet, why would you want to know the current ratio or the debt to equity ratio?

**CASES****LO 1 Conceptual Understanding: Consistency, Full Disclosure, and Materiality**

**C1. CONCEPT** ► Metro Parking, which operates a seven-story parking building, has a calendar year-end. It serves daily and hourly parkers, as well as monthly parkers who pay a fixed monthly rate in advance. The company traditionally has recorded all cash receipts as revenues when received. Most monthly parkers pay in full during the month prior to that in which they have the right to park. The company's auditors have said that beginning in 2014, the company should consider recording the cash receipts from monthly parking on an accrual basis, crediting Unearned Revenues. Total cash receipts for 2014 were \$1,250,000, and the cash receipts received in 2014 and applicable to January 2015 were \$62,500. Discuss the relevance of the accounting concepts of consistency, full disclosure, and materiality to the decision to record the monthly parking revenues on an accrual basis.

**LO 1 Conceptual Understanding: Materiality**

**C2. CONCEPT** ► Laskowski, Inc., operates a chain of consumer electronics stores. This year, the company achieved annual sales of \$75 million, on which it earned a net income of \$3 million. At the beginning of the year, management implemented a new inventory system that enabled it to track all purchases and sales. At the end of the year, a physical inventory revealed that the actual inventory was \$120,000 below what the new system indicated it should be. The inventory loss, which probably resulted from shoplifting, was reflected in a higher cost of goods sold. The problem concerns management but seems to be less important to the company's auditors. What is materiality? Why might the inventory loss concern management more than it does the auditors? Do you think the amount of inventory loss is material?

LO 3 **Interpreting Financial Reports: Comparison of Profitability**

**RATIO**

**C3. BUSINESS APPLICATION** ▶ Two of the largest chains of clothing stores in the United States are **The Gap, Inc.** and **Abercrombie & Fitch Co.** In fiscal 2011, Gap had net income of \$833 million, and Abercrombie & Fitch had net income of \$128 million. It is difficult to judge from these figures alone which company is more profitable because they do not take into account the relative sales, sizes, and investments of the companies. Data (in millions) needed for a complete financial analysis of the two companies follow:

	Gap	Abercrombie & Fitch*
Net sales	\$14,549	\$4,158
Beginning total assets	7,065	2,941
Ending total assets	7,422	3,048
Beginning total liabilities	2,985	1,051
Ending total liabilities	4,667	1,186
Beginning stockholders' equity	4,080	1,891
Ending stockholders' equity	2,755	1,862

\*Abercrombie & Fitch's data is rounded to the nearest dollar.

1. Determine which company was more profitable by computing profit margin, asset turnover, the debt to equity ratio, return on assets, and return on equity for the two companies. Comment on the relative profitability of the two companies. (Round to one decimal place or the nearest tenth of a percent.)
2. What do the ratios tell you about the factors that go into achieving an adequate return on assets in the clothing retail industry? For industry data, refer to the graphs in the ratio boxes throughout the chapter.
3. How would you characterize the use of debt financing in the clothing retail industry and the use of debt by these two companies?

LO 2, 3 **Annual Report Case: Classified Balance Sheet**

**C4. BUSINESS APPLICATION** ▶ Refer to the **CVS** annual report in the Supplement to Chapter 16 to answer the following questions.

1. Does CVS use a classified balance sheet?
2. Did CVS's debt to equity ratio change from 2010 to 2011? (Round to the nearest tenth of a percent.)
3. What is the contributed capital for 2011? How does contributed capital compare with retained earnings?

LO 3 **Comparison Case: Financial Performance**

**C5. BUSINESS APPLICATION** ▶ Compare the financial performance of **CVS** and **Southwest Airlines Co.** on the basis of profitability in 2011 and 2010. Use the following ratios: profit margin, asset turnover, return on assets, and return on equity. (Round to one decimal place or to the nearest tenth of a percent.) In 2009, total assets, total stockholders' equity, and cash flows from operating activities for CVS were \$61,141 million, \$35,768 million, and \$4,035 million, respectively. Southwest's total assets were \$14,269 million in 2009, and its total stockholders' equity and cash flow from operating activities were \$5,454 million and \$985 million, respectively. Comment on the relative performance of the two companies. In general, how does Southwest's performance compare to CVS's with respect to profitability? What distinguishes Southwest's profitability performance from that of CVS?

LO 1 **Ethical Dilemma: Ethics and Financial Reporting**

**C6.** Beacon Systems develops computer software and licenses it to financial institutions. The firm records revenues from the software it has developed on a percentage of com-

(Continued)

pletion basis. For example, if a project is 50 percent complete, then 50 percent of the contracted revenue is recognized. Preliminary estimates for a \$7 million project now in development are that the project is 75 percent complete. Estimates of completion are a matter of judgment, and management therefore feels justified in asking for a new report showing that the project is 90 percent complete. The change will enable senior managers to meet their financial goals for the year and thus receive substantial year-end bonuses. Do you think management's action is ethical? If you were the company controller and were asked to prepare the new report, would you do it? What action would you take?

### Continuing Case: Annual Report Project

**RATIO**

**C7. BUSINESS APPLICATION** ► Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, use the classified balance sheet together with the income statement to compute the following ratios for the last two years and indicate whether each has improved. (Round to one decimal place or to the nearest tenth of a percent.)

- a. Current ratio
- b. Profit margin
- c. Asset turnover
- d. Return on assets
- e. Debt to equity ratio
- f. Return on equity



# CHAPTER 6

## Accounting for Merchandising Operations

### BUSINESS INSIGHT

#### Mink Company

Mink Company is a fast-growing, discount merchandising company that specializes in selling stylish, low-priced fashions to young people. Like all other merchandisers, Mink has two key decisions to make: the price at which it will sell goods and the level of service it will provide. A department store may set the price of its merchandise at a relatively high level and provide a great deal of service. A discount store, on the other hand, may price its merchandise at a relatively low level and provide limited service.

- 1. CONCEPT** ► How do faithful representation and classification apply to merchandise operations?
- 2. ACCOUNTING APPLICATION** ► How can merchandising transactions be recorded to reflect the company's performance?
- 3. BUSINESS APPLICATION** ► How can Mink manage its operating cycle so that it has adequate cash to maintain liquidity?

### LEARNING OBJECTIVES

- LO 1** Define *merchandising accounting*, and differentiate perpetual from periodic inventory systems.
- LO 2** Describe the features of multistep and single-step classified income statements.
- LO 3** Describe the terms of sale related to merchandising transactions.
- LO 4** Prepare an income statement, and record merchandising transactions under the perpetual inventory system.
- LO 5** Prepare an income statement, and record merchandising transactions under the periodic inventory system.
- LO 6** Explain the role of the operating cycle and foreign business transactions in evaluating the liquidity of a merchandising company.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Faithful representation
- Classification

RELEVANT  
LEARNING OBJECTIVE

- Lo 1** Define *merchandising accounting* and differentiate perpetual from periodic inventory systems.

## Lo 1 Concepts Underlying Merchandising Accounting

A merchandising company earns income by buying and selling goods, which are called **merchandise inventory**. Whether a merchandiser is a wholesaler or a retailer, it uses the same basic accounting methods as a service company. However, the buying and selling of goods adds to the complexity of the accounting process. One complexity is the *classification* of items on the merchandising income statement so that the statement *faithfully represents* the operations of the company. Further, merchandise inventory is an important component on the **operating cycle**, which is the cycle of buying and holding merchandise until it is sold and then collecting payment for the sales.

To *faithfully represent* accounting for merchandising inventories, two basic systems of accounting for merchandise inventory are used: the *perpetual inventory system* and the *periodic inventory system*.

- Under the **perpetual inventory system**, continuous records are kept of the quantity and, usually, the cost of individual items as they are bought and sold. The cost of each item is recorded in the Merchandise Inventory account when it is purchased. As merchandise is sold, its cost is transferred from the Merchandise Inventory account to the Cost of Goods Sold account. Thus, at all times the balance of the Merchandise Inventory account equals the cost of goods on hand, and the balance in Cost of Goods Sold equals the cost of merchandise sold to customers.
- Under the **periodic inventory system**, the inventory not yet sold is counted periodically. This physical count is called **physical inventory**, which is usually taken at the end of the accounting period. No detailed records of the inventory are maintained during the accounting period. The figure for inventory is accurate only on the balance sheet date. (Note that the value of ending inventory on the balance sheet is determined by multiplying the quantity of each inventory item by its unit cost.) As soon as any purchases or sales are made in the new accounting period, the inventory figure becomes a historical amount, and it remains so until the new ending inventory amount is entered at the end of this accounting period.

Note that the perpetual inventory system does not eliminate the need for a physical count of the inventory. One should be taken periodically to ensure that the actual number of goods on hand matches the quantity indicated by the computer records.

Each system has advantages. Managers use the detailed data from the perpetual inventory system to respond to customers' inquiries about product availability, to order inventory more effectively in order to avoid running out of stock, and to control the costs associated with investments in inventory. Managers may choose the periodic inventory system because it reduces the amount of clerical work. If a business is fairly small, management can maintain control over its inventory simply through observation or by use of an offline system of cards or computer records. However, for larger companies, the lack of detailed records may lead to lost sales or high operating costs.



## Business Perspective

### How Have Bar Codes Influenced the Choice of Inventory Systems?

Most grocery stores, which traditionally used the periodic inventory system, now employ bar coding to update the physical inventory as items are sold. At the checkout counter, the cashier scans into the cash register the electronic marking, called a *bar code* or *universal product code (UPC)*, that appears on each product. The cash register is linked to a computer that records the sale. Bar coding has become common in all types of retail companies, manufacturing firms, and hospitals. It has also become a major factor in the increased use of the perpetual inventory system. Interestingly, some retail businesses now use the perpetual inventory system for keeping track of the physical flow of inventory and the periodic inventory system for preparing their financial statements.

© Aljia / iStockphoto.com

© Cengage Learning 2014

Because of the difficulty and expense of accounting for the purchase and sale of each item, companies that sell items of low value in high volume have traditionally used the periodic inventory system. Examples of such companies include small retailers, drugstores, and grocery stores. In contrast, companies that sell items that have a high unit value, such as appliances, have tended to use the perpetual inventory system. The distinction between high and low unit value for inventory systems has blurred considerably in recent years. Although the periodic inventory system is still widely used, computerization has led to an increase in the use of the perpetual inventory system.

## APPLY IT!

Indicate whether each of the statements that follow is more applicable to (a) perpetual inventory system, (b) periodic inventory system, or (c) both systems.

- Requires a physical count of inventory at end of period.
- No detailed records of the inventory are maintained during the accounting period.
- Continuous records are kept of the quantity.
- Inventory figure is accurate only on the balance sheet date.
- The balance in Cost of Goods Sold equals the cost of merchandise sold to customers at all times.
- Helps to manage inventory more effectively and thus avoid running out of stock.
- Is less costly to maintain but may lead to lost sales.

### SOLUTION

1. c; 2. b; 3. a; 4. b; 5. a; 6. a; 7. b

### TRY IT! SE1, E1A, E1B

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Prepare a multistep income statement
- Prepare a single-step income statement
- Record inventory transactions under the perpetual method
- Record inventory transactions under the periodic method

## RELEVANT LEARNING OBJECTIVES

**LO 2** Describe the features of multistep and single-step classified income statements.

**LO 3** Describe the terms of sale related to merchandising transactions.

**LO 4** Prepare an income statement, and record merchandising transactions under the perpetual inventory system.

**LO 5** Prepare an income statement, and record merchandising transactions under the periodic inventory system.

## LO 2 Forms of the Income Statement

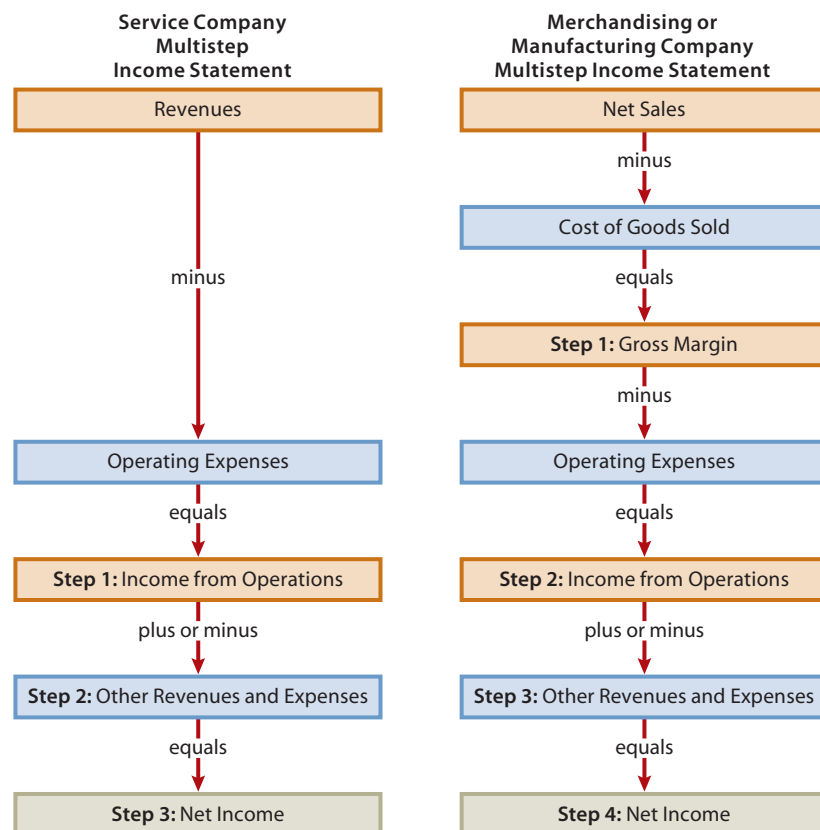
In the income statements we have presented thus far, expenses have been deducted from revenue in a single step to arrive at net income. Here, we look at a multistep income statement and a more complex single-step format.

### Multistep Income Statement

A **multistep income statement** goes through a series of steps, or subtotals, to arrive at net income. In a service company's multistep income statement, the operating expenses are deducted from revenues in a single step to arrive at income from operations. In contrast, because manufacturing and merchandising companies make or buy goods for sale, their income statements include an additional step of calculating gross margin by subtracting the cost of goods from net sales. Exhibit 1 compares the multistep income statement of a service company (which provides services as opposed to products) with that of a **merchandising company** (which buys and sells products) and a **manufacturing company** (which makes and sells products).

#### Exhibit 1

A Comparison of the Components of Multistep Income Statements for Service and Merchandising or Manufacturing Companies



We will use Davila Company, a merchandising company, to illustrate the multistep income statement. Davila's multistep income statement is presented in Exhibit 2. Like balance sheets, income statements vary among companies. You will rarely, if ever, find an income statement exactly like the one presented for Davila Company. Companies use different terms and different structures.

**Exhibit 2**  
Multistep Income Statement  
for Davila Company

<b>Davila Company</b>		<b>Income Statement</b>	
<b>For the Year Ended December 31, 2014</b>			
<b>Step 1</b>	Gross sales	\$1,300,924	
	Less Sales returns and allowances	52,300	
	Net sales		\$1,248,624
	Cost of goods sold		815,040
	Gross margin		\$ 433,584
<b>Step 2</b>	Operating expenses:		
	Selling expenses	\$ 219,120	
	General and administrative expenses	138,016	
	Total operating expenses		357,136
	Income from operations		\$ 76,448
<b>Step 3</b>	Other revenues and expenses:		
	Interest income	\$ 5,600	
	Less interest expense	10,524	
	Excess of other expenses over other revenues		4,924
<b>Step 4</b>	Net income		\$ 71,524

© Cengage Learning 2014

**Net Sales (or Net Revenue)** **Net sales** (or *net revenue*) is computed as follows.

$$\text{Net Sales} = \text{Gross Sales} - \text{Sales Returns and Allowances}$$

- **Gross sales** consist of the total revenue from cash and credit sales during a period. Under the revenue recognition concept, even when cash from a credit sale is not received during the current period, it is recorded if title to the merchandise has passed to the buyer.
- **Sales returns and allowances** include cash refunds and credits on account. They also include any discounts from selling prices made to customers who have returned defective products or products that are otherwise unsatisfactory. If other types of discounts are given to customers, they also should be deducted from gross sales.

For Davila, net sales is computed as follows.

$$\$1,300,924 - \$52,300 = \$1,248,624$$

**Cost of Goods Sold (or Cost of Sales)** **Cost of goods sold** (or *cost of sales* or *cost of revenue*) is the amount a merchandiser paid for the merchandise it sold during a period. For a manufacturer, it is the cost of making the products it sold during a period. Davila's cost of goods sold is \$815,040.

**Gross Margin (or Gross Profit)** **Gross margin** (or *gross profit*) is computed as follows.

$$\text{Gross Margin} = \text{Net Sales} - \text{Cost of Goods Sold}$$





## International Perspective



### Income Statements Under IFRS May Not Show Cost of Goods Sold

Under U.S. GAAP, the Cost of Goods Sold account is needed because the income statement requires listing costs and expense by function, such as cost of goods sold, selling expenses, and general and administrative expenses. IFRS, on the other hand, give companies the option of listing by function, like U.S. GAAP, or by nature, such as materials costs, labor costs, and so forth. Most European companies choose the latter option, thus not showing any cost of goods sold, gross margin, or operating income on their income statements.

**STUDY NOTE:** *Gross margin measures profitability. When it is less than operating expenses, the company suffers a net loss from operations.*

A company's gross margin must be sufficient to cover operating expenses and provide an adequate net income. Davila's gross margin is computed as follows (as shown in Step 1 in Exhibit 2).

$$\$1,248,624 - \$815,040 = \$433,584$$

Managers and owners are interested in both the amount and **percentage of gross margin**. The percentage is computed as follows.

$$\text{Percentage of Gross Margin} = \text{Gross Margin} \div \text{Net Sales}$$

For Davila, percentage of gross margin is computed as follows.

$$\$433,584 \div \$1,248,624 = 34.7\% \text{ %}$$

\*Rounded

**Business Application** Gross margin information is useful in planning business operations.

- For instance, management may try to increase total sales of a product by reducing the selling price. Although this strategy reduces the percentage of gross margin, it will work if the number of items sold increases enough to raise the absolute amount of gross margin. Discount warehouse stores like **Sam's Club** and **Costco Wholesale Corporation** follow this strategy.
- On the other hand, management may decide to keep a high gross margin from sales and try to increase sales and the amount of gross margin by increasing operating expenses, such as advertising. Upscale specialty stores like **Neiman Marcus** and **Tiffany & Co.** use this strategy.

Other strategies to increase gross margin include using better purchasing methods to reduce the cost of goods sold.

**Operating Expenses** **Operating expenses** are the expenses, other than the cost of goods sold, that are incurred in running a business. They are often grouped into the categories of selling expenses and general and administrative expenses and computed as follows.

$$\text{Operating Expenses} = \text{Selling Expenses} + \text{General and Administrative Expenses}$$

- **Selling expenses** include the costs of storing goods and preparing them for sale; preparing displays, advertising, and otherwise promoting sales; and delivering goods to a buyer if the seller has agreed to pay the cost of delivery.
- **General and administrative expenses** include expenses for accounting, personnel, credit checking, collections, and any other expenses that apply to overall operations. Although occupancy expenses, such as expenses of rent, insurance, and utilities, are often classified as general and administrative expenses, they can also be allocated between selling expenses and general and administrative expenses.

For Davila, operating expenses are computed as follows.

$$\$219,120 + \$138,016 = \$357,136$$

**Business Application** Careful planning and control of operating expenses can improve a company's profitability.

**Income from Operations (or Operating Income)** **Income from operations** (or *operating income*) is the income from a company's main business and is computed as follows.

$$\text{Income from Operations} = \text{Gross Margin} - \text{Operating Expenses}$$

For Davila, income from operations is computed as follows (as shown in Step 2 in Exhibit 2).

$$\$433,584 - \$357,136 = \$76,448$$

**STUDY NOTE:** *Income from operations is a key measure of profitability for financial analysts.*

**Business Application** Income from operations is often used to compare the profitability of two or more companies or divisions within a company.

**Other Revenues and Expenses (or Nonoperating Revenues and Expenses)** **Other revenues and expenses** (or *nonoperating revenues and expenses*) are not related to a company's operating activities. Among the items included in this section are revenues from investments (such as dividends and interest on stocks, bonds, and savings accounts) and interest expense and other expenses that result from borrowing money. Davila's other revenues and expenses appear in Step 3 of Exhibit 2.

**Net Income (or Net Earnings)** **Net income** (or *net earnings*) is the final figure, or "bottom line," of an income statement and is computed as follows.

$$\text{Net Income} = \text{Gross Margin} - \text{Operating Expenses} + / - \text{Other Revenues and Expenses}$$

For Davila, net income is computed as follows (as shown in Step 4 of Exhibit 2).

$$\$433,584 - \$357,136 - \$4,924 = \$71,524$$

Net income is an important performance measure because it represents the amount of earnings that accrue to owners. It is the amount transferred to owner's capital from all the income that business operations have generated during a period.

## Single-Step Income Statement

Exhibit 3 shows a **single-step income statement** for Davila Company. In this statement, net income is derived in a single step by putting the major categories of revenues in the first part of the statement and the major categories of costs and expenses in the second part. Both the multistep form and the single-step form have advantages: the multistep form shows the components used in deriving net income, and the single-step form has the advantage of simplicity.

**STUDY NOTE:** *If you encounter income statement components not covered in this chapter, refer to the index at the end of the book to find the topic and read about it.*

### Exhibit 3 Single-Step Income Statement for Davila Company

© Cengage Learning 2014

<b>Davila Company</b>	
<b>Income Statement</b>	
<b>For the Year Ended December 31, 2014</b>	
<hr/>	
Revenues:	
Net sales	\$1,248,624
Interest income	5,600
Total revenues	<u>\$1,254,224</u>
Costs and expenses:	
Cost of goods sold	\$815,040
Selling expenses	219,120
General and administrative expenses	138,016
Interest expense	<u>10,524</u>
Total costs and expenses	<u>1,182,700</u>
Net income	<u>\$ 71,524</u>



## APPLY IT!

A single-step income statement follows. Present the information in a multistep income statement, and indicate what insights can be obtained from the multistep form as opposed to the single-step form.

Revenues:	
Net sales	\$500,000
Interest income	50,000
Total revenues	<u>\$550,000</u>
Costs and expenses:	
Cost of goods sold	\$300,000
Selling expenses	100,000
General and administrative expenses	75,000
Interest expense	<u>25,000</u>
Total costs and expenses	<u>500,000</u>
Net income	<u>\$ 50,000</u>

### SOLUTION

Net sales	\$500,000
Cost of goods sold	<u>300,000</u>
Gross margin	\$200,000
Operating expenses:	
Selling expenses	\$100,000
General and administrative expenses	<u>75,000</u>
Total operating expenses	<u>175,000</u>
Income from operations	\$ 25,000
Other revenues and expenses:	
Interest income	\$ 50,000
Less interest expense	<u>25,000</u>
Excess of other revenues over other expenses	<u>25,000</u>
Net income	<u>\$ 50,000</u>

**TRY IT! SE2, SE3, E1A, E2A, E3A, E4A, E1B, E2B, E3B, E4B**

## LO 3 Terms of Sale

When goods are sold on credit, both parties should understand the amount and timing of payment as well as other terms of the purchase. Sellers quote prices in different ways. Many merchants quote the price at which they expect to sell their goods. Others, particularly manufacturers and wholesalers, quote prices as a percentage (usually 30 percent or more) off their list or catalogue prices. Such a reduction is called a **trade discount**.

For example, if an article is listed at \$1,000 with a trade discount of 40 percent, or \$400, the seller records the sale at \$600, and the buyer records the purchase at \$600. The seller may raise or lower the trade discount depending on the quantity purchased. The list price and related trade discount are used only to arrive at an agreed-upon price. They do not appear in the accounting records.

### Sales and Purchases Discounts

The terms of sale are usually printed on the sales invoice and are part of the sales agreement. Terms differ from industry to industry. In some industries, payment is expected in a short period of time. In these cases, the invoice is marked “n/10” (“net 10”) or “n/30” (“net 30”), meaning that the amount of the invoice is due either 10 days or 30 days after the invoice date. If the invoice is due 10 days after the end of the month, it is marked “n/10 eom.”

**Sales Discount** In some industries, it is customary to give a **sales discount** for early payment. An invoice that offers a sales discount might be labeled “2/10, n/30,” which means that the buyer either can pay within 10 days of the invoice date and take a 2 percent discount or can wait 30 days and pay the full amount. It is often advantageous for a buyer to take the discount because the saving of 2 percent over a period of 20 days (from the 11th day to the 30th day) represents an effective annual rate of 36.5 percent

**STUDY NOTE:** A trade discount applies to the list or catalogue price. A sales discount applies to the sales price.

**STUDY NOTE:** Early collection also reduces the probability of a customer's defaulting.

( $365 \text{ days} \div 20 \text{ days} \times 2\% = 36.5\%$ ). Most companies would be better off borrowing money from a lender so that they can take advantage of the discount from the supplier.

Because it is not possible to know at the time of a sale whether the customer will take advantage of a sales discount, the discounts are recorded by the seller only at the time the customer pays. For example, suppose Kavar Motor Company sells merchandise to a customer on September 20 for \$600 on terms of 2/10, n/30. Kavar records the sale on September 20 for the full amount of \$600. If the customer pays on or before September 30, Kavar will receive \$588 in cash and will reduce its accounts receivable by \$600. The difference of \$12 ( $\$600 \times 0.02$ ) will be debited to an account called *Sales Discounts*. Sales Discounts is a contra-revenue account with a normal debit balance that is deducted from sales on the income statement.

Although sales discounts were intended to increase the seller's liquidity by reducing the amount of money tied up in accounts receivable, the practice of giving sales discounts has been declining. Sales discounts are costly to the seller, and from the buyer's viewpoint, the amount of the discount is usually very small in relation to the price of the purchase.

**Purchase Discounts** Purchase discounts are discounts that a buyer takes for the early payment of merchandise. For example, the buyer that purchased the merchandise from Kavar Motor Company will record the purchase on September 20 at \$600. If the buyer pays on or before September 30, it will record cash paid of \$588 and reduce its Accounts Payable by \$600. The difference of \$12 is recorded as a credit to an account called *Purchases Discounts*. The Purchases Discounts account reduces the Cost of Goods Sold account or the Purchases account, depending on the inventory method used. As a result of the decline in the use of sales discounts, the use of purchase discounts is also declining.

## Transportation Costs

In some industries, the seller usually pays transportation costs and charges a price that includes those costs. In other industries, it is customary for the purchaser to pay transportation charges. The following special terms designate whether the seller or the purchaser pays the freight charges.

- **FOB shipping point** means that the seller places the merchandise “free on board” at the point of origin and the buyer bears the shipping costs. The title to the merchandise passes to the buyer at that point. For example, when the sales agreement for the purchase of a car says “FOB factory,” the buyer must pay the freight from the factory where the car was made to wherever he or she is located, and the buyer owns the car from the time it leaves the factory.
- **FOB destination** means that the seller bears the transportation costs to the delivery point. The seller retains title until the merchandise reaches its destination and usually prepays the shipping costs, in which case the buyer makes no accounting entry for freight.

The effects of these special shipping terms are summarized as follows.

Shipping Term	Where Title Passes	Who Pays the Cost of Transportation
FOB shipping point	At origin	Buyer
FOB destination	At destination	Seller

When the buyer pays the transportation charge, it is called **freight-in**, and it is added to the cost of merchandise purchased. Thus, freight-in increases the buyer's cost of inventory, as well as the cost of goods sold after they are sold. When freight-in is a relatively small amount, most companies include the cost in the cost of goods sold on the income statement rather than allocating part of it to merchandise inventory.



Pierre-Yves Babelon/Shutterstock

Shipping terms affect the financial statements. FOB shipping point means the buyer pays the freight charges. When relatively small, these charges are usually included in the cost of goods sold on the buyer's income statement. FOB destination means the seller pays the freight charges. They are included in selling expenses on the seller's income statement.

When the seller pays the transportation charge, it is called **delivery expense** (or *freight-out*). Because the seller incurs this cost to facilitate the sale of its product, the cost is included in selling expenses on the income statement.

## Terms of Debit and Credit Card Sales

Many retailers allow customers to use debit or credit cards to charge their purchases. Debit cards deduct directly from a person's bank account, whereas a credit card allows for payment later. Three of the most widely used credit cards are **American Express**, **MasterCard**, and **Visa**. The customer establishes credit with the lender (the credit card issuer) and receives a card to use in making purchases. If a seller accepts the card, the customer signs an invoice at the time of the sale. The sale

is communicated to the seller's bank, resulting in a cash deposit in the seller's bank account. Thus, the seller does not have to establish the customer's credit, collect from the customer, or tie up money in accounts receivable. The lender takes a discount, which is a selling expense for the merchandiser. For example, if a restaurant makes sales of \$1,000 on Visa credit cards and Visa takes a 4 percent discount on the sales, the restaurant would record Cash in the amount of \$960 and Credit Card Expense in the amount of \$40.



## Business Perspective

### Are We Becoming a Cashless Society?

Are checks and cash obsolete? Do you "swipe it"? Most Americans do. About 71 percent of Americans (including 41 percent of college students) use credit or debit cards rather than checks. Consumers who have cards like the convenience and have on average 3.5 cards. Retailers, like **McDonald's** and **Starbucks**, like the cards, even though there are fees, because the use of cards usually increases the amount of sales.<sup>1</sup>

## APPLY IT!

A local appliance dealer sells refrigerators that it buys from the manufacturer.

1. The manufacturer sets a list or catalogue price of \$1,200 for a refrigerator. The manufacturer offers its dealers a 40 percent trade discount.
2. Assume the same terms as **1**, except the manufacturer sells the machine under terms of FOB shipping point. The cost of shipping is \$120.
3. Assume the same terms as **2**, except the manufacturer offers a sales discount of 2/10, n/30. Sales discounts do not apply to shipping costs.

What is the net cost of the refrigerator to the dealer, assuming payment is made within 10 days of purchase?

### SOLUTION

1.  $\$1,200 - (\$1,200 \times 0.40) = \$720$
2.  $\$720 + \$120 = \$840$
3.  $\$840 - (\$720 \times 0.02) = \$825.60$

**TRY IT! SE4, SE5, E5A, E5B**

## LO 4 Perpetual Inventory System

We will use Kawar Motor Company to illustrate merchandising transactions under the perpetual inventory system. Kawar’s income statement is presented in Exhibit 4. The focal point of the statement is cost of goods sold, which is deducted from net sales to arrive at gross margin. Under the perpetual inventory system, the Merchandise Inventory and Cost of Goods Sold accounts are continually updated during the accounting period as purchases, sales, and other inventory transactions occur.

**Exhibit 4**  
Income Statement Under the Perpetual Inventory System

**STUDY NOTE:** On the income statement, freight-in is included as part of cost of goods sold, and delivery expense (freight-out) is included as an operating (selling) expense.

© Cengage Learning 2014

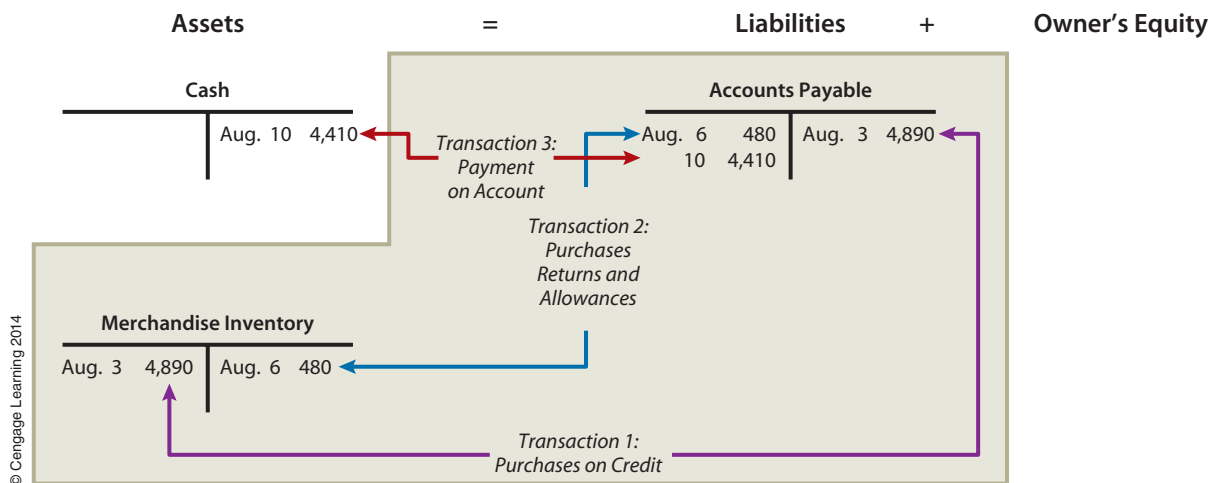
Net sales	\$957,300
Cost of goods sold*	525,440
Gross margin	\$431,860
Operating expenses	313,936
Net income	<u>\$117,924</u>

\*Freight-in has been included in cost of goods sold.

## Purchases of Merchandise

**Exhibit 5**  
Recording Purchase Transactions Under the Perpetual Inventory System

Exhibit 5 shows how transactions involving purchases of merchandise are recorded under the perpetual inventory system. The focus of these journal entries is Accounts Payable. In this section, we present a summary of the entries made for merchandise purchases.<sup>2</sup>



The examples that follow show how Kawar Motor Company would record purchase transactions under the perpetual inventory system.

### Purchase on Credit

**Transaction 1** On August 3, Kawar received merchandise purchased on credit, invoice dated August 1, terms n/10, \$4,890.

**Analysis** Under the perpetual inventory system, the cost of merchandise is recorded in the Merchandise Inventory account at the time of purchase, which

- ▲ increases the *Merchandise Inventory* account
- ▲ increases the *Accounts Payable* account

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
Merchandise Inventory			Accounts Payable				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
Aug. 3 4,890			Aug. 3	4,890			

### Journal Entry

		<i>Dr.</i>		<i>Cr.</i>
Aug. 3	Merchandise Inventory	4,890		
	Accounts Payable			4,890
	Purchased merchandise on credit			

**Comment** In this transaction, payment is due ten days from the invoice date. If an invoice includes a charge for shipping or if shipping is billed separately, it should be *recognized* as a debit to Freight-In.

### Purchases Returns and Allowances

**Transaction 2** On August 6, Kavar returned part of merchandise received on August 3 for credit, \$480.

**Analysis** Under the perpetual inventory system, when a buyer is allowed to return all or part of a purchase or is given an allowance, accounts payable is reduced and merchandise inventory is decreased for the cost of the merchandise returned. This journal entry

- ▼ *decreases* the *Accounts Payable* account
- ▼ *decreases* the *Merchandise Inventory* account

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
Merchandise Inventory			Accounts Payable				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
Aug. 6 480			Aug. 6 480				

### Journal Entry

		<i>Dr.</i>		<i>Cr.</i>
Aug. 6	Accounts Payable	480		
	Merchandise Inventory			480
	Returned merchandise from purchase			

**Comment** Note that under the perpetual inventory method, the Purchase Returns and Allowances account is not used and does not appear as a separate item on a merchandising company income statement.

### Payments on Account

**Transaction 3** On August 10, Kavar paid amount in full due for the purchase of August 3, part of which was returned on August 6, \$4,410.

**Analysis** The journal entry to record the payment for the net amount due of \$4,410 (\$4,890 – \$480)

- ▼ *decreases* the *Accounts Payable* account
- ▼ *decreases* the *Cash* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity
<b>Cash</b>			<b>Accounts Payable</b>			
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		
	Aug. 10 4,410		Aug. 10 4,410			

**Journal Entry**

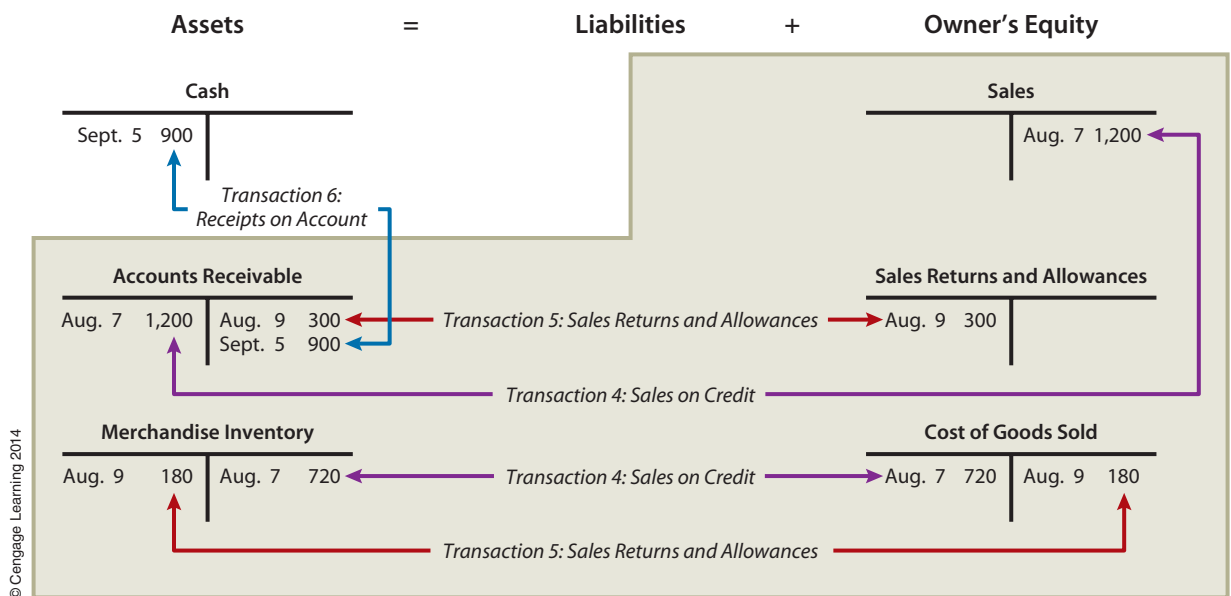
Aug. 10	Accounts Payable	<i>Dr.</i>	4,410	<i>Cr.</i>	
	Cash				4,410
	Made payment on account				

**Comment** Kawar pays the purchase price less the price of merchandise returned. After the payment, the balance of accounts payable for the purchase recorded on August 3 is zero.

**Sales of Merchandise**

Exhibit 6 shows how transactions involving sales of merchandise are recorded under the perpetual inventory system. These transactions involve several accounts, including Cash, Accounts Receivable, Merchandise Inventory, Sales Returns and Allowances, and Cost of Goods Sold. The following sections present a summary of the entries made for sales of merchandise.

**Exhibit 6**  
Recording Sales Transactions Under the Perpetual Inventory System



**Sales on Credit**

**Transaction 4** On August 7, Kawar sold merchandise on credit, terms n/30, FOB shipping point, \$1,200. The cost of the merchandise was \$720.

**Analysis** Under the perpetual inventory system, sales always require two entries, as shown in Exhibit 6. First, the sale is recorded, which

- ▲ increases the *Accounts Receivable* account
- ▲ increases the *Sales* account

Second, Cost of Goods Sold is updated by a transfer from Merchandise Inventory, which

▲ *increases* the *Cost of Goods Sold* account

▼ *decreases* the *Merchandise Inventory* account

### Application of Double Entry

Assets		=	Liabilities	+	Owner's Equity		
<b>Accounts Receivable</b>					<b>Sales</b>		
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
Aug. 7	1,200					Aug. 7	1,200

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
Aug. 7	Account Receivable	1,200	
	Sales		1,200
	Sold merchandise on credit		

### Application of Double Entry

Assets		=	Liabilities	+	Owner's Equity	
<b>Merchandise Inventory</b>					<b>Cost of Goods Sold</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
	Aug. 7	720			Aug. 7	720

### Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
Aug. 7	Cost of Goods Sold	720	
	Merchandise Inventory		720
	Transferred cost of merchandise inventory sold to Cost of Goods Sold		

**Comment** In the case of cash sales, Cash is debited for the amount of the sale. If the seller pays for the shipping, it should be *recognized* as a debit to Delivery Expense.

### Sales Returns and Allowances

**Transaction 5** On August 9, Kawar accepted, for full credit, a return of part of merchandise sold on August 7, and returned it to merchandise inventory, \$300. The cost of the merchandise was \$180.

**Analysis** Under the perpetual inventory system, when a seller allows the buyer to return all or part of a sale or gives an allowance, two journal entries are necessary. First, the original sale is reversed using a contra-revenue account, which

▲ *increases* the *Sales Returns and Allowances* account

▼ *decreases* the *Accounts Receivable* account

The **Sales Returns and Allowances account** gives management a readily available measure of unsatisfactory products and dissatisfied customers. This account is a contra-revenue account with a normal debit balance, and it is deducted from sales on the income statement.

Second, the cost of the merchandise must also be transferred from the Cost of Goods Sold account back into the Merchandise Inventory account, which

▲ *increases* the *Merchandise Inventory* account

▼ *decreases* the *Cost of Goods Sold* account

**STUDY NOTE:** Because the *Sales* account is established with a credit, its contra account, *Sales Returns and Allowances*, is established with a debit.



**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Accounts Receivable</b>						<b>Sales Returns and Allowances</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
	Aug. 9 300				Aug. 9 300		

**Journal Entry**

			<i>Dr.</i>	<i>Cr.</i>
Aug. 9	Sales Returns and Allowances		300	
	Accounts Receivable			300
	Accepted returns of merchandise			

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Merchandise Inventory</b>						<b>Cost of Goods Sold</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
Aug. 9 180						Aug. 9 180	

**Journal Entry**

			<i>Dr.</i>	<i>Cr.</i>
Aug. 9	Merchandise Inventory		180	
	Cost of Goods Sold			180
	Transferred cost of merchandise returned to Merchandise Inventory			

**Comment** If the company makes an allowance instead of accepting a return, or if the merchandise cannot be returned to inventory and resold, this second entry transferring into Merchandise Inventory and reducing Cost of Goods Sold is not made.

**Receipts on Account**

**Transaction 6** On September 5, Kawar collected in full for sale of merchandise on August 7, less the return on August 9, \$900.

**Analysis** The journal entry to record the collection for the net amount due of \$900 (\$1,200 – \$300)

- ▲ *increases* the *Cash* account
- ▼ *decreases* the *Accounts Receivable* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>							
<i>Dr.</i>				<i>Cr.</i>			
Sept. 5	900						
<b>Accounts Receivable</b>							
				<i>Cr.</i>			
			Sept. 5	900			

**Journal Entry**

Sept. 5	Cash	<i>Dr.</i>	900		
	Accounts Receivable			<i>Cr.</i>	900
	Received payment on account				

**Comment** After the payment on the account, the balance in accounts receivable for the August 7 transaction is zero.



**Business Perspective**  
How Are Web Sales Doing?

© Alija / iStockphoto.com

In spite of the demise of many Internet retailers, merchandise sales over the Internet continue to thrive. U.S. Internet sales are expected to reach almost \$300 billion in 2014.<sup>3</sup> The companies that have been most successful in using the Internet are established mail-order retailers like **Lands' End** and **L.L. Bean**. Other retailers have also used the Internet to enhance their operations. For example, **Office Depot**, which focuses primarily on business-to-business Internet sales, has set up customized webpages for tens of thousands of corporate clients. These webpages allow customers to make online purchases and check store inventories. Although Internet transactions are recorded in the same way as on-site transactions, the technology adds a level of complexity to the transactions.

**APPLY IT!**

For each lettered transaction that follows, indicate which numbered accounts are debited or credited by placing the account numbers in the appropriate columns, assuming the use of a perpetual inventory system. (Note: Some may require more than one transaction.)

- |                          |                                 |
|--------------------------|---------------------------------|
| 1. Cash                  | 5. Sales                        |
| 2. Accounts Receivable   | 6. Sales Returns and Allowances |
| 3. Merchandise Inventory | 7. Cost of Goods Sold           |
| 4. Accounts Payable      |                                 |

	Account Debited	Account Credited
a. Purchase on credit	—	—
b. Purchase return for credit	—	—
c. Purchase for cash	—	—
d. Sale on credit	—	—
e. Sale for cash	—	—
f. Sales return for credit	—	—
g. Payment on account	—	—
h. Receipt on account	—	—

**SOLUTION**

	Account Debited	Account Credited
a. Purchase on credit	3	4
b. Purchase return for credit	4	3
c. Purchase for cash	3	1
d. Sale on credit	2, 7	3, 5
e. Sale for cash	1, 7	3, 5
f. Sales return for credit	3, 6	2, 7
g. Payment on account	4	1
h. Receipt on account	1	2

**TRY IT! SE6, E6A, E8A, E9A, E10A, E6B, E8B, E9B, E10B**

## LO 5 Periodic Inventory System

To illustrate merchandising transactions under the periodic inventory system, we will continue with the Kavar Motor Company example. Kavar's income statement appears in Exhibit 7. A major feature of this statement is the computation of cost of goods sold. The cost of goods sold must be computed on the income statement because it is not updated for purchases, sales, and other transactions during the accounting period, as it is under the perpetual inventory system.

### Exhibit 7 Income Statement Under the Periodic Inventory System

**STUDY NOTE:** Most published financial statements are condensed, eliminating the detail shown here under cost of goods sold.

© Cengage Learning 2014

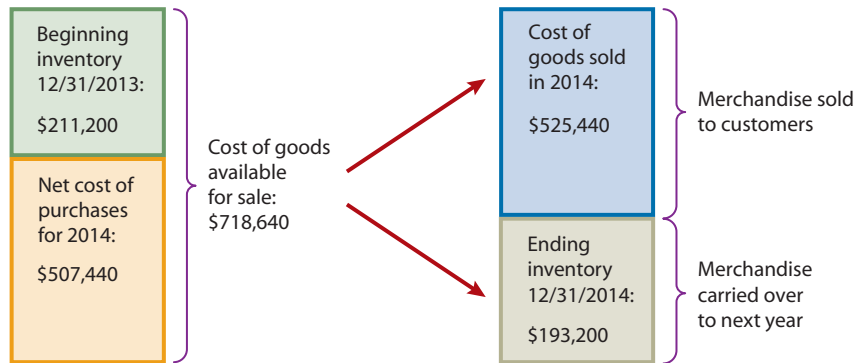
Kavar Motor Company Income Statement For the Year Ended December 31, 2014		
Net sales		\$957,300
Cost of goods sold:		
Merchandise inventory, December 31, 2013		\$211,200
Purchases	\$505,600	
Less purchases returns and allowances	31,104	
Net purchases	\$474,496	
Freight-in	32,944	
Net cost of purchases		507,440
Cost of goods available for sale		\$718,640
Less merchandise inventory, December 31, 2014		193,200
Cost of goods sold		525,440
Gross margin		\$431,860
Operating expenses		313,936
Net income		\$117,924

It is important to distinguish between the cost of goods available for sale and the cost of goods sold. The **cost of goods available for sale** is the total cost of merchandise that *could* be sold in the accounting period. The *cost of goods sold* is the cost of merchandise *actually* sold. The difference between the two numbers is the amount *not* sold, or the ending merchandise inventory. The cost of goods available for sale is the sum of the following two factors.

- The amount of merchandise on hand at the beginning of the period.
- The net cost of purchases during the period. (**Net cost of purchases** consist of total purchases plus freight-in less any deductions such as purchases returns and allowances and discounts from suppliers for early payment.)

In Exhibit 7, Kavar has cost of goods available for sale of \$718,640 (\$211,200 + \$507,440). The ending inventory of \$193,200 is deducted from this figure to determine the cost of goods sold of \$525,440 (\$718,640 – \$193,200). Exhibit 8 illustrates these relationships.

**Exhibit 8**  
The Components of  
Cost of Goods Sold



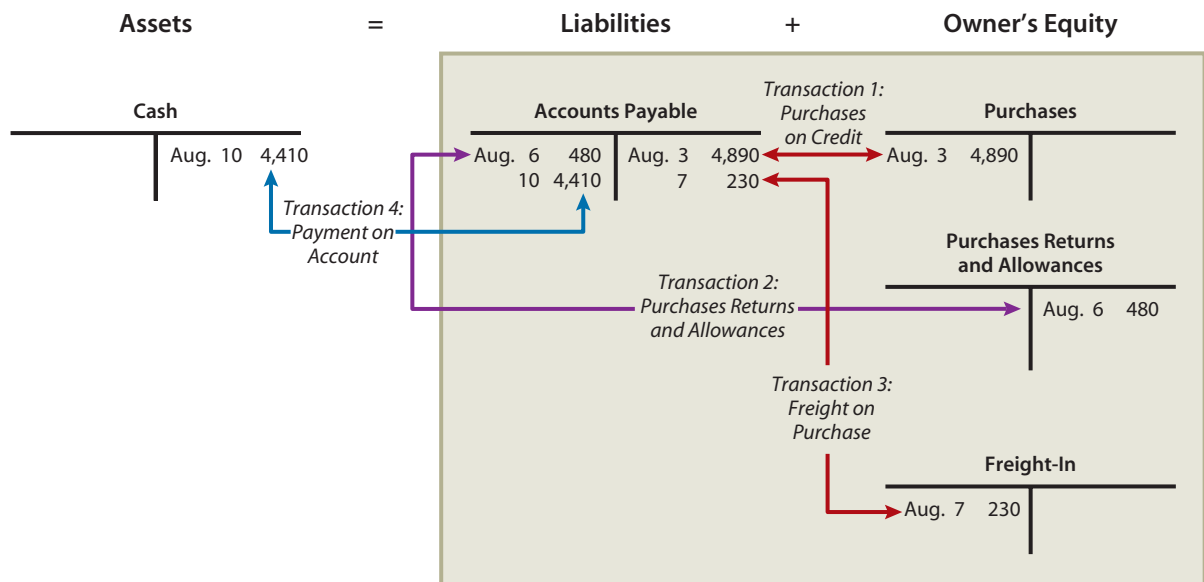
© Cengage Learning 2014

## Purchases of Merchandise

**STUDY NOTE:** *Purchases and Purchases Returns and Allowances accounts are used only in a periodic inventory system.*

Exhibit 9 shows how purchases of merchandise are recorded under the periodic inventory system. In the perpetual inventory system, the Merchandise Inventory account is adjusted each time a purchase, a sale, or another inventory transaction occurs. In the periodic inventory system, the Merchandise Inventory account stays at its beginning balance until the physical inventory is recorded at the end of the period. The periodic system uses a Purchases account to accumulate purchases and a Purchases Returns and Allowances account to accumulate returns of and allowances on purchases.

**Exhibit 9**  
Recording Purchase Transactions  
Under the Periodic Inventory System



© Cengage Learning 2014

The examples that follow show how Kavar Motor Company would record purchase transactions under the periodic inventory system.

### Purchases on Credit

**Transaction 1** On August 3, Kavar received merchandise purchased on credit, invoice dated August 1, terms n/10, \$4,890.

**Analysis** Under the periodic inventory system, the cost of merchandise is recorded in the **Purchases account** at the time of purchase. The Purchases account does not indicate whether merchandise has been sold or is still on hand. The journal entry to record purchases made by a company

- ▲ increases the *Purchases* account
- ▲ increases the *Accounts Payable* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity
<b>Purchases</b>			<b>Accounts Payable</b>			
Dr.	Cr.		Dr.	Cr.		
Aug. 3	4,890		Aug. 3	4,890		

**Journal Entry**

Aug. 3	Purchases	Dr.	4,890	Cr.	
	Accounts Payable				4,890
	Purchased merchandise on credit				

**Comment** Under the periodic inventory system, purchased merchandise is temporarily *classified* as Purchases. Its sole purpose is to accumulate the total cost of merchandise purchased for resale during a period. (Purchases of other assets, such as equipment, are recorded and *classified* in the appropriate asset account, not in the Purchases account.)

**Purchases Returns and Allowances**

**Transaction 2** On August 6, Kavar returned part of merchandise received on August 3 for credit, \$480.

**Analysis** Purchases Returns and Allowances is a contra-purchases account with a normal credit balance, and it is deducted from purchases on the income statement to arrive at net purchases, which

- ▼ *decreases* the *Accounts Payable* account
- ▲ *increases* the *Purchases Returns and Allowances* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity
<b>Purchases Returns and Allowances</b>			<b>Accounts Payable</b>			
Dr.	Cr.		Dr.	Cr.		
	Aug. 6	480	Aug. 6	480		

**Journal Entry**

Aug. 6	Accounts Payable	Dr.	480	Cr.	
	Purchases Returns and Allowances				480
	Returned merchandise from purchase				

**Comment** The **Purchases Returns and Allowances account** is used in a periodic inventory system.

**STUDY NOTE:** Because debits establish the Purchases account, credits create its contra account, Purchases Returns and Allowances.

**Freight-In**

**Transaction 3** On August 7, Kavar received a bill for freight costs of the purchases on August 3, \$230.

**Analysis** The journal entry to record freight costs on purchases

- ▲ *increases* the *Freight-In* account
- ▲ *increases* the *Accounts Payable* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>			<b>Accounts Payable</b>			<b>Freight-In</b>	
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
			Aug. 7	230		Aug. 7	230

**Journal Entry**

Aug. 7	Freight-In	<i>Dr.</i>	<i>Cr.</i>
	→ Accounts Payable	230	← 230
	Recorded freight costs on August 3 purchase		

**Comment** Freight-in is added on the income statement to net purchases to arrive at the net cost of purchases under the periodic method.

**Payments on Account**

**Transaction 4** On August 10, Kawar paid amount in full due for the purchase of August 3, part of which was returned on August 6, \$4,410.

**Analysis** The journal entry to record payment for the net amount due of \$4,410 (\$4,890 – \$480)

- ▼ *decreases* the *Accounts Payable* account
- ▼ *decreases* the *Cash* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>			<b>Account Payable</b>				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
	Aug. 10 4,410		Aug. 10 4,410				

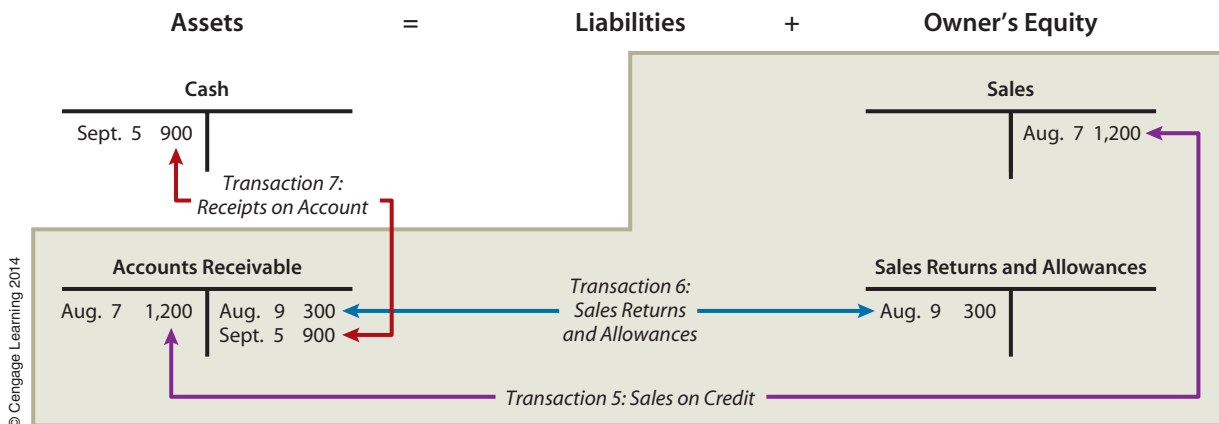
**Journal Entry**

Aug. 10	Accounts Payable	<i>Dr.</i>	<i>Cr.</i>
	→ Cash	4,410	← 4,410
	Made payment on account		

**Comment** Kawar pays the purchase price less the price of merchandise returned. After the payment, the balance of accounts payable with the supplier is zero.

**Sales of Merchandise**

Exhibit 10 shows how transactions involving sales of merchandise are recorded under the periodic inventory system.



**Exhibit 10**  
Recording Sales Transactions Under the Periodic Inventory System

**Sales on Credit**

**Transaction 5** On August 7, Kawar sold merchandise on credit, terms n/30, FOB destination, \$1,200. The cost of the merchandise was \$720.

**Analysis** As shown in Exhibit 10, under the periodic inventory system, credit sales require only one entry, which

- ▲ increases the *Accounts Receivable* account
- ▲ increases the *Sales* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Accounts Receivable</b>						<b>Sales</b>	
<i>Dr.</i>	<i>Cr.</i>					<i>Dr.</i>	<i>Cr.</i>
Aug. 7	1,200					Aug. 7	1,200

**Journal Entry**

		<i>Dr.</i>	<i>Cr.</i>
Aug. 7	Account Receivable	1,200	
	Sales		1,200
	Sold merchandise on credit		

**Comment** In the case of cash sales, Cash is debited for the amount of the sale. If the seller pays for the shipping, the amount should be debited to Delivery Expense.

**Sales Returns and Allowances**

**Transaction 6** On August 9, Kawar accepted return of part of merchandise sold on August 7 for full credit and returned it to merchandise inventory, \$300. The cost of the merchandise was \$180.

**Analysis** Under the periodic inventory system, when a seller allows the buyer to return all or part of a sale or gives an allowance, only one journal entry is needed, which

- ▲ increases the *Sales Returns and Allowances* account
- ▼ decreases the *Accounts Receivable* account



**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Accounts Receivable</b>						<b>Sales Returns and Allowances</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
	Aug. 9	300			Aug. 9	300	

**Journal Entry**

Aug. 9	Sales Returns and Allowances	<i>Dr.</i>	<i>Cr.</i>
	Accounts Receivable	300	
	Accepted return of merchandise		300

**Comment** The Sales Returns and Allowances account is a contra-revenue account with a normal debit balance and is deducted from sales on the income statement.

**Receipts on Account**

**Transaction 7** On September 5, Kavar collected in full for sale of merchandise on August 7, less the return on August 9, \$900.

**Analysis** The journal entry to record collection for the net amount due of \$900 (\$1,200 – \$300)

- ▲ increases the *Cash* account
- ▼ decreases the *Accounts Receivable* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>							
<i>Dr.</i>	<i>Cr.</i>						
Sept. 5	900						
<b>Accounts Receivable</b>							
<i>Dr.</i>	<i>Cr.</i>						
	Sept. 5	900					

**Journal Entry**

Sept. 5	Cash	<i>Dr.</i>	<i>Cr.</i>
	Accounts Receivable	900	
	Received payment on account		900

**Comment** After the payment on the account, the balance in accounts receivable for that transaction is zero.



## Business Perspective

### Are Sales Returns Worth Accounting For?

© Allija / iStockphoto.com

Some industries routinely have a high percentage of sales returns. More than 6 percent of all nonfood items sold in stores are eventually returned to vendors. This amounts to over \$100 billion a year, or more than the gross national product of two-thirds of the world's nations.<sup>4</sup> Book publishers like **Simon & Schuster** often have returns as high as 30 to 50 percent because to gain the attention of potential buyers, they must distribute large numbers of copies to many outlets. Magazine publishers like **AOL Time Warner** expect to sell no more than 35 to 38 percent of the magazines they send to newsstands and other outlets.<sup>5</sup> In all these businesses, it pays management to scrutinize the Sales Returns and Allowances account for ways to reduce returns and increase profitability.

## Merchandising Transactions and the Financial Statements

Merchandising transactions can affect all the financial statements as shown in Exhibit 11.

**Exhibit 11**  
Merchandising Income Statement Groups Accounts in Useful Categories

© Cengage Learning 2014

<b>Income Statement</b>	
<b>For the Year Ended December 31, 2014</b>	
Net sales	
<u>Cost of goods sold</u>	
Gross margin	
<u>Operating expenses</u>	
Income from operations	
<u>Other revenues and expenses</u>	
Net income	

### APPLY IT!

For each lettered transaction that follows, indicate which numbered accounts are debited or credited by placing the account numbers in the appropriate columns, assuming the use of a periodic inventory system.

- |                          |                                     |
|--------------------------|-------------------------------------|
| 1. Cash                  | 5. Sales                            |
| 2. Accounts Receivable   | 6. Sales Returns and Allowances     |
| 3. Merchandise Inventory | 7. Purchases                        |
| 4. Accounts Payable      | 8. Purchases Returns and Allowances |

	<b>Account Debited</b>	<b>Account Credited</b>
a. Purchase on credit	—	—
b. Purchase return for credit	—	—
c. Purchase for cash	—	—
d. Sale on credit	—	—
e. Sale for cash	—	—
f. Sales return for credit	—	—
g. Payment on account	—	—
h. Receipt on account	—	—

### SOLUTION

	<b>Account Debited</b>	<b>Account Credited</b>
a. Purchase on credit	7	4
b. Purchase return for credit	4	8
c. Purchase for cash	7	1
d. Sale on credit	2	5
e. Sale for cash	1	5
f. Sales return for credit	6	2
g. Payment on account	4	1
h. Receipt on account	1	2

**TRY IT! SE7, SE8, SE9, E7A, E11A, E12A, E13A, E14A, E7B, E11B, E12B, E13B, E14B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Calculating operating cycle
- Liquidity

RELEVANT  
LEARNING OBJECTIVE

**LO 6** Explain the role of the operating cycle and the effect of foreign business transactions in evaluating the liquidity of a merchandising company.

## LO 6 The Operating Cycle and Foreign Business Transactions

Maintaining adequate liquidity in the operating cycle is important to managing a merchandising company.

## CASH FLOW

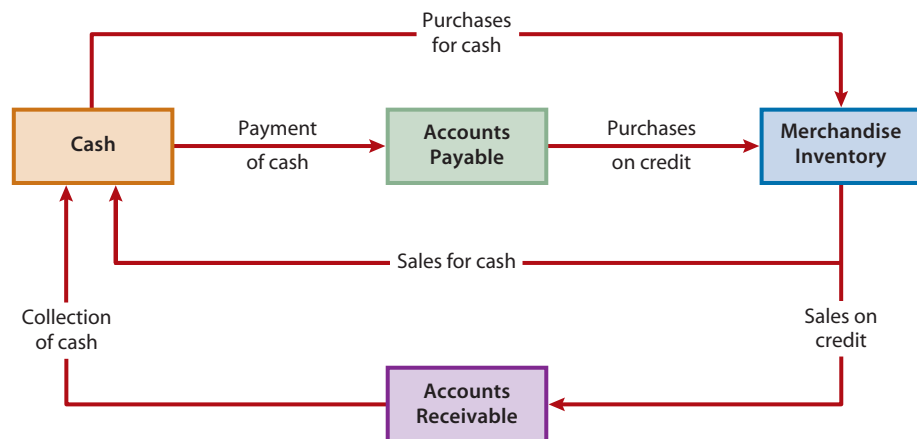
### Operating Cycle

Merchandising businesses engage in a series of transactions to buy, sell, and collect for merchandise inventory called the *operating cycle*. Exhibit 12 shows these transactions. Some companies buy merchandise for cash and sell it for cash, but these companies are usually small companies, such as a produce market or a hot dog stand. Most companies buy merchandise on credit and sell it on credit, thereby engaging in the following four transactions:

1. Purchase of merchandise inventory for cash or on credit
2. Sales of merchandise inventory for cash or on credit
3. Collection of cash from credit sales
4. Payment for purchases made on credit

The first three transactions represent the time it takes to purchase inventory, sell it, and collect for it. Merchandisers must be able to do without the cash for this period of time either by relying on cash flows from other sources within the company or by borrowing. If they lack the cash to pay bills when they come due, they can be forced out of business. Thus, managing cash flow is a critical concern.

**Exhibit 12**  
Cash Flows in the Operating Cycle

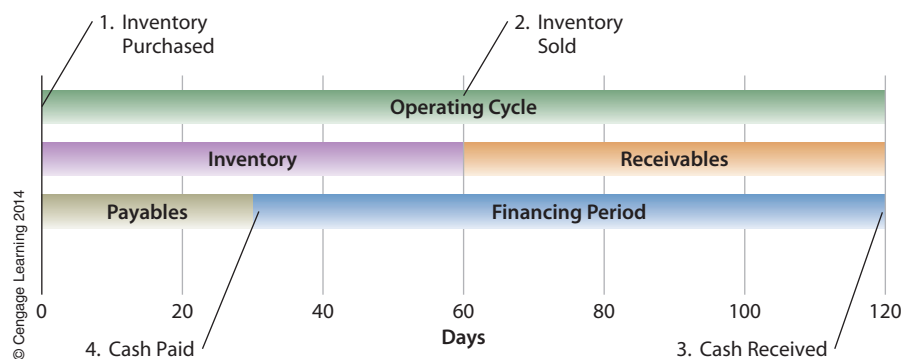


© Cengage Learning 2014

The suppliers that sell the company the merchandise usually also sell on credit, thus helping alleviate the cash flow problem by providing financing for a period of time before they require payment (transaction 4). However, this period is rarely as long as the operating cycle. The period between the time the supplier must be paid and the end of the operating cycle is called the *financing period* (or *cash gap*).

The **financing period**, illustrated in Exhibit 13, is the amount of time from the purchase of inventory until it is sold and payment is collected, less the amount of time

**Exhibit 13**  
The Financing Period



**STUDY NOTE:** A company must provide financing for the average days' inventory plus the average number of days to collect credit sales less the average number of days it is allowed to pay its suppliers.

creditors give the company to pay for the inventory. Thus, if it takes 60 days to sell the inventory, 60 days to collect for the sale, and creditors' payment terms are 30 days, the financing period is 90 days  $[(60 + 60) - 30]$ . During the financing period, the company will be without cash from this series of transactions and will need either to have funds available internally or to borrow from a bank.

The way in which a merchandising company manages its inventories, receivables, and payables will affect its financing period. For example, compare **Costco's** financing period with that of a traditional discount store chain, **Target Corporation**:

	Target	Costco	Difference
Days' inventory	58 days	29 days	(29) days
Days' receivables	35	4	(31)
Less days' payable	(60)	(31)	29
Financing period	33 days	2 days	(31) days

Costco has an advantage over Target because it sells inventory and collects receivables much faster. Its very short financing period is one of the reasons Costco can charge such low prices.<sup>6</sup>

By reducing its financing period, a company can improve its cash flow. Many merchandisers, including Costco, do this by selling as much as possible for cash. Cash sales include sales made on bank *credit cards*, such as Visa or MasterCard, and on *debit cards*, which draw directly on the purchaser's bank account. They are considered cash sales because funds from them are available to the merchandiser immediately. Small retail stores may have mostly cash sales and very few credit sales, whereas large wholesale concerns may have almost all credit sales.

## Foreign Business Transactions

Most large merchandising and manufacturing firms and even many small ones transact some of their business overseas. For example, a U.S. manufacturer may expand by selling its product to foreign customers, or it may lower its product cost by buying a less expensive part from a source in another country. Such sales and purchase transactions may take place in Japanese yen, British pounds, or some other foreign currency.

While all transactions involve money measures, an international transaction is measured in two different currencies, and one currency has to be translated into another by using an *exchange rate*. As noted earlier, the values of other currencies in relation to the dollar rise and fall daily according to supply and demand. Thus, if there is a delay between the date of sale or purchase and the date of payment, the amount of cash involved in an international transaction may differ from the originally agreed-upon amount.

If the billing of an international sale and the payment for it are both in the domestic currency, no accounting problem arises. For example, if a U.S. maker of precision

tools sells \$160,000 worth of its products to a British company and bills the British company in dollars, the U.S. company will receive \$160,000 when it collects payment. However, if the U.S. company bills the British company in pounds and accepts payment in pounds, it will incur an **exchange gain or loss** if the exchange rate between dollars and pounds changes between the date of sale and the date of payment, as shown in the following examples.

- **Sale in foreign currency:** Assume that a U.S. company billed a sale of \$200,000 at £100,000, reflecting an exchange rate of 2.00 (that is, \$2.00 per pound) on the sale date. Now assume that by the date of payment, the exchange rate has fallen to 1.90. When the U.S. company receives its £100,000, it will be worth only \$190,000 ( $£100,000 \times \$1.90 = \$190,000$ ). It will have incurred an exchange loss of \$10,000 because it agreed to accept a fixed number of British pounds in payment for its products, and the value of each pound dropped before the payment was made. Had the value of the pound in relation to the dollar increased, the company would have made an exchange gain.
- **Purchase in foreign currency:** The same logic applies to purchases as to sales. Assume that a U.S. company purchases products from a British company for \$200,000. If the payment is to be made in U.S. dollars, no accounting problem arises. However, if the British company expects to be paid in pounds, the U.S. company will have an exchange gain of \$10,000 because it agreed to pay a fixed £100,000, and between the dates of purchase and payment, the exchange value of the pound decreased from \$2.00 to \$1.90. To make the £100,000 payment, the U.S. company has to expend only \$190,000.

Exchange gains and losses are reported on the income statement. Because of their bearing on financial performance, they are of interest to managers and investors.

## APPLY IT!

Rola Company's management made the following decisions. Indicate whether each decision pertains primarily to (a) cash flow management, (b) choice of inventory system, or (c) foreign transactions.

1. Decided to decrease the credit terms offered to customers from 30 days to 20 days to speed up collection of accounts.
2. Decided to purchase goods made by a supplier in India.
3. Decided that sales would increase if salespeople knew how much inventory was on hand at any one time.
4. Decided to try to negotiate a longer time to pay suppliers than had been previously granted.

### SOLUTION

1. a; 2. c; 3. b; 4. a

### TRY IT! SE10, SE11, E1A, E15A, E1B, E15B

## TriLevel Problem



10 Images/Shutterstock

**Mink Company**

The beginning of this chapter focused on Mink Company, a merchandiser. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*How do faithful representation and classification apply to merchandise operations?*

### Section 2: Accounting Applications

*How can merchandising transactions be recorded to reflect the company's performance?*

To answer this question, prepare journal entries to record the transactions that follow, assuming that Mink uses (1) the perpetual inventory system and (2) the periodic inventory system.

- July 1 Sold merchandise to Eric Ortega on credit, terms n/30, FOB shipping point, \$2,100 (cost, \$1,260).
- 2 Purchased merchandise on credit from Debra Company, terms n/30, FOB shipping point, \$3,800.
- 2 Paid Custom Freight \$290 for freight charges on merchandise received.
- 9 Purchased merchandise on credit from RBT Company, terms n/30, FOB shipping point, \$3,600, including \$200 freight costs paid by RBT Company.
- 11 Accepted from Eric Ortega a return of merchandise, which was returned to inventory, \$300 (cost, \$180).
- 14 Returned for credit \$600 of merchandise purchased on July 2.
- 16 Sold merchandise for cash, \$1,000 (cost, \$600).
- 22 Paid Debra Company for purchase of July 2 less return on July 14.
- 23 Received full payment from Eric Ortega for his July 1 purchase, less return on July 11.



### Section 3: Business Applications

*How can Mink manage its operating cycle so that it has adequate cash to maintain liquidity?*

## SOLUTION

### Section 1: Concepts

*Classification* of items on the merchandising company financial statements is important because how the amount of goods available for sale is split between ending inventory and cost of goods sold impacts both the income statement and the balance sheet. Thus, a merchandising company needs to classify its accounts properly so that the statements *faithfully represent* the operations of the company. In order to faithfully represent accounting for merchandising inventories, a company can choose between the perpetual inventory system and the periodic inventory system. The perpetual inventory system is a system in which continuous records are kept of the quantity and the cost of individual items as they are bought and sold. The periodic inventory system is a system in which continuous records are not kept but the inventory not yet sold is counted periodically.

## Section 2: Accounting Applications

(1) and (2). (Note: Accounts that differ under the two systems are in bold type.)

	A	B	C	D	E	F	G	H	I	J	K	L	M	N
1	<b>1. Perpetual Inventory System</b>						<b>2. Periodic Inventory System</b>							
2	July	1				Accounts Receivable	2,100					Accounts Receivable	2,100	
3						Sales		2,100				Sales		2,100
4						Sold merchandise on						Sold merchandise on		
5						account to Eric Ortega,						account to Eric Ortega,		
6						terms n/30, FOB shipping						terms n/30, FOB shipping		
7						point						point		
8		1				<b>Cost of Goods Sold</b>	1,260							
9						<b>Merchandise Inventory</b>		1,260						
10						Transferred cost of								
11						merchandise sold to Cost								
12						of Goods Sold account								
13		2				<b>Merchandise Inventory</b>	3,800					<b>Purchases</b>	3,800	
14						Accounts Payable		3,800				Accounts Payable		3,800
15						Purchased merchandise						Purchased merchandise		
16						on account from Debra						on account from Debra		
17						Company, terms n/30, FOB						Company, terms n/30, FOB		
18						shipping point						shipping point		
19		2				Freight-In	290					Freight-In	290	
20						Cash		290				Cash		290
21						Paid freight on July 2						Paid freight on July 2		
22						purchase						purchase		
23		9				<b>Merchandise Inventory</b>	3,400					<b>Purchases</b>	3,400	
24						Freight-In	200					Freight-In	200	
25						Accounts Payable		3,600				Accounts Payable		3,600
26						Purchased merchandise on						Purchased merchandise on		
27						account from RBT Company,						account from RBT Company,		
28						terms n/30, FOB shipping						terms n/30, FOB shipping		
29						point, freight paid by supplier						point, freight paid by supplier		
30		11				Sales Returns and Allowances	300					Sales Returns and Allowances	300	
31						Accounts Receivable		300				Accounts Receivable		300
32						Accepted return of						Accepted return of		
33						merchandise from Eric						merchandise from Eric		
34						Ortega						Ortega		





## Chapter Review

Define *merchandising accounting*, and differentiate perpetual from periodic inventory systems. **LO 1**

Merchandising companies differ from service companies in that they earn income by buying and selling goods. The buying and selling of goods adds to the complexity of the business and requires choosing whether to use the perpetual or the periodic inventory system. Using these systems and use of the multistep income statement, properly classified, results in faithful representation of the company's operations.

Describe the features of multistep and single-step classified income statements. **LO 2**

Classified income statements for external reporting can be in multistep or single-step form. The multistep form arrives at net income through a series of steps, usually with a separate section for other revenues and expenses; the single-step form arrives at net income in a single step.

Describe the terms of sale related to merchandising transactions. **LO 3**

A trade discount is a reduction from the list or catalogue price of a product. A sales discount is a discount given for early payment of a sale on credit. Terms of 2/10, n/30 mean that the buyer can take a 2 percent discount if the invoice is paid within 10 days of the invoice date. Otherwise, the buyer is obligated to pay the full amount in 30 days. Discounts on sales are recorded in the Sales Discounts account, and discounts on purchases are recorded in the Purchases Discounts account. FOB shipping point means that the buyer bears the cost of transportation and that title to the goods passes to the buyer at the shipping origin. FOB destination means that the seller bears the cost of transportation and that title does not pass to the buyer until the goods reach their destination. Debit and credit card sales are considered cash sales and involve a fee paid by the seller for convenience.

Prepare an income statement, and record merchandising transactions under the perpetual inventory system. **LO 4**

Under the perpetual inventory system, the Merchandise Inventory account is continuously adjusted by entering purchases, sales, and other inventory transactions as they occur. Purchases increase the Merchandise Inventory account, and purchases returns decrease it. As goods are sold, their cost is transferred from the Merchandise Inventory account to the Cost of Goods Sold account.

Prepare an income statement, and record merchandising transactions under the periodic inventory system. **LO 5**

When the periodic inventory system is used, the cost of goods sold section of the income statement must include the following elements.

$$\begin{aligned} & \text{Purchases} - \text{Purchases Returns and Allowances} + \text{Freight-In} = \text{Net Cost of Purchases} \\ & \text{Beginning Merchandise Inventory} + \text{Net Cost of Purchases} = \text{Cost of Goods Available for Sale} \end{aligned}$$

$$\text{Cost of Goods Available for Sale} - \text{Ending Merchandise Inventory} = \text{Cost of Goods Sold}$$

Under the periodic inventory system, the Merchandise Inventory account stays at the beginning level until the physical inventory is recorded at the end of the period. A Purchases account is used to accumulate purchases of merchandise during the period, and a Purchases Returns and Allowances account is used to accumulate returns of purchases and allowances on purchases.

Explain the role of the operating cycle and foreign business transactions in evaluating the liquidity of a merchandising company. **LO 6**

The series of transactions (the operating cycle) of a merchandising company requires careful cash flow management. Also, if a company has international transactions, it must deal with changing exchange rates.

## Key Terms

<b>cost of goods available for sale</b> 221 (LO5)	<b>merchandising company</b> 208 (LO1)	<b>purchase discounts</b> 213 (LO3)
<b>cost of goods sold</b> 209 (LO2)	<b>multistep income statement</b> 208 (LO2)	<b>Purchases account</b> 222 (LO5)
<b>delivery expense</b> 214 (LO3)	<b>net cost of purchases</b> 221 (LO5)	<b>Purchases Returns and Allowances account</b> 223 (LO5)
<b>exchange gain or loss</b> 230 (LO6)	<b>net income</b> 211 (LO2)	<b>sales discount</b> 212 (LO3)
<b>financing period</b> 228 (LO6)	<b>net sales</b> 209 (LO2)	<b>sales returns and allowances</b> 209 (LO2)
<b>FOB destination</b> 213 (LO3)	<b>operating cycle</b> 206 (LO1)	<b>Sales Returns and Allowances account</b> 218 (LO4)
<b>FOB shipping point</b> 213 (LO3)	<b>operating expenses</b> 210 (LO2)	<b>selling expenses</b> 210 (LO2)
<b>freight-in</b> 213 (LO3)	<b>other revenues and expenses</b> 211 (LO2)	<b>single-step income statement</b> 211 (LO2)
<b>general and administrative expenses</b> 210 (LO2)	<b>percentage of gross margin</b> 210 (LO2)	<b>trade discount</b> 212 (LO3)
<b>gross margin</b> 209 (LO2)	<b>periodic inventory system</b> 206 (LO1)	
<b>gross sales</b> 209 (LO2)	<b>perpetual inventory system</b> 206 (LO1)	
<b>income from operations</b> 211 (LO2)	<b>physical inventory</b> 206 (LO1)	
<b>manufacturing company</b> 208 (LO2)		
<b>merchandise inventory</b> 206 (LO1)		

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ► In what ways does having merchandise inventory impact faithful representation and classification?
- LO 1 **DQ2.** Why is a physical inventory needed under both the periodic and perpetual inventory systems?
- LO 2 **DQ3.** Which is the better measure of a company's performance—income from operations or net income?
- LO 3 **DQ4.** Assume a large shipment of uninsured merchandise to your company is destroyed when the delivery truck has an accident and burns. Would you want the terms to be FOB shipping point or FOB destination?
- LO 4 **DQ5.** Under the perpetual inventory system, the Merchandise Inventory account is constantly updated. What would cause it to have the wrong balance?
- LO 6 **DQ6. BUSINESS APPLICATION** ► Can a company have a “negative” financing period?
- LO 6 **DQ7. BUSINESS APPLICATION** ► Suppose you sold goods to a company in Europe at a time when the exchange rate for the dollar was declining in relation to the euro. Would you want the European company to pay you in dollars or euros?

### SHORT EXERCISES

- LO 1 **Characteristics of Inventory Systems**
- SE1.** Indicate whether each of the statements that follow is more applicable to a perpetual inventory system, periodic inventory system, or both.
- Inventory figure is not accurate until the balance sheet date.
  - Requires a physical count of inventory at end of period.

(Continued)

3. No detailed records of the inventory are maintained during the accounting period.
4. Continuous records are kept of the quantity of inventory on hand.
5. Cost of Goods Sold is calculated only at the end of the accounting period.
6. Effective system for managing inventory and thus avoiding running out of stock.
7. Is more costly to maintain but may lead to increased sales.

**LO 2 Single-Step Income Statement**

**SE2.** Using the following accounts, prepare a single-step income statement at year end, May 31, 2014: Cost of Goods Sold, \$1,680; General Expenses, \$900; Interest Expense, \$420; Interest Income, \$180; Net Sales, \$4,800; Selling Expenses, \$1,110.

**LO 2 Multistep Income Statement**

**SE3.** Using the accounts presented in **SE2**, prepare a multistep income statement.

**LO 3 Terms of Sale**

**SE4.** A dealer buys tooling machines from a manufacturer and resells them to its customers.

- a. The manufacturer sets a list or catalogue price of \$6,000 for a machine. The manufacturer offers its dealers a 20 percent trade discount.
- b. The manufacturer sells the machine under terms of FOB shipping point. The cost of shipping is \$350.
- c. The manufacturer offers a sales discount of 2/10, n/30. The sales discount does not apply to shipping costs.

What is the net cost of the machine to the dealer, assuming it is paid for within 10 days of purchase?

**LO 3 Sales and Sales Returns**

**SE5.** On April 15, Sanborn Company sold merchandise to Barr Company for \$3,000 on terms of 2/10, n/30. Assume a return of merchandise on April 20 of \$600 and collection in full on April 25. What is the amount collected by Sanborn on April 25?

**LO 4 Purchases of Merchandise: Perpetual Inventory System**

**SE6.** Record each of the following transactions using T accounts, assuming the perpetual inventory system is used:

- Aug. 2 Purchased merchandise on credit from Vera Company, invoice dated August 1, terms n/10, FOB shipping point, \$1,150.
- 3 Received bill from Strauss Shipping Company for transportation costs on August 2 shipment, invoice dated August 1, terms n/30, \$105.
- 7 Returned damaged merchandise received from Vera on August 2 for credit, \$180.
- 10 Paid in full the amount due to Vera for the purchase of August 2, part of which was returned on August 7.

**LO 5 Purchases of Merchandise: Periodic Inventory System**

**SE7.** Record the transactions in **SE6** using T accounts, assuming the periodic inventory system is used.

**LO 5 Cost of Goods Sold: Periodic Inventory System**

**SE8.** Using the data that follows and assuming cost of goods sold is \$273,700, prepare the cost of goods sold section of a merchandising income statement (periodic inventory system). Include the amount of purchases for the month of October.

Freight-in	\$13,800
Merchandise inventory, Sept. 30, 2014	37,950
Merchandise inventory, Oct. 31, 2014	50,600
Purchases	?
Purchases returns and allowances	10,350

**LO 5 Sales of Merchandise: Periodic Inventory System**

**SE9.** Record the following transactions using T accounts, assuming the periodic inventory system is used:

- Aug. 4 Sold merchandise on credit to Rock Company, terms n/30, FOB destination, \$2,520.  
 5 Paid transportation costs for sale of August 4, \$231.  
 9 Part of the merchandise sold on August 4 was accepted back from Rock for full credit and returned to merchandise inventory, \$735.
- Sept. 3 Collected in full the amount due from Rock for merchandise sold on August 4, less the return on August 9.

**LO 6 Operating Cycle**

**SE10. BUSINESS APPLICATION** ▶ On average, Obras Company holds its inventory 40 days before it is sold, waits 25 days for customers' payments, and takes 33 days to pay suppliers. For how many days must it provide financing in its operating cycle?

**LO 1, 6 Identification of Management Issues**

**SE11. BUSINESS APPLICATION** ▶ Identify each of the following decisions as most directly related to (a) cash flow management, (b) choice of inventory system, or (c) foreign merchandising transactions:

1. Determination of the amount of time from the purchase of inventory until it is sold and the amount due is collected.
2. Determination of the effects of changes in exchange rates.
3. Determination of policies governing sales of merchandise on credit.
4. Determination of whether to use the periodic or the perpetual inventory system.

**EXERCISES: SET A****LO 1, 2 Concept Identification**

**E1A. CONCEPT** ▶ Sutton Hills Company's management made the decisions that follow. Indicate which of the decisions relates primarily to (a) classification, (b) merchandising inventory, (c) periodic inventory system, or (d) operating cycle.

1. Decided to purchase and sell goods.
2. Decided to use a form of income statement that would show gross margin separately from operating income.
3. Decided to reduce the credit terms offered to customers from 30 days to 20 days to speed up collection of accounts.
4. Decided that the benefits of keeping track of each item of inventory as it is bought and sold would exceed the costs of such a system.

**LO 2 Classification of Accounts: Income Statement**

**E2A.** Using the classification scheme below for a multistep income statement, match each account with the letter of the category in which it belongs.

- |  |   |
|--|---|
| a. Other revenues and expenses         | 1. Sales Discounts                          |
| b. Cost of sales                       | 2. Cost of Goods Sold                       |
| c. General and administrative expenses | 3. Dividend Income                          |
| d. Selling expenses                    | 4. Advertising Expense                      |
| e. Net sales                           | 5. Office Salaries Expense                  |
| f. Not on income statement             | 6. Freight Out Expense                      |
|  | 7. Prepaid Insurance                        |
|  | 8. Utilities Expense                        |
|  | 9. Sales Salaries Expense                   |
|  | 10. Rent Expense                            |
|  | 11. Depreciation Expense—Delivery Equipment |
|  | 12. Interest Expense                        |

**LO 2 Preparation of Income Statements**

**E3A.** A company has the following data: net sales, \$405,000; cost of goods sold, \$220,000; selling expenses, \$90,000; general and administrative expenses, \$60,000; interest expense, \$4,000; and interest income, \$3,000.

1. Prepare a single-step income statement.
2. Prepare a multistep income statement.

**LO 2 Multistep Income Statement**

**E4A. ACCOUNTING CONNECTION** ▶ A single-step income statement follows. Present the information in a multistep income statement, and indicate what insights can be obtained from the multistep form as opposed to the single-step form.

<b>Nomar Parra Company</b>		
<b>Income Statement</b>		
<b>For the Year Ended December 31, 2014</b>		
<hr/>		
Revenues:		
Net sales		\$1,197,132
Interest income		5,720
Total revenues		<u>\$1,202,852</u>
Costs and expenses:		
Cost of goods sold	\$777,080	
Selling expenses	203,740	
General and administrative expenses	100,688	
Interest expense	<u>13,560</u>	
Total costs and expenses		<u>1,095,068</u>
Net income		<u>\$ 107,784</u>
<hr/>		

**LO 3 Terms of Sale**

**E5A.** A household appliance dealer buys microwave ovens from a manufacturer and resells them to its customers.

- a. The manufacturer sets a list or catalogue price of \$1,500 for a microwave. The manufacturer offers its dealers a 30 percent trade discount.
- b. The manufacturer sells the machine under terms of FOB destination. The cost of shipping is \$150.
- c. The manufacturer offers a sales discount of 2/10, n/30. Sales discounts do not apply to shipping costs.

What is the net cost of the microwave to the dealer, assuming it is paid for within 10 days of purchase?

**LO 3, 4 Purchases Involving Discounts: Perpetual Inventory System**

**E6A.** Linear Company engaged in the following transactions:

- |      |    |   |
|------|----|---|
| July | 2  | Purchased merchandise on credit from Green Company, terms 2/10, n/30, FOB destination, invoice dated July 1, \$2,000. |
|      | 6  | Returned some merchandise to Green for full credit, \$250.  |
|      | 11 | Paid Green for purchase of July 2 less return and discount.   |
|      | 14 | Purchased merchandise on credit from Green, terms 2/10, n/30, FOB destination, invoice dated July 12, \$2,250.        |
|      | 31 | Paid amount owed Green for purchase of July 14.   |

Prepare journal entries and, assuming the perpetual inventory system, determine the total amount paid to Green.

**LO 3, 5 Sales Involving Discounts: Periodic Inventory System**

**E7A.** Given the following transactions engaged in by Fournier Company, prepare journal entries and, assuming the periodic inventory system, determine the total amount received from Brook Company:

- Dec. 1 Sold merchandise on credit to Brook Company, terms 2/10, n/30, FOB shipping point, \$500.  
 3 Accepted a return from Brook for full credit, \$200.  
 10 Collected amount due from Brook for the sale, less the return and discount.  
 11 Sold merchandise on credit to Brook, terms 2/10, n/30, FOB shipping point, \$800.  
 31 Collected amount due from Brook for the sale of December 11.

**LO 4 Preparation of the Income Statement: Perpetual Inventory System**

**E8A.** Selected account balances at December 31, 2014, for Infosys Company follow. Prepare a multistep income statement for the year ended December 31, 2014. Show detail of net sales. The company uses the perpetual inventory system, and Freight-In has not been included in Cost of Goods Sold.

Account Name	Debit	Credit
Sales		\$475,000
Sales Returns and Allowances	\$ 23,500	
Cost of Goods Sold	280,000	
Freight-In	13,500	
Selling Expenses	43,000	
General and Administrative Expenses	87,000	

**LO 4 Recording Purchases: Perpetual Inventory System**

**E9A.** The transactions that follow took place under the perpetual inventory system. Record each transaction using T accounts.

- Purchased merchandise on credit, terms n/30, FOB shipping point, \$5,000.
- Paid freight on the shipment in transaction a, \$270.
- Purchased merchandise on credit, terms n/30, FOB destination, \$2,800.
- Purchased merchandise on credit, terms n/30, FOB shipping point, \$5,200, which includes freight paid by the supplier of \$400.
- Returned part of the merchandise purchased in transaction c, \$1,000.
- Paid the amount owed on the purchase in transaction a.
- Paid the amount owed on the purchase in transaction d.
- Paid the amount owed on the purchase in transaction c less the return in e.

**LO 4 Recording Sales: Perpetual Inventory System**

**E10A.** On November 15, TCS Company sold merchandise for \$2,600 on terms of n/30 to Quaker Company. On November 20, Quaker returned some of the merchandise for a credit of \$600, and on November 25, Quaker paid the balance owed. Use T accounts to record the sale, return, and receipt of cash under the perpetual inventory system for TCS. The cost of the merchandise sold on November 15 was \$1,500, and the cost of the merchandise returned to inventory on November 20 was \$350.

**LO 5 Preparation of the Income Statement: Periodic Inventory System**

**E11A.** Using the selected year-end account balances at December 31, 2014, for Proof General Store that follow, prepare a 2014 multistep income statement. Show detail of net sales. The company uses the periodic inventory system. Beginning merchandise inventory was \$26,000; ending merchandise inventory is \$22,000.

(Continued)



Account Name	Debit	Credit
Sales		\$297,000
Sales Returns and Allowances	\$ 15,200	
Purchases	114,800	
Purchases Returns and Allowances		4,000
Freight-In	5,600	
Selling Expenses	48,500	
General and Administrative Expenses	37,200	

**LO 5 Merchandising Income Statement: Missing Data, Multiple Years**

**E12A.** Determine the missing data for each letter in the following three income statements for Fulco Company (in thousands):

	2014	2013	2012
Sales	\$ p	\$ h	\$1,144
Sales returns and allowances	96	76	a
Net sales	q	1,268	b
Merchandise inventory, beginning	r	i	152
Purchases	768	676	c
Purchases returns and allowances	124	j	68
Freight-in	s	116	88
Net cost of purchases	756	k	d
Cost of goods available for sale	888	848	728
Merchandise inventory, ending	156	l	168
Cost of goods sold	t	716	e
Gross margin	568	m	504
Selling expenses	u	312	f
General and administrative expenses	156	n	132
Total operating expenses	520	512	g
Net income	v	o	108

**LO 5 Recording Purchases: Periodic Inventory System**

**E13A.** Using the data in E9A, use T accounts to record each of the transactions under the periodic inventory system.

**LO 5 Recording Sales: Periodic Inventory System**

**E14A.** Using the relevant data in E10A, use T accounts to record each of the transactions under the periodic inventory system.

**LO 6 Foreign Merchandising Transactions**

**E15A. BUSINESS APPLICATION** ► Winter Treats Company purchased a special-purpose machine from Blanco Company, a French firm, on credit for €50,000. At the date of purchase, the exchange rate was \$1.00 per euro. On the date of the payment, which was made in euros, the value of the euro was \$1.25. Did Winter Treats incur an exchange gain or loss? How much was it?

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 2 Forms of the Income Statement

- ✓1: Income from operations 2014: \$66,426  
 ✓ 1: Income from operations 2013:  
 \$110,628

**P1.** Matuska Tools Corporation's income statements follow.

	2014	2013
Revenues:		
Net sales	\$525,932	\$475,264
Interest income	800	700
Total revenues	<u>\$526,732</u>	<u>\$475,964</u>
Costs and expenses:		
Cost of goods sold	\$234,948	\$171,850
Selling expenses	161,692	150,700
General and administrative expenses	62,866	42,086
Interest expense	3,600	850
Total costs and expenses	<u>\$463,106</u>	<u>\$365,486</u>
Net income	<u>\$ 63,626</u>	<u>\$110,478</u>

#### REQUIRED

1. Prepare a multistep income statement for 2013 and 2014 showing percentages of net sales for each component (e.g., cost of goods sold divided by net sales). (Round percentages to one decimal place.)
2. **ACCOUNTING CONNECTION** ► Did income from operations increase or decrease between 2013 and 2014? Write a short explanation of why this change occurred.

### LO 2, 4, 6

- ✓ 1: Net income: \$15,435

#### Merchandising Income Statement: Perpetual Inventory System

**P2.** Selected accounts from Murray's Furniture Store's adjusted trial balance as of June 30, 2014, the end of the fiscal year, follow.

Sales		162,000
Sales Returns and Allowances	2,000	
Cost of Goods Sold	61,400	
Freight-In	2,300	
Store Salaries Expense	32,625	
Office Salaries Expense	12,875	
Advertising Expense	24,300	
Rent Expense	2,400	
Insurance Expense	1,200	
Utilities Expense	1,560	
Store Supplies Expense	2,880	
Office Supplies Expense	1,175	
Depreciation Expense—Store Equipment	1,050	
Depreciation Expense—Office Equipment	800	

#### REQUIRED

1. Prepare a multistep income statement for Murray's. Freight-In should be combined with Cost of Goods Sold. Store Salaries Expense, Advertising Expense, Store Supplies Expense, and Depreciation Expense—Store Equipment are selling expenses. The other expenses are general and administrative expenses. The company uses the perpetual inventory system. Show details of net sales and operating expenses.
2. **BUSINESS APPLICATION** ► Based on your knowledge at this point in the course, how would you use Murray's income statement to evaluate the company's profitability? What other financial statement should you consider and why?

LO 4 **Merchandising Transactions: Perpetual Inventory System**

SPREADSHEET

GENERAL LEDGER

**P3.** Fulco Company engaged in the following transactions in March 2014:

- Mar. 7 Sold merchandise on credit to James William, terms n/30, FOB shipping point, \$3,000 (cost, \$1,800).  
 8 Purchased merchandise on credit from Leverage Company, terms n/30, FOB shipping point, \$6,000.  
 9 Paid Leverage Company for shipping charges on merchandise purchased on March 8, \$254.  
 10 Purchased merchandise on credit from Rourke Company, terms n/30, FOB shipping point, \$9,600, including \$600 freight costs paid by Rourke.  
 14 Sold merchandise on credit to Deepak Soni, terms n/30, FOB shipping point, \$2,400 (cost, \$1,440).  
 14 Returned damaged merchandise received from Leverage Company on March 8 for credit, \$600.  
 17 Received check from James William for his purchase of March 7.  
 19 Sold merchandise for cash, \$1,800 (cost, \$1,080).  
 20 Paid Rourke Company for purchase of March 10.  
 21 Paid Leverage Company the balance from the transactions of March 8 and March 14.  
 24 Accepted from Deepak Soni a return of merchandise, which was put back in inventory, \$200 (cost, \$120).

**REQUIRED**

1. Prepare journal entries to record the transactions, assuming use of the perpetual inventory system. (*Hint:* Refer to the TriLevel Problem feature.)
2. **ACCOUNTING CONNECTION** ► Receiving cash rebates from suppliers based on the past year's purchases is a common practice in some industries. If, at the end of the year, Fulco receives rebates in cash from a supplier, should these cash rebates be reported as revenue? Why or why not?

LO 2, 5, 6 **Merchandising Income Statement: Periodic Inventory System**

SPREADSHEET

✓ 1: Net income: \$23,941

**P4.** Selected accounts from Dence's Gourmet Shop's adjusted trial balance as of March 31, 2014, the end of the current fiscal year, follow. The merchandise inventory for Dence's was \$81,222 at the beginning of the year and \$76,664 at the end of the year.

**Dence's Gourmet Shop**  
**Partial Adjusted Trial Balance**  
**March 31, 2014**

Sales		433,912
Sales Returns and Allowances	11,250	
Purchases	221,185	
Purchases Returns and Allowances		30,238
Freight-In	10,078	
Store Salaries Expense	107,550	
Office Salaries Expense	26,500	
Advertising Expense	18,200	
Rent Expense	14,400	
Insurance Expense	2,800	
Utilities Expense	18,760	
Store Supplies Expense	464	
Office Supplies Expense	814	
Depreciation Expense—Store Equipment	1,800	
Depreciation Expense—Office Equipment	1,850	

**REQUIRED**

1. Prepare a multistep income statement for Dence's. Store Salaries Expense, Advertising Expense, Store Supplies Expense, and Depreciation Expense—Store Equipment are selling expenses. The other expenses are general and administrative expenses. The company uses the periodic inventory system. Show details of net sales and operating expenses.
2. **BUSINESS APPLICATION** ► Based on your knowledge at this point in the course, how would you use Dence's income statement to evaluate the company's profitability? What other financial statements should you consider, and why?

**LO 5 Merchandising Transactions: Periodic Inventory System**

**P5.** Refer to the data in **P3**.

**REQUIRED**

1. Prepare journal entries to record the transactions, assuming use of the periodic inventory system. (*Hint:* Refer to the TriLevel Problem feature.)
2. **ACCOUNTING CONNECTION** ► Most companies call the first line of the income statement *net sales*. Other companies call it *sales*. Do you think these terms are equivalent and comparable? What would be the content of net sales? Why might a company use *sales* instead of *net sales*?

**LO 4 Merchandising Transactions: Perpetual Inventory System****GENERAL LEDGER**

**P6.** Teague Company engaged in the following transactions in October 2014:

- Oct. 7 Sold merchandise on credit to Mel Forde, terms n/30, FOB shipping point, \$12,000 (cost, \$7,200).
- 8 Purchased merchandise on credit from Surf Company, terms n/30, FOB shipping point, \$24,000.
- 9 Paid Surf Company for shipping charges on merchandise purchased on October 8, \$1,016.
- 10 Purchased merchandise on credit from Tata Company, terms n/30, FOB shipping point, \$38,400, including \$2,400 freight costs paid by Tata.
- 14 Sold merchandise on credit to David Johnson, terms n/30, FOB shipping point, \$9,600 (cost, \$5,760).
- 14 Returned damaged merchandise received from Surf Company on October 8 for credit, \$2,400.
- 17 Received check from Mel Forde for her purchase of October 7.
- 19 Sold merchandise for cash, \$7,200 (cost, \$4,320).
- 20 Paid Tata Company for purchase of October 10.
- 21 Paid Surf Company the balance from the transactions of October 8 and October 14.
- 24 Accepted from David Johnson a return of merchandise, which was put back in inventory, \$800 (cost, \$480).

**REQUIRED**

1. Prepare journal entries to record the transactions, assuming use of the perpetual inventory system. (*Hint:* Refer to the TriLevel Problem feature.)
2. **ACCOUNTING CONNECTION** ► Receiving cash rebates from suppliers based on the past year's purchases is a common practice in some industries. If, at the end of the year, Teague receives rebates in cash from a supplier, should these cash rebates be reported as revenue? Why or why not?

## ALTERNATE PROBLEMS

### LO 2 Forms of the Income Statement

- ✓ 1: Income from operations 2014: \$132,852  
 ✓ 1: Income from operations 2013: \$221,256

**P7.** Sigma Company's single-step income statements for 2014 and 2013 follow.

<b>Sigma Company</b>		
<b>Income Statements</b>		
<b>For the Years Ended April 30, 2014 and 2013</b>		
	<b>2014</b>	<b>2013</b>
Revenues:		
Net sales	\$1,051,864	\$950,528
Interest income	3,600	1,700
Total revenues	<u>\$1,055,464</u>	<u>\$952,228</u>
Costs and expenses:		
Cost of goods sold	\$ 469,896	\$343,700
Selling expenses	323,384	301,400
General and administrative expenses	125,732	84,172
Interest expense	7,200	3,400
Total costs and expenses	<u>\$ 926,212</u>	<u>\$732,672</u>
Net income	<u>\$ 129,252</u>	<u>\$219,556</u>

#### REQUIRED

- Prepare multistep income statements for 2013 and 2014 showing percentages of net sales for each component (e.g., cost of goods sold divided by net sales). (Round percentages to one decimal place.)
- ACCOUNTING CONNECTION** ► Did income from operations increase or decrease from 2013 to 2014? Write a short explanation of why this change occurred.

### LO 2, 4, 6

- ✓ 1: Net income: \$10,522

### Merchandising Income Statement: Perpetual Inventory System

**P8.** Selected accounts from Keystone Furniture's adjusted trial balance as of August 31, 2014, the end of the fiscal year, follow.

<b>Keystone Furniture</b>	
<b>Partial Adjusted Trial Balance</b>	
<b>August 31, 2014</b>	
Sales	867,824
Sales Returns and Allowances	22,500
Cost of Goods Sold	442,370
Freight-In	20,156
Store Salaries Expense	215,100
Office Salaries Expense	53,000
Advertising Expense	36,400
Rent Expense	28,800
Insurance Expense	5,600
Utilities Expense	17,520
Store Supplies Expense	4,928
Office Supplies Expense	3,628
Depreciation Expense—Store Equipment	3,600
Depreciation Expense—Office Equipment	3,700

#### REQUIRED

- Prepare a multistep income statement for Keystone. Store Salaries Expense, Advertising Expense, Store Supplies Expense, and Depreciation Expense—Store Equipment are selling expenses. The other expenses are general and administrative expenses. The company uses the perpetual inventory system. Show details of net sales and operating expenses.

2. **BUSINESS APPLICATION** ► Based on your knowledge at this point in the course, how would you use the income statement for Keystone to evaluate the company's profitability? What other financial statement should be considered, and why?

LO 4

SPREADSHEET

GENERAL LEDGER

### Merchandising Transactions: Perpetual Inventory System

**P9.** Naib Company engaged in the following transactions in July 2014:

- July 1 Sold merchandise to Lina Lopez on credit, terms n/30, FOB shipping point, \$4,200 (cost, \$2,520).  
 3 Purchased merchandise on credit from Ruff Company, terms n/30, FOB shipping point, \$7,600.  
 5 Paid Craft Freight for freight charges on merchandise received, \$580.  
 8 Purchased merchandise on credit from Kansas Supply Company, terms n/30, FOB shipping point, \$7,200, which includes \$400 freight costs paid by Kansas Supply.  
 12 Returned some of the merchandise purchased on July 3 for credit, \$1,200.  
 15 Sold merchandise on credit to Peter Watts, terms n/30, FOB shipping point, \$2,400 (cost, \$1,440).  
 17 Sold merchandise for cash, \$2,000 (cost, \$1,200).  
 18 Accepted for full credit a return from Lina Lopez and returned merchandise to inventory, \$400 (cost, \$240).  
 24 Paid Ruff Company for purchase of July 3 less return of July 12.  
 25 Received check from Lina Lopez for July 1 purchase less the return on July 18.

#### REQUIRED

1. Prepare journal entries to record the transactions, assuming use of the perpetual inventory system. (*Hint:* Refer to the TriLevel Problem feature.)
2. **ACCOUNTING CONNECTION** ► Most companies call the first line of the income statement *net sales*. Other companies call it *sales*. Do you think these terms are equivalent and comparable? What would be the content of net sales? Why might a company use *sales* instead of *net sales*?

LO 5

### Merchandising Transactions: Periodic Inventory System

**P10.** Refer to the data in **P9**.

#### REQUIRED

1. Prepare journal entries to record the transactions, assuming use of the periodic inventory system. (*Hint:* Refer to the TriLevel Problem feature.)
2. **ACCOUNTING CONNECTION** ► Receiving cash rebates from suppliers based on the past year's purchases is common in some industries. If at the end of the year, Naib receives rebates in cash from a supplier, should these cash rebates be reported as revenue? Why or why not?

LO 2, 5, 6

SPREADSHEET

✓ 1: Net income: \$3,435

### Merchandising Income Statement: Periodic Inventory System

**P11.** Selected accounts from Will's Sports Equipment's adjusted trial balance on September 30, 2014, the fiscal year end, follow. The company's beginning merchandise inventory was \$38,200 and ending merchandise inventory is \$29,400 for the period.

(Continued)

**Will's Sports Equipment  
Partial Adjusted Trial Balance  
September 30, 2014**

Sales		165,000
Sales Returns and Allowances	2,000	
Purchases	70,200	
Purchases Returns and Allowances		2,600
Freight-In	2,300	
Store Salaries Expense	32,625	
Office Salaries Expense	12,875	
Advertising Expense	24,300	
Rent Expense	2,400	
Insurance Expense	1,200	
Utilities Expense	1,560	
Store Supplies Expense	2,880	
Office Supplies Expense	1,175	
Depreciation Expense—Store Equipment	1,050	
Depreciation Expense—Office Equipment	800	

**REQUIRED**

1. Prepare a multistep income statement for Will's. Store Salaries Expense, Advertising Expense, Store Supplies Expense, and Depreciation Expense—Store Equipment are selling expenses. The other expenses are general and administrative expenses. The company uses the periodic inventory system. Show details of net sales and operating expenses.
2. **BUSINESS APPLICATION** ► Based on your knowledge at this point in the course, how would you use Will's income statement to evaluate the company's profitability? What other financial statements should you consider and why?

LO 5

**Merchandising Transactions: Periodic Inventory System**

GENERAL LEDGER

**P12.** Refer to the data in **P6**.**REQUIRED**

Prepare journal entries to record the transactions, assuming use of the periodic inventory system. (*Hint:* Refer to the TriLevel Problem feature.)

**CASES**

LO 1

**Conceptual Understanding: Periodic versus Perpetual Inventory Systems**

**C1.** Books Unlimited is a well-established chain of 20 bookstores in western Ohio. In recent years, the company has grown rapidly, adding five new stores in regional malls. Each store's manager selects stock based on the market in his or her region. Managers select books from a master list of titles that the central office provides. Every six months, a physical inventory is taken, and financial statements are prepared using the periodic inventory system. At that time, books that have not sold well are placed on sale or, whenever possible, returned to the publisher.

Management has found that when selecting books, managers of the new stores are not judging the market as well as the managers of the older, more established stores. Management is therefore thinking of implementing a perpetual inventory system and carefully monitoring sales from the central office. Do you think Books Unlimited should switch to the perpetual inventory system or stay with the periodic inventory system it has used in the past? Discuss the advantages and disadvantages of each system.



LO 6 **Conceptual Understanding: Effects of a Weak Dollar**

**C2. BUSINESS APPLICATION** ► **McDonald's** reports that its sales in Europe exceed its sales in the United States. This performance, while reflective of the company's phenomenal success in Europe, was also attributed to the weak dollar in relation to the euro. McDonald's reports its sales wherever they take place in U.S. dollars. Explain why a weak dollar relative to the euro would lead to an increase in McDonald's reported European sales. Why is a weak dollar not relevant to a discussion of McDonald's sales in the United States?

LO 6 **Conceptual Understanding: Cash Flow Management**



**C3. BUSINESS APPLICATION** ► Amazing Sound Source, Inc., has been in business for 30 years. It carries a large inventory so that it can offer customers a wide selection of merchandise and deliver purchases quickly. It accepts credit cards and checks but also provides 90 days' credit to reliable customers who have made purchases in the past. It maintains good relations with suppliers by paying invoices quickly.

To pay bills during the past year, the company has had to borrow from its bank. An analysis of the company's financial statements reveals that, on average, inventory is on hand for 70 days before being sold and that receivables are held for 90 days before being paid. Accounts payable are, on average, paid in 20 days.

What are the operating cycle and financing period? How long are Amazing Sound Source's operating cycle and financing period? Describe three ways in which this company can improve its cash flow management.

LO 6 **Annual Report Case: The Operating Cycle and Financing Period**

**C4. BUSINESS APPLICATION** ► Write a brief memorandum to your instructor describing **CVS's** operating cycle and financing period. To do this, refer to the CVS annual report in the Supplement to Chapter 16 and to Exhibits 5 and 8. Your memorandum should identify the most common transactions in the operating cycle as they apply to CVS. It should also refer to the importance of accounts receivable, accounts payable, and merchandise inventory in CVS's financial statements. Recall from previous chapters that CVS had inventory days on hand of about 44 days, days' receivable of 19 days, and days payable of 21 days. Complete the memorandum by explaining why CVS's operating cycle and financing period are favorable to the company.

LO 2 **Comparison Analysis: Income Statement Analysis**

**C5.** Refer to the **CVS** annual report in the Supplement to Chapter 16 and to the following data (in millions) for **Walgreens** in 2011: net sales, \$72,184; cost of sales, \$51,692; total operating expenses, \$16,561; and inventories, \$8,044. Determine which company—CVS or Walgreens—had more profitable merchandising operations in 2011 by preparing a schedule that compares the companies based on net sales, cost of sales, gross margin, total operating expenses, and income from operations as a percentage of sales. (*Hint:* You should put the income statements in comparable formats.) In addition, for each company, compute inventories as a percentage of the cost of sales. Which company has the highest prices in relation to costs of sales? Which company is more efficient in its operating expenses? Which company manages its inventories better? Overall, on the basis of the income statement, which company is more profitable? Explain your answers.

LO 1, 2, 4, 5 **Decision Analysis: Analysis of a Merchandising Income Statement**

**C6.** In 2013, Lisa Perry opened Lisa's Jeans Company, a small store that sold designer jeans in a suburban mall. Perry worked 14 hours a day and controlled all aspects of the operation. The company was such a success that in 2014, Perry opened a second store in another mall. Because the new shop needed her attention, she hired a manager for the original store.

During 2014, the new store was successful, but the original store's performance did not match its performance in 2013. Concerned about this, Perry compared the two years' results for the original store. Her analysis showed the following:

(Continued)

	2014	2013
Net sales	\$325,000	\$350,000
Cost of goods sold	<u>225,000</u>	<u>225,000</u>
Gross margin	\$100,000	\$125,000
Operating expenses	<u>75,000</u>	<u>50,000</u>
Income before income taxes	\$ 25,000	\$ 75,000

Perry's analysis also revealed that the cost and the selling price of the jeans were roughly the same in both years, as was the level of operating expenses, except for the new manager's \$25,000 salary. The amount of sales returns and allowances was insignificant in both years.

Studying the situation further, Perry discovered the following about the cost of goods sold.

	2014	2013
Purchases	\$200,000	\$271,000
Total purchases allowances	15,000	20,000
Freight-in	19,000	27,000
Physical inventory, end of year	32,000	53,000

Still not satisfied, Perry went through all the individual sales and purchase records for 2014. She found that they were correct, but given the unit purchases and sales during the year, the 2014 ending inventory should have been \$57,000. After puzzling over all this information, Perry has come to you for accounting help.

1. Using Perry's new information, compute the cost of goods sold for 2013 and 2014 and account for the difference in income before income taxes between 2013 and 2014.
2. Suggest at least two reasons for the discrepancy in the 2014 ending inventory. How might Perry improve the management of the original store?

### Continuing Case: Annual Report Project

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the income statement of your company. Answer the following questions.

1. Does your company use a multistep income statement?
2. For the most recent year, what is the company's gross margin, operating income, and net income? Briefly explain why these numbers are different.

# SUPPLEMENT TO CHAPTER 6

## Special-Purpose Journals

**Special-purpose journals** promote efficiency, economy, and control. Although manual special-purpose journals are used by some companies, the concepts also underlie computerized general ledger accounting systems.

Most business transactions—90 to 95 percent—fall into one of four categories. Each kind of transaction can be recorded in a special-purpose journal.

Transaction	Special-Purpose Journal	Posting Abbreviation
Sale of merchandise on credit	Sales journal	S
Purchase on credit	Purchases journal	P
Receipt of cash	Cash receipts journal	CR
Disbursement of cash	Cash payments journal	CP

The general journal is used to record transactions, like purchase returns, sales returns, and adjusting and closing entries, that do not fall into any of these special categories. (When transactions are posted from the general journal to the ledger accounts, the posting abbreviation used is *J*.)

Using special-purpose journals greatly reduces the work involved in entering and posting transactions in the general ledger. For example, in most cases, instead of posting every debit and credit for each transaction, only the total amounts of the transactions are posted. In addition, labor can be divided by assigning each journal to a different employee. This division of labor is important in establishing good internal control.

## Sales Journal

**STUDY NOTE:** A cash sale is entered into the cash receipts journal, not into the sales journal.

The **sales journal** is designed to handle all credit sales. Cash sales are recorded in the cash receipts journal. Exhibit 1 illustrates a page from a typical sales journal and related ledger accounts. Six sales transactions involving five customers are recorded.

Notice how the sales journal saves time:

- Only one line is needed to record each transaction. Each entry consists of a debit to a customer in Accounts Receivable. The corresponding credit to Sales is understood.
- The account names do not have to be written out because each entry automatically is debited to Accounts Receivable and credited to Sales.
- No explanations are necessary because the function of the sales journal is to record only credit sales.
- Only one amount—the total credit sales for the month—has to be posted. It is posted twice: once as a debit to Accounts Receivable and once as a credit to Sales. Imagine the time saved when there are hundreds of sales transactions.

**Controlling Accounts and Subsidiary Ledgers** Controlling accounts and subsidiary ledgers contain important details about the figures in special-purpose journals and the general journal. A **controlling account** (or *control account*) is an account in the general ledger that maintains the total of the individual account balances in a subsidiary ledger. A **subsidiary ledger** is a ledger separate from the general ledger that contains a group of related accounts, such as a list of customers. The total of the balances in the subsidiary ledger accounts equals the balance in the corresponding controlling account.

Up to this point, we've used a single Accounts Receivable account. However, a single entry in Accounts Receivable does not tell us how much each customer has bought and how much each customer has paid or still owes. In practice, almost all companies that sell to customers on credit keep an individual accounts receivable record for each customer. If the company has 6,000 credit customers, there are 6,000 accounts receivable.

**Exhibit 1**  
Sales Journal and Related  
Ledger Accounts

**STUDY NOTE:** The check marks indicate daily postings to the subsidiary ledger accounts, which normally are listed in alphabetical or numerical order. Also, the column totals are posted to the appropriate general ledger accounts at the end of the month.

Sales Journal						Page 1
Date		Account Debited	Invoice Number	Terms	Post. Ref.	Amount (Debit/ Credit Accounts Receivable/Sales)
July	1	Peter Clark	721	2/10, n/30	✓	750
	5	Georgetta Jones	722	2/10, n/30	✓	500
	8	Eugene Cumberland	723	2/10, n/30	✓	335
	12	Maxwell Gertz	724	2/10, n/30	✓	1,165
	18	Peter Clark	725	1/10, n/30	✓	1,225
	25	Michael Powers	726	2/10, n/30	✓	975
						<u>4,950</u>
						(114/411)

Post total at end of month.

Accounts Receivable						114	Sales				411
Date	Post. Ref.	Debit	Credit	Balance		Date	Post. Ref.	Debit	Credit	Balance	
				Debit	Credit					Debit	Credit
July	31	S1	4,950		4,950		July	31	S1		4,950

To include all these accounts in the general ledger with the other asset, liability, and owner's equity accounts would make it very bulky. Consequently, most companies place individual customers' accounts in a separate, subsidiary ledger. In the accounts receivable subsidiary ledger, customers' accounts are filed either alphabetically or numerically (if account numbers are used).

When a company uses an accounts receivable subsidiary ledger, it still must maintain an Accounts Receivable account in the general ledger. This account controls in the sense that its balance must equal the total of the individual account balances in the subsidiary ledger. Transactions that involve accounts receivable, such as credit sales, must be posted to the individual customers' accounts daily. Postings to the controlling account in the general ledger are made at least once a month. When the amounts in the subsidiary ledger and the controlling account do not match, the accountant must find the error and correct it.

Most companies use an accounts payable subsidiary ledger as well. It is possible to use a subsidiary ledger for almost any account in the general ledger, such as Notes Receivable or Equipment, when management wants specific information on individual items.

**Summary of the Sales Journal Procedure** Using a sales journal involves the following steps, as shown in Exhibit 2:

- **Step 1:** Enter each sales invoice in the sales journal on a single line. Record the date, the customer's name, the invoice number, and the amount. No column is needed for the terms if the terms on all sales are the same.
- **Step 2:** At the end of each day, post each individual sale to the customer's account in the accounts receivable subsidiary ledger. As each sale is posted, place a check mark (or customer account number, if used) in the Post. Ref. (posting reference) column of the sales journal to indicate that it has been posted. In the Post. Ref.

**STUDY NOTE:** In theory, the sum of the account balances from the subsidiary accounts must equal the balance in the related general ledger controlling account at any point in time. In practice, however, the equality is verified only at the end of the month, when the general ledger is posted.

- **Step 3:** At the end of the month, sum the Amount column in the sales journal to determine the total credit sales, and post the total to the general ledger accounts (debit Accounts Receivable and credit Sales). Place the numbers of the accounts debited and credited beneath the total in the sales journal to indicate that this step has been completed. In the general ledger, indicate the source of the entry in the Post. Ref. column of each account.
- **Step 4:** Verify the accuracy of the posting by adding the account balances of the accounts receivable subsidiary ledger and comparing the total with the balance of the Accounts Receivable controlling account in the general ledger. You can do this by listing the accounts in a schedule of accounts receivable, like the one in Exhibit 3, in the order in which the accounts are maintained. This step is performed after posting collections on account in the *cash receipts journal*, which we explain later.

**Exhibit 2**  
Relationship of Sales Journal, General Ledger, and Accounts Receivable Subsidiary Ledger and the Posting Procedure

Sales Journal						Page 1
Date		Account Debited	Invoice Number	Terms	Post. Ref.	Amount (Debit/Credit Accounts Receivable/Sales)
July	1	Peter Clark	721	2/10, n/30	√	750
	5	Georgetta Jones	722	2/10, n/30	√	500
	8	Eugene Cumberland	723	2/10, n/30	√	335
	12	Maxwell Gertz	724	2/10, n/30	√	1,165
	18	Peter Clark	725	1/10, n/30	√	1,225
	25	Michael Powers	726	2/10, n/30	√	975
						<u>4,950</u>
						(114/411)

Post individual amounts daily to subsidiary ledger accounts.

Post total at end of month to general ledger accounts.

**STUDY NOTE:** Accounts in the subsidiary ledger are maintained in alphabetical order. If account numbers are used to identify customers, the accounts would be listed in account number order.

**STUDY NOTE:** Subsidiary accounts are posted daily to prevent customers from exceeding their credit limits and to have up-to-date balances for customers wishing to pay their accounts.

General Ledger						
Accounts Receivable						114
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	S1	4,950		4,950		
Sales						411
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	S1		4,950		4,950	

Accounts Receivable Sub. Ledger					
Peter Clark					
Date	Post. Ref.	Debit	Credit	Balance	
July 1	S1	750			750
July 18	S1	1,225			1,975
Eugene Cumberland					
Date	Post. Ref.	Debit	Credit	Balance	
				Debit	Credit
July 8	S1	335			335

Continue posting to Maxwell Gertz, Georgetta Jones, and Michael Powers.

© Cengage Learning 2014

**Exhibit 3**  
Schedule of Accounts Receivable

**Mitchell's Used Car Sales**  
**Schedule of Accounts Receivable**  
**July 31, 2011**

Peter Clark	\$1,975
Eugene Cumberland	335
Maxwell Gertz	1,165
Georgetta Jones	500
Michael Powers	975
Total Accounts Receivable	<u>\$4,950</u>

© Cengage Learning 2014

**STUDY NOTE:** Columns can be added to a special-purpose journal for accounts that are commonly used.

**Sales Taxes** Many cities and states require retailers to collect a sales tax from their customers and periodically remit the total collected to the city or state. In this case, an additional column is needed in the sales journal to record the credit to Sales Taxes Payable on credit sales, as shown in Exhibit 4.

**Exhibit 4**  
Section of a Sales Journal with a Column for Sales Taxes

Sales Journal						Page 7	
Date	Account Debited	Invoice Number	Terms	Post. Ref.	Debit	Credits	
					Accounts Receivable	Sales Tax Payable	Sales
Sept. 1	Ralph P. Hake	727	2/10, n/30	√	206	6	200

© Cengage Learning 2014

**STUDY NOTE:** A cash purchase is entered into the cash payments journal, not into the purchases journal.

## Purchases Journal

The **purchases journal** is used to record purchases on credit. It can take the form of either a single-column journal or a multicolumn journal. In the single-column journal (shown in Exhibit 5), only credit purchases of merchandise for resale to customers are recorded. This kind of transaction is recorded with a debit to Purchases and a credit to Accounts Payable. When the single-column purchases journal is used, credit purchases of items other than merchandise are recorded in the general journal. Cash purchases are recorded in the *cash payments journal*, which we explain later.

Like the Accounts Receivable account, the Accounts Payable account in the general ledger is generally used as a controlling account. So that the company knows how much it owes each supplier, it keeps a separate account for each supplier in an accounts payable subsidiary ledger.

The procedure for using the purchases journal is much like that for using the sales journal.

- **Step 1:** Enter each purchase invoice in the purchases journal on a single line. Record the date, the supplier's name, the invoice date, the terms (if given), and the amount. It is not necessary to record the shipping terms in the terms column because they do not affect the payment date.

- Step 2:** At the end of each day, post each individual purchase to the supplier's account in the accounts payable subsidiary ledger. As each purchase is posted, place a check mark in the Post. Ref. column of the purchases journal to show that it has been posted. Also place a *P* and the page number of the purchases journal (*P1* stands for Purchases Journal—Page 1) in the Post. Ref. column of each supplier's account to show the source of the entry.
- Step 3:** At the end of the month, sum the Amount column in the purchases journal, and post the total to the general ledger as a debit to Purchases and a credit to Accounts Payable. Place the numbers of the accounts debited and credited beneath the totals in the purchases journal to show that this step has been carried out. In the general ledger, indicate the source of the entry in the Post. Ref. column of each account.
- Step 4:** Check the accuracy of the posting by adding the account balances of the accounts payable subsidiary ledger and comparing the total with the balance of the Accounts Payable controlling account in the general ledger. This step can be done by preparing a schedule of accounts payable from the subsidiary ledger.

Exhibit 5 illustrates the procedure for using a purchases journal.

**Exhibit 5**  
Relationship of Single-Column Purchases Journal to the General Ledger and the Accounts Payable Subsidiary Ledger

Purchases Journal						Page 1
Date		Account Credited	Date of Invoice	Terms	Post. Ref.	Amount (Debit/Credit Purchases/Accounts Payable)
July	1	Jones Chevrolet	7/1	2/10, n/30	√	2,500
	2	Marshall Ford	7/2	2/15, n/30	√	300
	3	Dealer Sales	7/3	n/30	√	700
	12	Thomas Auto	7/11	n/30	√	1,400
	17	Dealer Sales	7/17	2/10, n/30	√	3,200
	19	Thomas Auto	7/17	n/30	√	1,100
						<u>9,200</u>
						(511/212)

Post total at end of month.

Post individual amounts daily.

General Ledger						
Accounts Payable						212
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	P1		9,200			9,200

Purchases						511
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	P1	9,200				9,200

Accounts Payable Sub. Ledger					
Dealer Sales					
Date	Post. Ref.	Debit	Credit	Balance	
July 3	P1		700		700
July 17	P1		3,200		3,900

Jones Chevrolet					
Date	Post. Ref.	Debit	Credit	Balance	
July 1	P1		2,500		2,500

Continue posting to Marshall Ford and Thomas Auto.

© Cengage Learning 2014



**STUDY NOTE:** The multicolumn purchases journal can accommodate the purchase of anything on credit. Each column total (except the total of Other Accounts) must be posted at the end of the month.

The single-column purchases journal can be expanded to record credit purchases of items other than merchandise by adding separate debit columns for other accounts that are used often. For example, the multicolumn purchases journal in Exhibit 6 has columns for Freight In, Store Supplies, Office Supplies, and Other Accounts. In Exhibit 6, the total credits to Accounts Payable (\$9,637) equal the total debits to Purchases, Freight In, Store Supplies, Office Supplies, and Parts (\$9,200 + \$50 + \$145 + \$42 + \$200). Again, the individual transactions in the Accounts Payable column are posted daily to the accounts payable subsidiary ledger, and the totals of each column in the purchases journal are posted monthly to the corresponding general ledger accounts. Entries in the Other Accounts column are posted individually to the named accounts, and the column total is not posted.

### Exhibit 6 A Multicolumn Purchases Journal

Purchases Journal													Page 1
Date	Account Credited	Date of Invoice	Terms	Post. Ref.	Credit	Debits							
					Accounts Payable	Purchases	Freight In	Store Supplies	Office Supplies	Other Accounts			
										Account	Post. Ref.	Amount	
July	1	Jones Chevrolet	7/1	2/10, n/30	√	2,500	2,500						
	2	Marshall Ford	7/2	2/15, n/30	√	300	300						
	2	Shelby Car Delivery	7/2	n/30	√	50		50					
	3	Dealer Sales	7/3	n/30	√	700	700						
	12	Thomas Auto	7/11	n/30	√	1,400	1,400						
	17	Dealer Sales	7/17	2/10, n/30	√	3,200	3,200						
	19	Thomas Auto	7/17	n/30	√	1,100	1,100						
	25	Osborne Supply	7/21	n/10	√	187			145	42			
	28	Auto Supply	7/28	n/10	√	200					Parts	120	200
						9,637	9,200	50	145	42			200
						(212)	(511)	(514)	(132)	(133)			(√)

© Cengage Learning 2014

## Cash Receipts Journal

**STUDY NOTE:** The cash receipts journal can accommodate all receipts of cash. Daily postings are made not only to the subsidiary accounts but also to the "other accounts." The Other Accounts column totals, therefore, are not posted at the end of the month. Only at the end of the month are the control account balances meaningful or correct.

All transactions involving receipts of cash are recorded in the **cash receipts journal**. Examples of these transactions are cash from cash sales and cash from credit customers in payment of their accounts. Although all cash receipts require a debit to Cash, they differ in that they require a variety of credit entries. Thus, the cash receipts journal must have several columns. The Other Accounts column is used to record credits to accounts not specifically represented by a column. The account numbers are entered in the Post. Ref. column, and the amounts are posted daily to the appropriate account in the general ledger. The Other Accounts column totals, therefore, are not posted at the end of the month. Only at the end of the month are the control account balances meaningful or correct.

The cash receipts journal presented in Exhibit 7 has the following debit and credit columns:

- Debit columns
  - **Cash:** Each entry must have an amount in this column because each transaction involves a receipt of cash.
  - **Sales Discounts:** This company allows a 2 percent discount for prompt payment. Therefore, it is useful to have a column for sales discounts. Notice that in the transactions of July 8 and 28, the debits to Cash and Sales Discounts equal the credits to Accounts Receivable.
  - **Other Accounts:** The Other Accounts column (sometimes called *Sundry Accounts*) is used for transactions that involve both a debit to Cash and a debit to some account other than Sales Discounts.
- Credit columns
  - **Accounts Receivable:** This column is used to record collections on account from customers. The name of the customer is written in the Account Debited/Credited column so that the payment can be entered in the corresponding account in the accounts receivable subsidiary ledger. Posting to the individual accounts receivable accounts is usually done daily so that each customer's balance is up-to-date.
  - **Sales:** This column is used to record all cash sales. Retail firms that use cash registers would make an entry at the end of each day for the total sales from each cash register. The debit, of course, is in the Cash debit column.
  - **Other Accounts:** This column is used for the credit portion of any entry that is neither a cash collection from accounts receivable nor a cash sale. The name of the account to be credited is indicated in the Account Debited/Credited column. For example, the transactions of July 1, 20, and 24 involve credits to accounts other than Accounts Receivable or Sales. These individual postings should be done daily (or weekly if there are just a few of them). If a company finds that it consistently is crediting a certain account in the Other Accounts column, it can add another credit column to the cash receipts journal for that particular account.

The procedure for posting the cash receipts journal follows.

- **Step 1:** Post the transactions in the Accounts Receivable column daily to the individual accounts in the accounts receivable subsidiary ledger. The amount credited to the customer's account is the same as that credited to Accounts Receivable. A check mark in the Post. Ref. column of the cash receipts journal indicates that the amount has been posted, and a *CRI* (Cash Receipts Journal—Page 1) in the Post. Ref. column of each subsidiary ledger account indicates the source of the entry.
- **Step 2:** Post the debits/credits in the Other Accounts columns daily, or at intervals during the month, to the general ledger accounts. Write the account number in the Post. Ref. column of the cash receipts journal as the individual items are posted to indicate that the posting has been done, and write *CRI* in the Post. Ref. column of the general ledger account to indicate the source of the entry.
- **Step 3:** At the end of the month, total the columns in the cash receipts journal, as shown below. The sum of the Debits column totals must equal the sum of the Credits column totals:

Debits Column Totals		Credits Column Totals	
Cash	\$32,528	Accounts Receivable	\$ 1,850
Sales Discounts	22	Sales	5,200
Other Accounts	0	Other Accounts	25,500
Total Debits	<u>\$32,550</u>	Total Credits	<u>\$32,550</u>

This step is called *crossfooting*.

**Exhibit 7**

Relationship of the Cash Receipts Journal to the General Ledger and the Accounts Receivable Subsidiary Ledger

Cash Receipts Journal									Page 1
Date	Account Debited/Credited	Post. Ref.	Debits			Credits			
			Cash	Sales Discounts	Other Accounts	Accounts Receivable	Sales	Other Accounts	
July 1	Henry Mitchell, Capital	311	20,000					20,000	
5	Sales		1,200				1,200		
8	Georgetta Jones	√	490	10		500			
13	Sales		1,400				1,400		
16	Peter Clark	√	750			750			
19	Sales		1,000				1,000		
20	Store Supplies	132	500					500	
24	Notes Payable	213	5,000					5,000	
26	Sales		1,600				1,600		
28	Peter Clark	√	588	12		600			
			32,528	22		1,850	5,200	25,500	
			(111)	(412)		(114)	(411)	(√)	

Post individual amounts in Accounts Receivable ledger columns daily.

Post totals at end of month.

Total not posted.

Post individual amounts in Other Accounts column daily.

General Ledger						
<b>Cash</b>						<b>111</b>
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	CR1	32,528		32,528		
<b>Accounts Receivable</b>						<b>114</b>
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	S1	4,950		4,950		
31	CR1		1,850		3,100	
<b>Store Supplies</b>						<b>132</b>
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
Bal. July 20	CR1		500	500		
			500			

Accounts Receivable Subsidiary Ledger					
<b>Peter Clark</b>					
Date	Post. Ref.	Debit	Credit	Balance	
July 1	S1	750		750	
16	CR1		750		—
18	S1	1,225		1,225	
28	CR1		600		625
<b>Georgetta Jones</b>					
Date	Post. Ref.	Debit	Credit	Balance	
July 5	S1	500		500	
8	CR1		500		—

Continue posting to Notes Payable and Henry Mitchell, Capital.

Continue posting to Sales and Sales Discounts.

- **Step 4:** Post the Debits column totals as follows.
  - a. **Cash:** Posted as a debit to the Cash account.
  - b. **Sales Discounts:** Posted as a debit to the Sales Discounts account.
- **Step 5:** Post the Credits column totals as follows.
  - a. **Accounts Receivable:** Posted as a credit to the Accounts Receivable controlling account.
  - b. **Sales:** Posted as a credit to the Sales account.
- **Step 6:** Write the account numbers below each column in the cash receipts journal as they are posted to indicate that these steps have been completed. *CRI* is written in the Post. Ref. column of each account in the general ledger to indicate the source of the entry.
- **Step 7:** Notice that the total of the Other Accounts column is not posted because each entry was posted separately when the transaction occurred. The individual accounts were posted in Step 2. Place a check mark at the bottom of the column to show that postings in that column have been made and that the total is not posted.

## Cash Payments Journal

**STUDY NOTE:** The cash payments journal can accommodate all cash payments. It functions like the cash receipts journal, although it uses some different general ledger accounts.

All transactions involving payments of cash are recorded in the **cash payments journal** (or *cash disbursements journal*). Examples of these transactions are cash purchases and payments of obligations resulting from earlier purchases on credit. The form of the cash payments journal is much like that of the cash receipts journal.

The cash payments journal presented in Exhibit 8 includes the following credit and debit columns:

- Credit columns
  - **Cash:** Each entry must have an amount in this column because each transaction involves a payment of cash.
  - **Purchases Discounts:** When purchases discounts are taken, they are recorded in this column.
  - **Other Accounts:** This column is used to record credits to accounts other than Cash or Purchases Discounts. Notice that the July 31 transaction shows a purchase of Land for \$15,000, with a check for \$5,000 and a note payable for \$10,000.
- Debit columns
  - **Accounts Payable:** This column is used to record payments to suppliers that have extended credit to the company. Each supplier's name is written in the Payee column so that the payment can be entered in the supplier's account in the accounts payable subsidiary ledger.
  - **Salary Expense, Advertising Expense, and Rent Expense:** Continue posting the column total for any column that has an account title at the top. These are accounts for which there are usually multiple expenditures in a month. Placing the account number at the bottom of the column indicates the total has been posted to its respective account.
  - **Other Accounts:** Cash can be expended for many reasons. Therefore, an Other Accounts or Sundry Accounts column is needed in the cash payments journal. The title of the account to be debited is written in the Account Credited/Debited column, and the amount is entered in the Other Accounts debit column. If a company finds that a particular account appears often in the Other Accounts column, it can add another debit column to the cash payments journal.

The procedure for posting the cash payments journal, shown in Exhibit 8, follows.

- **Step 1:** Post the transactions in the Accounts Payable columns daily to the individual accounts in the accounts payable subsidiary ledger. Place a check mark in the

**Exhibit 8**

Relationship of the Cash Payments Journal to the General Ledger and the Accounts Payable Subsidiary Ledger

Cash Payments Journal													Page 1			
Credits													Debits			
Date	Ck. No.	Payee	Account Credited/ Debited	Post. Ref.	Cash	Purchases Discounts	Other Accounts	Accounts Payable	Salary Expense	Advertising Expense	Rent Expense	Other Accounts				
July 2	101	Sondra Tidmore	Purchases	511	400							400				
6	102	Daily Journal			100					100						
8	103	Siviglia Agency			250						250					
11	104	Jones Chevrolet		√	2,450	50		2,500								
16	105	Charles Kuntz			600				600							
17	106	Marshall Ford		√	294	6		300								
24	107	Grabow & Company	Prepaid Insurance	119	480							480				
27	108	Dealer Sales		√	3,136	64		3,200								
		Daily Journal			100					100						
30	109	A&B Equipment Company	Office Equipment	144	900							400				
			Service Equipment	146								500				
31	110	Burns Real Estate	Notes Payable	213	5,000		10,000									
			Land	141								15,000				
					13,710	120	10,000	6,000	600	200	250	16,780				
					(111)	(512)	(√)	(212)	(611)	(612)	(613)	(√)				

Post individual amounts in Other Accounts column daily.

Post totals at end of month.

Post individual amounts in Accounts Payable column daily.

Totals not posted.

General Ledger						
<b>Cash</b>					<b>111</b>	
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 31	CR1	32,528		32,528		
	CP1		13,710	18,818		
<b>Prepaid Insurance</b>					<b>119</b>	
Date	Post. Ref.	Debit	Credit	Balance		
				Debit	Credit	
July 24	CP1	480		480		

Accounts Payable Subsidiary Ledger					
<b>Dealer Sales</b>					
Date	Post. Ref.	Debit	Credit	Balance	
July 3	P1		700	700	
17	P1		3,200	3,900	
27	CP1	3,200		700	
<b>Jones Chevrolet</b>					
Date	Post. Ref.	Debit	Credit	Balance	
July 1	P1		2,500	2,500	
11	CP1	2,500		—	
<b>Marshall Ford</b>					
Date	Post. Ref.	Debit	Credit	Balance	
July 2	P1		300	300	
17	CP1	300		—	

Continue posting to Land, Office Equipment, Service Equipment, Notes Payable, and Purchases.

Continue posting to Purchases Discounts and Accounts Payable, Salary Expense, Advertising Expense, and Rent Expense.

Post. Ref. column of the cash payments journal to indicate that the posting has been made.

- **Step 2:** Post the debits/credits in the Other Accounts debit/credit columns to the general ledger daily or at intervals during the month. Write the account number in the Post. Ref. column of the cash payments journal as the individual items are posted to indicate that the posting has been completed and *CPI* (Cash Payments Journal-Page 1) in the Post. Ref. column of each general ledger account.
- **Step 3:** At the end of the month, the columns are footed and crossfooted. That is, the sum of the Credits column totals must equal the sum of the Debits column totals, as follows.

Credit Column Totals		Debit Column Totals	
Cash	\$13,710	Accounts Payable	\$ 6,000
Purchases Discounts	120	Salary Expense	600
Other Accounts	10,000	Advertising Expense	200
		Rent Expense	250
		Other Accounts	16,780
Total Credits	<u>\$23,830</u>	Total Debits	<u>\$23,830</u>

- **Step 4:** At the end of the month, post the column totals for Cash, Purchases Discounts, Accounts Payable, Salary Expense, Advertising Expense, and Rent Expense to their respective accounts in the general ledger. Write the account number below each column in the cash payments journal as it is posted to indicate that this step has been completed and *CPI* in the Post. Ref. column of each general ledger account. Place a check mark under the total of each Other Accounts column in the cash payments journal to indicate that the postings in the column have been made and that the total is not posted.

## General Journal

Adjusting and closing entries are recorded in the general journal. Transactions that do not involve sales, purchases, cash receipts, or cash payments should also be recorded in the general journal. Usually, there are only a few of these transactions. Two examples of entries that do not fit in a special-purpose journal are a return of merchandise bought on account and an allowance from a supplier for credit. These entries are shown in Exhibit 9.

**Exhibit 9**  
Transactions Recorded in the General Journal

**STUDY NOTE:** The general journal is used only to record transactions that cannot be accommodated by the special-purpose journals. Whenever a controlling account is recorded, it must be "double posted" to the general ledger and the subsidiary accounts. All general journal entries are posted daily; column totals are neither obtained nor posted.

General Journal					Page 1
Date	Description	Post. Ref.	Debit	Credit	
July 25	Accounts Payable, Thomas Auto Purchases Returns and Allowances	212/√	700		
	Returned used car for credit; invoice date 7/11	513		700	
July 26	Sales Returns and Allowances Accounts Receivable, Maxwell Gertz	413	35		
	Allowance for faulty tire	114/√		35	

© Cengage Learning 2014

Notice that the entries include a debit or a credit to a controlling account (Accounts Payable or Accounts Receivable). The name of the customer or supplier also is given here. When this kind of debit or credit is made to a controlling account in the general ledger, the entry must be posted twice: once to the controlling account and once to the individual account in the subsidiary ledger. This procedure keeps the subsidiary ledger equal to the controlling account. Notice that the July 26 transaction is posted by a debit to Sales Returns and Allowances in the general ledger (shown by the account number 413), a credit to the Accounts Receivable controlling account in the general ledger (account number 114), and a credit to the Maxwell Gertz account in the accounts receivable subsidiary ledger (check mark).

## Key Terms

**cash payments journal** 257  
**cash receipts journal** 254  
**controlling account** 249

**purchases journal** 252  
**sales journal** 249  
**special-purpose journals** 249

**subsidiary ledger** 249

## Chapter Assignments

### PROBLEMS

#### Cash Receipt and Cash Payments Journals

##### GENERAL LEDGER

- ✓ 1: Total cash receipts: \$23,340
- ✓ 1: Total cash payments: \$17,012

**P1.** Kimball Company is a small retail business that uses a manual data processing system similar to the one described in the chapter. Among its special-purpose journals are multicolumn cash receipts and cash payments journals. The cash transactions for Kimball Company during the month of November follow.

- Nov. 1 Paid November rent to R. Carello, \$1,000, with check no. 782.
- 3 Paid Stavos Wholesale on account, \$2,300 less a 2 percent discount, check no. 783.
- 4 Received payment on account of \$1,000, within the 2 percent discount period, from J. Walker.
- 5 Cash sales, \$2,632.
- 8 Paid Moving Freight on account, \$598, with check no. 784.
- 9 The owner, Fred Kimball, invested an additional \$10,000 in cash and a truck valued at \$14,000 in the business.
- 11 Paid Escobedo Supply on account, \$284, with check no. 785.
- 14 Cash sales, \$2,834.
- 15 Paid Moving Freight \$310 for the freight on a shipment of merchandise received today, with check no. 786.
- 16 Paid Ludman Company on account, \$1,600 less a 2 percent discount, with check no. 787.
- 17 Received payment on account from P. Sivula, \$120.
- 18 Cash sales, \$1,974.
- 19 Received payment on a note receivable, \$1,800 plus \$36 interest.
- 20 Purchased office supplies from Escobedo Supply, \$108, with check no. 788.



- Nov. 21 Paid a note payable in full to Kenington Bank, \$4,100 including \$100 interest, with check no. 789.
- 24 Cash sales, \$2,964.
- 25 Paid \$500 less a 2 percent discount to Stavos Wholesale, with check no. 790.
- 26 Paid sales clerk Tracy Dye \$1,100 for her monthly salary, with check no. 791.
- 27 Purchased equipment from Standard Corporation for \$16,000, paying \$4,000 with check no. 792 and signing a note payable for the difference.
- 30 Fred Kimball withdrew \$1,200 from the business, using check no. 793.

**REQUIRED**

1. Enter these transactions in the cash receipts and cash payments journals.
2. Foot and crossfoot the journals.
3. **ACCOUNTING CONNECTION** ► If a manager wanted to know the total sales for the accounting period, where else would the manager need to refer to obtain the data needed?

**Purchases and General Journals**

**P2.** Meloon Lawn Supply Company uses a multicolumn purchases journal and a general journal similar to those illustrated in the text. The company also maintains an accounts payable subsidiary ledger. The items that follow represent the company's credit transactions for the month of July.

- July 2 Purchased merchandise from Diego Fertilizer Company, \$2,640.
- 3 Purchased office supplies of \$166 and store supplies of \$208 from Laronne Supply, Inc.
- 5 Purchased cleaning equipment from Whitman Company, \$1,856.
- 7 Purchased display equipment from Laronne Supply, Inc., \$4,700.
- 10 Purchased lawn mowers from Brandon Lawn Equipment Company, for resale, \$8,400 (which included transportation charges of \$350).
- 14 Purchased merchandise from Diego Fertilizer Company, \$3,444.
- 18 Purchased a lawn mower from Brandon Lawn Equipment Company to be used in the business, \$950 (which included transportation charges of \$70).
- 23 Purchased store supplies from Laronne Supply, Inc., \$54.
- 27 Returned a defective lawn mower purchased on July 10 for full credit, \$750.

**REQUIRED**

1. Enter the preceding transactions in the purchases journal and the general journal. Assume that all terms are n/30 and that invoice dates are the same as the transaction dates. Use Page 1 for all references.
2. Foot and crossfoot the purchases journal.
3. Open the following general ledger accounts: Store Supplies (116), Office Supplies (117), Lawn Equipment (142), Display Equipment (144), Cleaning Equipment (146), Accounts Payable (211), Purchases (611), Purchases Returns and Allowances (612), and Freight In (613). Open accounts payable subsidiary ledger accounts as needed. Post from the journals to the ledger accounts.

**Comprehensive Use of Special-Purpose Journals**

**P3.** Ye Olde Book Store opened its doors for business on May 1. During May, the following transactions took place:

- May 1 Linda Berrill began the business by depositing \$42,000 in the new company's bank account.
- 3 Issued check no. C001 to Remax Rentals for one month's rent, \$1,000.
- 4 Received a shipment of books from Chassman Books, Inc., invoice dated May 3, terms 5/10, n/60, FOB shipping point, \$15,680.

*(Continued)*

SPREADSHEET

GENERAL LEDGER

✓ 2: Total accounts payable in purchases journal: \$22,418

SPREADSHEET

GENERAL LEDGER

✓ 5: Total sales in sales journal: \$3,652  
 ✓ 5: Total accounts payable in purchases journal: \$34,748  
 ✓ 5: Total cash receipts: \$75,428  
 ✓ 5: Total cash disbursements: \$34,882  
 ✓ 7: Total debits in trial balance: \$91,616

- May 5 Received a bill for freight from Menden Shippers for the previous day's shipment, terms n/30, \$790.
- 6 Received a shipment from Lakeside Books, invoice dated May 6, terms 2/10, n/30, FOB shipping point, \$11,300.
- 7 Issued check no. C002 to Pappanopoulos Freight for transportation charges on the previous day's shipment, \$574.
- 8 Issued check no. C003 to Yun Chao Equipment Company for store equipment, \$10,400.
- 9 Sold books to Midtown Center, terms 5/10, n/30, invoice no. 1001, \$1,564.
- 10 Returned books to Chassman Books, Inc., for credit, \$760.
- 11 Issued check no. C004 to WCAM for radio commercials, \$235.
- 12 Issued check no. C005 to Chassman Books, Inc., for balance of amount owed less discount.
- 13 Cash sales for the first two weeks, \$4,018. (For this problem, cash sales are recorded every two weeks, not daily as they are in actual practice.)
- 14 Issued check no. C006 to Lakeside Books, \$6,000 less discount.
- 15 Signed a 90-day, 10 percent note for a bank loan and received \$20,000 in cash.
- 15 Sold books to Steve Oahani, terms n/30, invoice no. 1002, \$260.
- 16 Issued a credit memorandum to Midtown Center for returned books, \$124.
- 17 Received full payment from Midtown Center of balance owed less discount.
- 18 Sold books to Missy Porter, terms n/30, invoice no. 1003, \$194.
- 19 Received a shipment from Perspectives Publishing Company, invoice dated May 18, terms 5/10, n/60, \$4,604.
- 20 Returned additional books purchased on May 4 to Chassman Books, Inc., for credit at gross price, \$1,436.
- 21 Sold books to Midtown Center, terms 5/10, n/30, invoice no. 1004, \$1,634.
- 23 Received a shipment from Chassman Books, Inc., invoice dated May 19, terms 5/10, n/60, FOB shipping point, \$2,374.
- 24 Issued check no. C007 to Menden Shippers for balance owed on account plus shipping charges of \$194 on previous day's shipment.
- 27 Cash sales for the second two weeks, \$7,488.
- 29 Issued check no. C008 to Payroll for salaries for first four weeks of the month, \$1,400.
- 30 Issued check no. C009 to WXAM for radio commercials, \$235.
- 31 Cash sales for the last four days of the month, \$554.

**REQUIRED**

1. Prepare a sales journal, a multicolumn purchases journal, a cash receipts journal, a cash payments journal, and a general journal. Use Page 1 for all journal references.
2. Open the following general ledger accounts: Cash (111), Accounts Receivable (112), Store Equipment (141), Accounts Payable (211), Notes Payable (212), Linda Ber-rill, Capital (311), Sales (411), Sales Discounts (412), Sales Returns and Allowances (413), Purchases (511), Purchases Discounts (512), Purchases Returns and Allowances (513), Freight In (514), Salaries Expense (611), Advertising Expense (612), and Rent Expense (613).
3. Open accounts receivable subsidiary ledger accounts for Midtown Center, Steve Oahani, and Missy Porter.
4. Open accounts payable subsidiary ledger accounts for Chassman Books, Inc.; Lake-side Books; Menden Shippers; and Perspectives Publishing Company.
5. Enter the transactions in the journals and post as appropriate.
6. Foot and crossfoot the journals, and make the end-of-month postings.
7. Prepare a trial balance of the general ledger and prove the control balances of Accounts Receivable and Accounts Payable by preparing schedules of accounts receivable and accounts payable.

# CHAPTER 7

## Inventories

### BUSINESS INSIGHT

#### Grabs Company

Grabs Company is a new store that sells a variety of stylish leather boots and bags. Because Grabs is a merchandising company, inventory is an important component of its total assets. The decisions that Darcy Ming, the company's owner, makes about how to account for inventory can have a significant impact on its operating results. Darcy has several decisions to make, including which inventory system and costing method to use, how to value inventory, and how much inventory to keep in stock.

- 1. CONCEPT** ► *Why is the relationship between accrual accounting and valuation important for inventory accounting?*
- 2. ACCOUNTING APPLICATION** ► *How would Grabs account for merchandising inventory using (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method under periodic and perpetual inventory systems?*
- 3. BUSINESS APPLICATION** ► *How do decisions about inventory valuation and inventory levels affect operating results?*

### LEARNING OBJECTIVES

- LO 1** Explain the concepts underlying inventory accounting.
- LO 2** Calculate inventory cost under the periodic inventory system using various costing methods.
- LO 3** Explain the effects of inventory costing methods on income determination and income taxes.
- LO 4** Calculate inventory cost under the perpetual inventory system using various costing methods.
- LO 5** Use the retail method and gross profit method to estimate the cost of ending inventory.
- LO 6** Evaluate inventory level, and demonstrate the effects of inventory misstatements on income measurement.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Accrual accounting (matching rule)
- Valuation
- Conservatism
- Disclosure

## RELEVANT LEARNING OBJECTIVE

- LO 1** Explain the concepts underlying inventory accounting.

## LO 1 Concepts Underlying Inventory Accounting

For any company that makes or sells merchandise, inventory is an extremely important asset. Managing this asset requires not only protecting goods from theft or loss, but also ensuring that operations are highly efficient. Further, as you will see in this chapter, proper accounting for inventory is essential because misstatements will affect net income in at least two years.

Inventory is considered a current asset because a company normally sells it within a year or within its operating cycle. For a merchandising company like **CVS** or **Walgreens**, inventory consists of all goods owned and held for sale in the regular course of business. Because manufacturing companies like **Toyota** are engaged in making products, they have three kinds of inventory:

- Raw materials (goods used in making products)
- Work in process (partially completed products)
- Finished goods ready for sale

In a note to its financial statements, Toyota showed the following breakdown of its inventories (figures are in millions):<sup>1</sup>

Inventories	2011	2010
Raw materials (includes supplies)	\$ 4,457	\$ 3,634
Work in process	2,626	2,142
Finished goods	8,602	9,512
Total inventories	<u>\$15,685</u>	<u>\$15,288</u>

The work in process and the finished goods inventories have three cost components:

- Cost of the raw materials that go into the product
- Cost of the labor used to convert the raw materials to finished goods
- Overhead costs that support the production process

Overhead costs include the costs of indirect materials (such as packing materials), indirect labor (such as the salaries of supervisors), factory rent, depreciation of plant assets, utilities, and insurance.

## Accrual Accounting and Valuation of Inventories

The primary objective of **inventory accounting** is to apply *accrual accounting* to the determination of cost of inventory sold during the accounting period. *Valuation* of inventories is usually at cost. **Inventory cost** includes the following:

- Invoice price less purchases discounts
- Freight-in, including insurance in transit
- Applicable taxes and tariffs

Other costs—for ordering, receiving, and storing—should, in principle, be included in inventory cost. In practice, however, it is so difficult to allocate such costs to specific inventory items that they are usually considered expenses of the period.

Inventory *valuation* depends on the prices of goods, which usually vary during the year. A company may have purchased identical lots of merchandise at different prices. Also, for identical items, it is often impossible to tell which have been sold and which are still in inventory. Thus, it is necessary to make an assumption about the order in which



items have been sold. Because the assumed order of sale may or may not be the same as the actual order of sale, the assumption is really about the *flow of costs* rather than the *flow of physical inventory*.

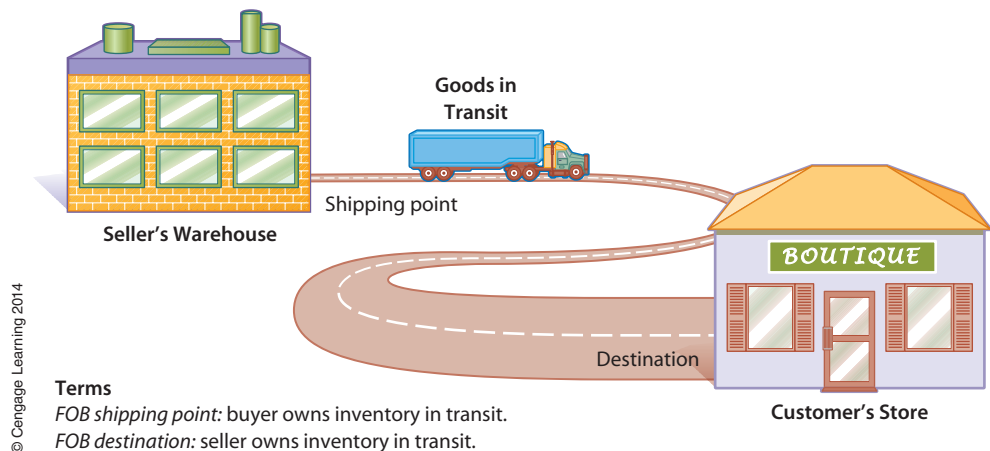
## Goods Flows and Cost Flows

**STUDY NOTE:** The assumed flow of inventory costs does not have to correspond to the physical flow of goods.

**Goods flow** refers to the actual physical movement of goods in the operations of a company. **Cost flow** refers to the association of costs with their *assumed* flow. The assumed cost flow may or may not be the same as the actual goods flow. A difference arises because several choices of assumed cost flow are available under generally accepted accounting principles. In fact, it is sometimes preferable to use an assumed cost flow that bears no relationship to goods flow because it results in a better estimate of income, which is the main goal of inventory accounting.

**Merchandise in Transit** Because merchandise inventory includes all items that a company owns and holds for sale, the status of any merchandise in transit, whether the company is selling it or buying it, must be evaluated to see if the merchandise should be included in the inventory count. Neither the seller nor the buyer has *physical* possession of merchandise in transit. As Exhibit 1 shows, ownership is determined by the terms of the shipping agreement, which indicate when title passes. Outgoing goods shipped FOB (free on board) destination are included in the seller’s merchandise inventory, whereas those shipped FOB shipping point are not. Conversely, incoming goods shipped FOB shipping point are included in the buyer’s merchandise inventory, but those shipped FOB destination are not.

**Exhibit 1**  
Merchandise in Transit



**Merchandise Not Included in Inventory** At the time a company takes a physical inventory, it may have merchandise to which it does not hold title. For example, it may have sold goods but not yet delivered them to the buyer, but because the sale has been completed, title has passed to the buyer. Thus, the merchandise should be included in the buyer’s inventory, not the seller’s. Goods held on consignment also fall into this category. A **consignment** is merchandise that its owner (the consignor) places on the premises of another company (the consignee) with the understanding that payment is expected only when the merchandise is sold and that unsold items may be returned to the consignor. Title to consigned goods remains with the consignor until the consignee sells the goods. Consigned goods should not be included in the consignee’s physical inventory.

## Conservatism and the Lower-of-Cost-or-Market (LCM) Rule

Although cost is usually the most appropriate *valuation* basis, inventory may at times be properly shown in the financial statements at less than its historical, or original, cost. If



## International Perspective

IFRS

### Is “Market” the Same as Fair Value Under IFRS?

When the lower-of-cost-or-market rule is used, what does “market” mean? Under international financial reporting standards (IFRS), market is considered fair value, which is defined as the amount at which an asset can be sold. However, in valuing inventory under U.S. standards, market is normally considered the replacement cost, or the amount at which an identical asset can be purchased. The two “market” values, selling price and purchasing price, can often be quite different for the same asset. This is an issue that will have to be addressed if the U.S. and international standards are to achieve convergence.

**STUDY NOTE:** Cost must be determined by one of the inventory costing methods before it can be compared with the market value.

the market value of inventory falls below its historical cost because of physical deterioration, obsolescence, or decline in price level, a loss has occurred. This loss is recognized by writing the inventory down to **market**—that is, to its current replacement cost. For a merchandising company, market is the amount that it would pay at the present time for the same goods, purchased from the usual suppliers and in the usual quantities.

When the replacement cost of inventory falls below its historical cost (as determined by an inventory costing method), the **lower-of-cost-or-market (LCM) rule** requires that the inventory be written down to the lower value and that a loss be recorded. This rule is an example of the *conservatism* concept because the loss is recognized before an actual transaction takes place. It is also an application of conservatism because, if the replacement cost rises, no gain is recognized and the inventory remains at cost until it is sold. According to an AICPA survey, approximately 80 percent of large companies apply the LCM rule to their inventories for financial reporting.<sup>2</sup>

## Disclosure of Inventory Methods

The *disclosure* concept requires that companies disclose their inventory methods, including the use of LCM, in the notes to their financial statements. For example, **Toyota** discloses its use of the lower-of-cost-or-market method in this note to its financial statements:

*Inventories are valued at cost, not in excess of market, cost being determined on the “average cost” basis....<sup>3</sup>*

## Summary of Inventory Decisions

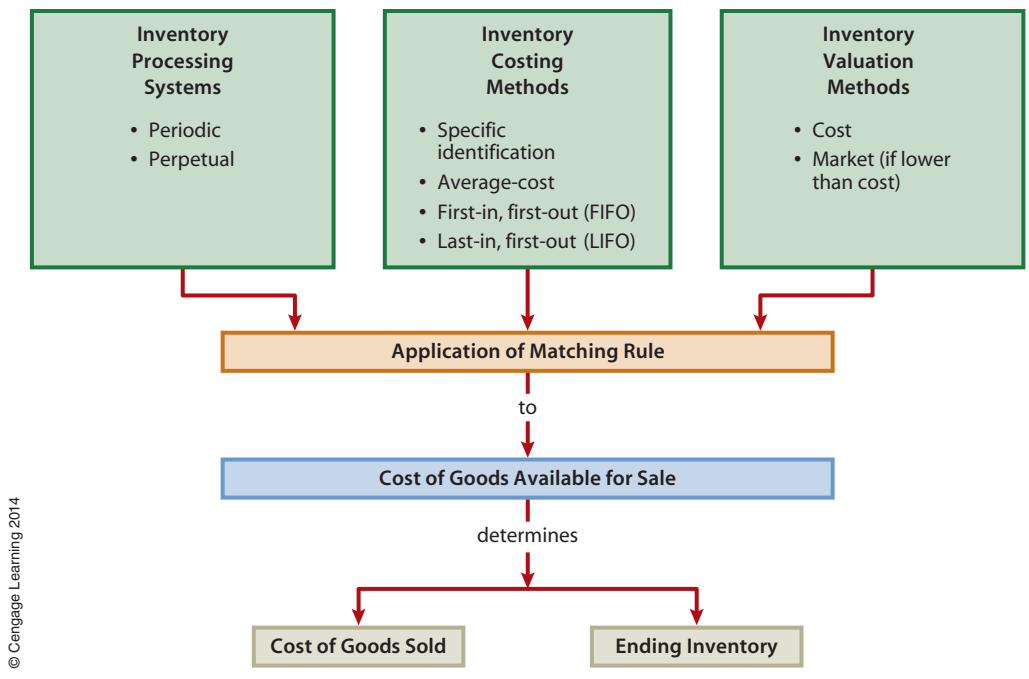
**STUDY NOTE:** Management considers the behavior of inventory costs over time when selecting inventory costing methods.

As you can see in Exhibit 2, in accounting for inventory, management must choose among different processing systems, costing methods, and *valuation* methods. These different systems and methods usually result in different amounts of reported net income. Thus, management’s choices affect investors’ and creditors’ evaluations of a company, as well as the internal performance reviews on which bonuses and executive compensation are based.

The *consistency* concept requires that once a company has decided on the accounting systems and methods it will use for inventory, it must use them from one period to the next. When a change is justifiable, the *full disclosure convention* requires that the company clearly describes the change and its effects in the notes to the financial statements.

Because the *valuation* of inventory affects income, it can have a large impact on the income taxes a company pays—and the taxes it pays can impact its cash flows. Federal income tax regulations are specific about the valuation methods a company may use. As a result, management is sometimes faced with the dilemma of how to apply GAAP to income determination and still minimize income taxes.

**Exhibit 2**  
Management Choices in Accounting for Inventories



## APPLY IT!

Match each lettered item or convention that follows with its related numbered item.

- a. An inventory cost
- b. An assumption used in the valuation of inventory
- c. Full disclosure convention
- d. Conservatism convention
- e. Consistency convention
- f. Not an inventory cost or assumed flow

- 1. Cost of consigned goods
- 2. A note to the financial statements explaining inventory policies
- 3. Application of the LCM rule
- 4. Goods flow
- 5. Transportation charge for merchandise shipped FOB shipping point
- 6. Cost flow
- 7. Choosing a method and sticking with it
- 8. Transportation charge for merchandise shipped FOB destination

### SOLUTION

1. f; 2. c; 3. d; 4. b; 5. a;  
6. b; 7. e; 8. f

### TRY IT! SE1, E1A, E1B



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Calculate inventory cost under the periodic inventory system using:
  - Specific identification method
  - Average-cost method
  - First-in, first-out (FIFO) method
  - Last-in, first-out (LIFO) method
- Calculate inventory cost under the perpetual inventory system using:
  - Specific identification method
  - Average-cost method
  - First-in, first-out (FIFO) method
  - Last-in, first-out (LIFO) method
- Use the retail method to estimate the cost of ending inventory
- Use the gross profit method to estimate the cost of ending inventory

## RELEVANT LEARNING OBJECTIVES

**LO 2** Calculate inventory cost under the periodic inventory system using various costing methods.

**LO 3** Explain the effects of inventory costing methods on income determination and income taxes.

**LO 4** Calculate inventory cost under the perpetual inventory system using various costing methods.

**LO 5** Use the retail method and gross profit method to estimate the cost of ending inventory.

## LO 2 Inventory Cost Under the Periodic Inventory System

The value assigned to the ending inventory is the result of two measurements: quantity and cost. Under the periodic inventory system, quantity is determined by taking a physical inventory. Cost is determined by using one of the following methods, each based on an assumption of cost flow:

- Specific identification method
- Average-cost method
- First-in, first-out (FIFO) method
- Last-in, first-out (LIFO) method

If the prices of merchandise purchased never changed, inventory methods would be unnecessary. However, because prices do change, assumptions must be made about the order in which goods are sold. The choice of method depends on the nature of the business, the financial effects, and the cost of implementation.

To illustrate how each method is used under the periodic inventory system, we use Boilen Company. The following data for April, a month in which prices were rising, are available:

April	1	Inventory	160 units @ \$10.00	\$ 1,600
	6	Purchase	440 units @ \$12.50	5,500
	25	Purchase	400 units @ \$14.00	5,600
		Goods available for sale	1,000 units	\$12,700
		Sales	560 units	
		On hand April 30	440 units	

The problem of inventory costing is to divide the cost of the goods available for sale (\$12,700) between the 560 units sold and the 440 units on hand.

### Specific Identification Method

The **specific identification method** identifies the cost of each item in the ending inventory. It can be used only when it is possible to identify the units as coming from specific purchases. For instance, if Boilen's April 30 inventory consisted of 100 units from the April 1 inventory, 200 units from the April 6 purchase, and 140 units from the April 25 purchase, the specific identification method would assign the costs as follows.

<i>Periodic Inventory System—Specific Identification Method</i>			
100 units @ \$10.00	\$1,000	Cost of goods available for sale	\$12,700
200 units @ \$12.50	2,500		
140 units @ \$14.00	1,960		
<u>440 units at a cost of</u>	<u>\$5,460</u>	← Less April 30 inventory	<u>5,460</u>
		Cost of goods sold	<u>\$ 7,240</u>

Although the specific identification method may appear logical, most companies do not use it for the following reasons:

- It is usually impractical, if not impossible, to keep track of the purchase and sale of individual items.
- When a company deals in items that are identical but bought at different prices, deciding which items were sold becomes arbitrary. If the company were to use the

specific identification method, it could raise or lower income by choosing the lower- or higher-priced items.

## Average-Cost Method

Under the **average-cost method** (or *weighted average method*), inventory is priced at the average cost of the goods available for sale during the period. Average cost is computed as follows.

$$\text{Average Cost} = \frac{\text{Total Cost of Goods Available for Sale}}{\text{Total Units Available for Sale}}$$

This gives an average unit cost that is applied to the units in the ending inventory. For Boilen, the ending inventory would be \$5,588, or \$12.70 per unit, determined as follows.

<b>Periodic Inventory System—Average-Cost Method</b>	
Cost of Goods Available for Sale ÷ Units Available for Sale = Average Unit Cost	
\$12,700 ÷ 1,000 units = \$12.70	
Ending inventory: 440 units @ \$12.70	= \$ 5,588
Cost of goods available for sale	\$12,700
Less April 30 inventory	<u>5,588</u>
Cost of goods sold	<u>\$ 7,112</u>

The average-cost method tends to level out the effects of cost increases and decreases because the cost of the ending inventory is influenced by all the prices paid during the year and by the cost of the beginning inventory. Some analysts, however, believe that recent costs are more relevant for income measurement and decision making.

## First-In, First-Out (FIFO) Method

**STUDY NOTE:** Because of their perishable nature, some products, such as milk, require a physical flow of first-in, first-out. However, the inventory method used to account for them can be based on an assumed cost flow that differs from FIFO, such as average-cost or LIFO.

The **first-in, first-out (FIFO) method** assumes that the costs of the first items acquired should be assigned to the first items sold. The costs of the goods on hand at the end of a period are assumed to be from the most recent purchases, and the costs assigned to goods that have been sold are assumed to be from the earliest purchases. Any business, regardless of its goods flow, can use the FIFO method because the assumption underlying it is based on the flow of costs, not the flow of goods. For Boilen, the FIFO method would result in an ending inventory of \$6,100, computed as follows.

<b>Periodic Inventory System—FIFO Method</b>	
400 units @ \$14.00 from purchase of April 25	\$ 5,600
40 units @ \$12.50 from purchase of April 6	<u>500</u>
440 units at a cost of	<u>\$ 6,100</u>
Cost of goods available for sale	\$12,700
Less April 30 inventory	<u>6,100</u>
Cost of goods sold	<u>\$ 6,600</u>

Thus, the FIFO method values the ending inventory at the most recent costs and includes earlier costs in the cost of goods sold.

- ▲ During periods of rising prices, FIFO yields the highest possible amount of net income because the cost of goods sold shows the earliest costs incurred, which are lower during periods of inflation. Another reason for this is that businesses tend to raise selling prices as costs increase, even when they purchased the goods before the cost increase.
- ▼ In periods of declining prices, FIFO tends to charge the older and higher prices against revenues, thus reducing income. Consequently, a major criticism of FIFO is that it magnifies the effects of the business cycle on income.

## Last-In, First-Out (LIFO) Method

The **last-in, first-out (LIFO) method** of costing inventories assumes that the costs of the last items purchased should be assigned to the first items sold and that the cost of the ending inventory should reflect the cost of the goods purchased earliest. Under LIFO, Boilen's April 30 inventory would be \$5,100, computed as follows.

### Periodic Inventory System—LIFO Method

160 units @ \$10.00 from April 1 inventory	\$ 1,600
280 units @ \$12.50 from purchase of April 6	3,500
440 units at a cost of	\$ 5,100
Cost of goods available for sale	\$12,700
Less April 30 inventory	5,100
Cost of goods sold	\$ 7,600

The effect of LIFO is to value inventory at the earliest prices and to include the cost of the most recently purchased goods in the cost of goods sold. The logical argument for LIFO is that a certain size of inventory is necessary in a going concern. When inventory is sold, it must be replaced with more goods. The supporters of LIFO reason that the fairest determination of income occurs if the current costs of merchandise are matched against current sales prices, regardless of which physical units of merchandise are sold. When prices are moving either up or down, the cost of goods sold will, under LIFO, show costs closer to the price level at the time the goods are sold. Thus, the LIFO method tends to show a smaller net income during inflationary times and a larger net income during deflationary times than other methods of inventory *valuation*. The peaks and valleys of the business cycle tend to be smoothed out.

An argument can also be made against LIFO. Because the inventory *valuation* on the balance sheet reflects earlier prices, it often gives an unrealistic picture of the inventory's current value. Balance sheet measures like working capital and current ratio may be distorted and must be interpreted carefully.

**STUDY NOTE:** Physical flow under LIFO can be likened to the changes in a gravel pile as the gravel is sold. As the gravel on top leaves the pile, more is purchased and added to the top. The gravel on the bottom may never be sold.

**STUDY NOTE:** In inventory valuation, the flow of costs—and hence income determination—is more important than the physical movement of goods and balance sheet valuation.



## International Perspective

IFRS

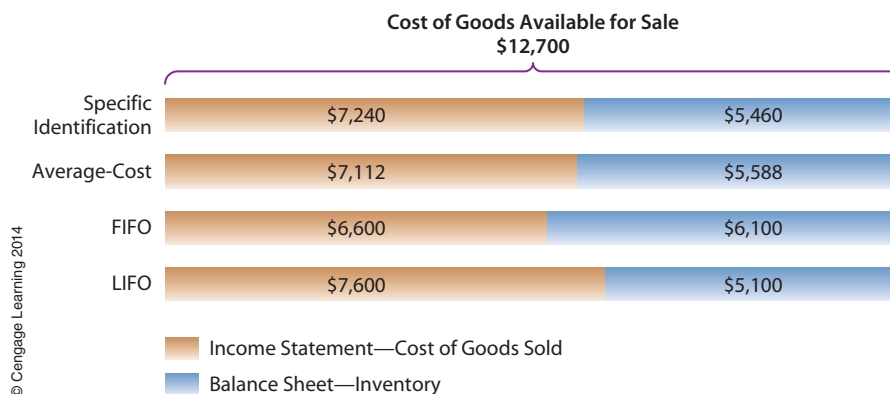
### Achieving Convergence of Inventory Methods Will Be Difficult

Achieving convergence in inventory methods between U.S. and international accounting standards will be very difficult. While, LIFO is the second most popular inventory method in the United States, outside the United States, very few companies use LIFO because it is not allowed under international financial reporting standards (IFRS). Furthermore, U.S. companies may use different inventory methods for different portions of their inventory as long as there is proper *disclosure*; but international standards only allow this practice in very limited cases. Also, as noted earlier in the chapter, U.S. and international standards have different ways of measuring the “market” value of inventories. Because these differences are so significant, the FASB and IASB have decided not to pursue convergence with regard to inventories at this time.<sup>4</sup>

## Summary of Inventory Costing Methods

Exhibit 3 summarizes how the four inventory costing methods affect the cost of goods sold and inventory when a company uses the periodic inventory system. In periods of rising prices, FIFO yields the highest inventory *valuation*, the lowest cost of goods sold, and hence a higher net income. LIFO yields the lowest inventory valuation, the highest cost of goods sold, and thus a lower net income.

### Exhibit 3 The Impact of Costing Methods on the Income Statement and Balance Sheet Under the Periodic Inventory System



## APPLY IT!

Using the data that follows and the periodic inventory system, determine the cost of goods sold associated with the sale on May 6 under the following methods: (a) average-cost, (b) FIFO, and (c) LIFO.

### Inventory Data—April 30

May 1	Inventory	100 units @ \$4.00
5	Purchase	200 units @ \$5.00
	Sales in May	250 units

### SOLUTION

a. Average-cost method:

100 units × \$4	\$ 400
200 units × \$5	1,000
300 units	<u>\$1,400</u>
$\$1,400 \div 300 = \$4.67^*$ per unit	
Cost of goods sold = 250 units × \$4.67* =	<u>\$1,168*</u>

\*Rounded

b. FIFO method:

100 units × \$4	\$ 400
150 units × \$5	750
Cost of goods sold	<u>\$1,150</u>

c. LIFO method:

200 units × \$5	\$1,000
50 units × \$4	200
Cost of goods sold	<u>\$1,200</u>

**TRY IT! SE2, SE3, SE4, SE5, E2A, E3A, E2B, E3B**

### LO 3 Impact of Inventory Decisions

Continuing with the Boilen Company example and assuming Boilen had April sales of \$10,000, Exhibit 4 shows how the specific identification, average-cost, FIFO, and LIFO methods of pricing inventory affect gross margin. Differences in gross margin will affect net income to the same extent.

**Exhibit 4**  
Effects of Inventory Costing  
Methods on Gross Margin

	Specific Identification Method	Average-Cost Method	FIFO Method	LIFO Method
Sales	\$10,000	\$10,000	\$10,000	\$10,000
Cost of goods sold				
Beginning inventory	\$ 1,600	\$ 1,600	\$ 1,600	\$ 1,600
Purchases	11,100	11,100	11,100	11,100
Cost of goods available for sale	\$12,700	\$12,700	\$12,700	\$12,700
Less ending inventory	5,460	5,588	6,100	5,100
Cost of goods sold	\$ 7,240	\$ 7,112	\$ 6,600	\$ 7,600
Gross margin	\$ 2,760	\$ 2,888	\$ 3,400	\$ 2,400

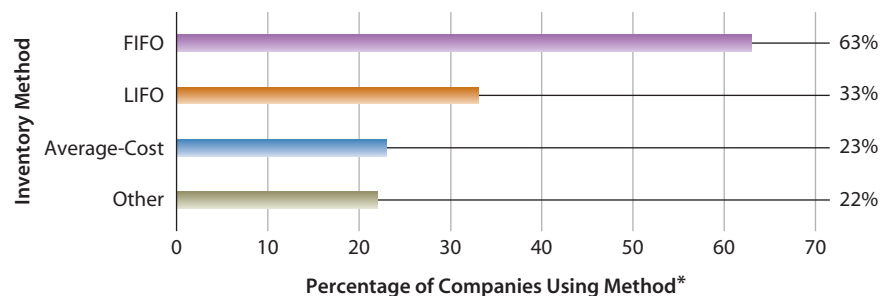
© Cengage Learning 2014

Keeping in mind that April was a period of rising prices, Exhibit 4 shows that LIFO, which charges the most recent—and, for Boilen, the highest—prices to the cost of goods sold, resulted in the lowest gross margin. Conversely, FIFO, which charges the earliest—and, in this case, the lowest—prices to the cost of goods sold, produced the highest gross margin. The gross margin under the average-cost method falls between the gross margins produced by LIFO and FIFO. During a period of declining prices, the LIFO method would produce a higher gross margin than the FIFO method because the cost of goods sold would be lower, thus the higher gross margin. Both methods have the greatest impact on gross margin during prolonged periods of price changes, whether up or down.

### Effects on the Financial Statements

As Exhibit 5 shows, the FIFO, LIFO, and average-cost methods are widely used. Each method has its advantages and disadvantages. Among the factors managers should consider in choosing an inventory costing method are the trend of prices and the effects of each method on financial statements, income taxes, and cash flows.

**Exhibit 5**  
Inventory Costing Methods  
Used by 500 Large Companies



\*Totals more than 100% due to use of more than one method.

Source: "Industry Costing Methods Used by 500 Large Companies." Copyright © 2011 by AICPA. Reproduced with permission.

As noted, inventory costing methods have different effects on the income statement and balance sheet. The LIFO method is best suited for the income statement because it *matches* revenues and the cost of goods sold. But it is not the best method for *valuing*

inventory on the balance sheet, particularly during a prolonged period of price increases or decreases. FIFO, on the other hand, is well suited to the balance sheet because the ending inventory is closest to current values, thus giving a more realistic view of a company's current assets.

## Effects on Income Taxes

The Internal Revenue Service governs how inventories must be valued for federal income tax purposes. IRS regulations give companies a wide choice of inventory costing methods, including specific identification, average-cost, FIFO, and LIFO. Except when companies use the LIFO method, they may use the lower-of-cost-or-market rule. However, if a company wants to change the *valuation* method it uses for income tax purposes, it must have advance approval from the IRS.\* This requirement conforms to the *consistency convention*. A company should change its inventory method only if there is a good reason to do so. The company must show the nature and effect of the change in its financial statements.

Many accountants believe that using the FIFO and average-cost methods in periods of rising prices causes businesses to overstate their profit, resulting in excess income tax. Profit is overstated because the cost of goods sold is understated relative to current prices. Thus, the company must buy replacement inventory at higher prices, and at the same time pay income taxes. During periods of rapid inflation, billions of dollars reported as profits and paid in income taxes were believed to be the result of the poor matching of current costs and revenues under the FIFO and average-cost methods. Consequently, many companies, believing that prices would continue to rise, switched to the LIFO inventory method. When a company uses the LIFO method for tax purposes, the IRS requires that it use the same method in its accounting records.

**STUDY NOTE:** In periods of rising prices, LIFO results in lower net income and lower taxes.

Over a period of rising prices, a business that uses the LIFO method may find that its inventory is valued at a figure far below what it currently pays for the same items. Management must monitor such a situation carefully. If it lets the inventory quantity at year end fall below the level at the beginning of the year, the company will pay higher income taxes. Higher income before taxes results because the company expenses the historical costs of inventory, which are below current costs.

When sales have reduced inventories below the levels set in prior years, it is called a **LIFO liquidation**—that is, units sold exceed units purchased for the period. Managers can prevent a LIFO liquidation by making enough purchases before the end of the year to restore the desired inventory level. Sometimes, however, a LIFO liquidation cannot be avoided because products are discontinued or supplies are interrupted, as in the case of a strike. In a recent year, 28 out of 500 large companies reported a LIFO liquidation in which their net income increased due to the matching of historical costs with present sales dollars.<sup>5</sup>



## Effects on Cash Flows

Generally speaking, a company's choice of average cost, FIFO, or LIFO does not affect cash flows. However, the choice of inventory method will affect the amount of income tax paid. Therefore, choosing a method that results in lower income will result in lower income taxes. In most other cases where there is a choice of accounting method, a company may choose different methods for income tax computations and financial reporting.

\*A single exception to this rule is that when companies change to LIFO from another method, they do not need advance approval from IRS.



**APPLY IT!**

Match the following inventory costing methods with the related statements:

(a) Average cost, (b) FIFO, or (c) LIFO

1. In periods of rising prices, this method results in the highest cost of goods sold.
2. In periods of rising prices, this method results in the highest income.
3. In periods of rising prices, this method results in the lowest ending inventory cost.
4. In periods of rising prices, this method results in the lowest income tax.
5. In periods of decreasing prices, this method results in neither the highest inventory cost nor the lowest income.
6. In periods of decreasing prices, this method results in the lowest income.
7. In periods of decreasing prices, this method results in the highest cost of goods sold.
8. In periods of decreasing prices, this method results in the lowest income tax.

**SOLUTION**

1. c; 2. b; 3. c; 4. c; 5. a; 6. b;  
7. b; 8. b

**TRY IT! SE6, E4A, E5A, E4B, E5B**

## **LO 4** Inventory Cost Under the Perpetual Inventory System

Under the perpetual inventory system, inventory is updated as purchases and sales take place. The cost of goods sold is accumulated as sales are made and costs are transferred from the Inventory account to the Cost of Goods Sold account. The cost of the ending inventory is the balance of the Inventory account. Goods are valued using one of the following inventory costing methods: specific identification, average-cost, first-in, first-out (FIFO), or last-in, first-out (LIFO). To illustrate costing methods under the perpetual inventory system, we continue with the Boilen Company example. The following data for April, a month in which prices were rising, are available:

### **Inventory Data—April 30**

April 1	Inventory	160 units @ \$10.00
6	Purchase	440 units @ \$12.50
10	Sale	560 units
25	Purchase	400 units @ \$14.00
30	Inventory	440 units

**STUDY NOTE:** The specific identification method produces the same inventory cost and cost of goods sold under the perpetual system as under the periodic system because the cost of goods sold and the ending inventory are based on the cost of the identified items sold and on hand.

## **Specific Identification Method**

The detailed records of purchases and sales maintained under the perpetual system facilitate the use of the specific identification method. For instance, if Boilen's April 30 inventory consisted of 100 units from the April 1 inventory, 200 units from the April 6 purchase, and 140 units from the April 25 purchase, the specific identification method would assign the costs as follows.

### **Perpetual Inventory System—Specific Identification Method**

100 units @ \$10.00	\$1,000	Cost of goods available for sale	\$12,700
200 units @ \$12.50	2,500		
140 units @ \$14.00	1,960		
<u>440 units at a cost of</u>	<u>\$5,460</u>	← Less April 30 inventory	<u>5,460</u>
		Cost of goods sold	<u>\$ 7,240</u>



## Average-Cost Method

Under the perpetual system, an average is computed after each purchase or series of purchases, as follows.

April 1	Inventory	160 units @ \$10.00	\$ 1,600	
6	Purchase	440 units @ \$12.50	5,500	
6	Balance	600 units @ \$11.83*	\$ 7,100	
				(new average computed)
10	Sale	560 units @ \$11.83*	(6,625)	
10	Balance	40 units @ \$11.83*	\$ 475	
25	Purchase	400 units @ \$14.00	5,600	
30	Inventory	440 units @ \$13.81*	\$ 6,075	
				(new average computed)
	Cost of goods sold		\$ 6,625	

\*Rounded

**STUDY NOTE:** The average-cost method produces different results under the perpetual and periodic systems. Under the periodic system, the average cost is computed for all goods available for sale during the period.

The costs applied to sales become the cost of goods sold, \$6,625. The ending inventory is the balance, \$6,075.

## FIFO Method

When costing inventory with the FIFO and LIFO methods, it is necessary to keep track of the components of inventory because, as sales are made, the costs must be assigned in the proper order. The FIFO method is applied as follows.

April 1	Inventory	160 units @ \$10.00	\$ 1,600	
6	Purchase	440 units @ \$12.50	5,500	
10	Sale	160 units @ \$10.00	\$(1,600)	
		400 units @ \$12.50	(5,000)	(6,600)
10	Balance	40 units @ \$12.50	\$ 500	
25	Purchase	400 units @ \$14.00	5,600	
30	Inventory	40 units @ \$12.50	\$ 500	
		400 units @ \$14.00	5,600	\$ 6,100
	Cost of goods sold			\$ 6,600



## Business Perspective

### More Companies Enjoy LIFO!

The availability of better technology may partially account for the increasing use of LIFO in the United States. Using the LIFO method under the perpetual inventory system has always been a tedious process, especially if done manually. The development of faster and less expensive computer systems has made it easier for companies that use the perpetual inventory system to switch to LIFO and enjoy its economic benefits.

## LIFO Method

The LIFO method is applied as follows.

April 1	Inventory	160 units @ \$10.00		\$ 1,600
6	Purchase	440 units @ \$12.50		5,500
10	Sale	440 units @ \$12.50	\$(5,500)	
		120 units @ \$10.00	(1,200)	(6,700)
10	Balance	40 units @ \$10.00		\$ 400
25	Purchase	400 units @ \$14.00		5,600
30	Inventory	40 units @ \$10.00	\$ 400	
		400 units @ \$14.00	5,600	\$ 6,000
	Cost of goods sold			\$ 6,700

**STUDY NOTE:** The LIFO method produces different results under the perpetual and periodic systems. Under the perpetual method system, the cost of good sold is computed after each sale during the period rather than for all sales.

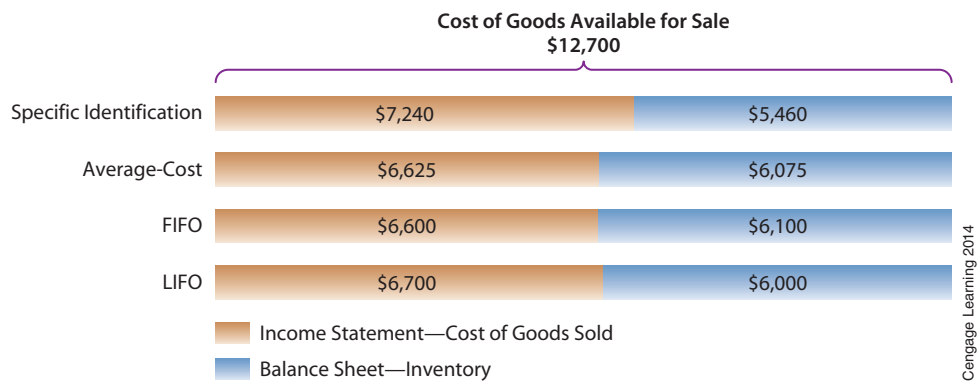
The ending inventory of \$6,000 includes 40 units from the beginning inventory and 400 units from the April 25 purchase.

## Summary of Inventory Costing Methods

Exhibit 6 compares the specific identification, average-cost, FIFO, and LIFO methods under the perpetual inventory system for Boilen. In this period of rising prices, FIFO produces the highest inventory value and lowest cost of goods sold, and LIFO produces the lowest inventory cost and highest cost of goods sold. The average-cost method is in between. Specific identification is the same as under the periodic inventory system.

**STUDY NOTE:** The rank of the results is the same as under the periodic inventory system, but some amounts have changed.

**Exhibit 6**  
The Impact of Costing Methods on the Income Statement and Balance Sheet Under the Perpetual Inventory System



© Cengage Learning 2014

**APPLY IT!**

Using the data that follows and the perpetual inventory system, determine the cost of goods sold associated with the sale on May 6 under the following methods: (a) average-cost, (b) FIFO, and (c) LIFO.

**Inventory Data—April 30**

May 1	Inventory	120 units @ \$8.00
5	Purchase	200 units @ \$10.00
6	Sale	220 units

**SOLUTION**

a. Average-cost method:

120 units × \$8	\$ 960
200 units × \$10	2,000
<u>320 units</u>	<u>\$2,960</u>
$\$2,960 \div 320 = \$9.25$ per unit	
Cost of goods sold = 220 units × \$9.25 =	<u>\$2,035</u>

b. FIFO method:

120 units × \$8	\$ 960
100 units × \$10	1,000
Cost of goods sold	<u>\$1,960</u>

c. LIFO method:

200 units × \$10	\$2,000
20 units × \$8	160
Cost of goods sold	<u>\$2,160</u>

**TRY IT! SE7, SE8, SE9, E6A, E7A, E6B, E7B****LO 5 Valuing Inventory by Estimation**

It is sometimes necessary or desirable to estimate the value of the ending inventory. The retail method and gross profit method are most commonly used for this purpose.

**Retail Method**

The **retail method** estimates the cost of the ending inventory by using the ratio of cost to retail price. Retail merchandising businesses use this method for two main reasons:

- To prepare financial statements for each period, the retail method can be used to estimate the cost without taking the time or going to the expense of determining the cost of each item in the inventory.
- Because items in a retail store normally have a price tag or a universal product code, it is common practice to take the physical inventory “at retail” from these price tags or codes and to reduce the total value to cost by using the retail method. *At retail* means the amount of the inventory at the marked selling prices of the items.

When the retail method is used, the records must show the beginning inventory at cost and at retail. They must also show the amount of goods purchased during the period at cost and at retail. The net sales at retail is the balance of the Sales account less returns and allowances. A simple example of the retail method is shown in Exhibit 7.

As shown in Exhibit 7, goods available for sale is determined at cost and at retail by listing the beginning inventory and net purchases for the period at cost and at their expected selling price, adding freight-in to the Cost column, and totaling. The ratio of these two amounts (cost to retail price) provides an estimate of the cost of each dollar of retail sales value. The estimated ending inventory at retail is then determined, as shown in Exhibit 7, by deducting sales for the period from the retail price of the goods that were available for sale during the period. The inventory at retail is then converted to cost on the basis of the ratio of cost to retail.

The cost of the ending inventory can also be estimated by applying the ratio of cost to retail price to the total retail value of the physical count of the ending inventory.

**STUDY NOTE:** When estimating inventory by the retail method, the inventory need not be counted.

**Exhibit 7**  
Retail Method of  
Inventory Estimation

	Cost	Retail
Beginning inventory	\$ 80,000	\$110,000
Net purchases for the period (excluding freight-in)	214,000	290,000
Freight-in	6,000	
Goods available for sale	<u>\$300,000</u>	<u>\$400,000</u>
Ratio of cost to retail price:	$\frac{\$300,000}{\$400,000} = 75\%$	
Net sales during the period		<u>320,000</u>
Estimated ending inventory at retail		<u>\$ 80,000</u>
Ratio of cost to retail		75%
Estimated cost of ending inventory	\$ 60,000	

© Cengage Learning 2014

**STUDY NOTE:** Freight-in does not appear in the Retail column because retailers automatically price their goods high enough to cover freight charges.

Applying the retail method in practice is often more difficult than this simple example because of such complications as changes in retail price during the period, different markups on different types of merchandise, and varying volumes of sales for different types of merchandise.

## Gross Profit Method

The **gross profit method** (or *gross margin method*) assumes that the ratio of gross margin for a business remains relatively stable from year to year. The gross profit method is used in place of the retail method when records of the retail prices of the beginning inventory and purchases are not available. It is a useful way of estimating the amount of inventory lost or destroyed by theft, fire, or other hazards. Insurance companies often use it to verify loss claims. The gross profit method is acceptable for estimating the cost of inventory for interim reports, but it is not acceptable for valuing inventory in the annual financial statements.

As Exhibit 8 shows, the gross profit method involves the following steps:

- **Step 1.** Calculate the cost of goods available for sale in the usual way (add purchases to beginning inventory).
- **Step 2.** Estimate the cost of goods sold by deducting the estimated gross margin of 30 percent from sales.
- **Step 3.** Deduct the estimated cost of goods sold from the goods available for sale to arrive at the estimated cost of the ending inventory.

**Exhibit 8**  
Gross Profit Method of  
Inventory Estimation

Step 1. Beginning inventory at cost		\$100,000
Purchases at cost (including freight-in)		<u>580,000</u>
Cost of goods available for sale		\$680,000
Step 2. Less estimated cost of goods sold		
Sales at selling price	\$800,000	
Less estimated gross margin		
(\$800,000 × 30%)	<u>240,000</u>	
Estimated cost of goods sold		<u>560,000</u>
Step 3. Estimated cost of ending inventory		<u>\$120,000</u>

© Cengage Learning 2014

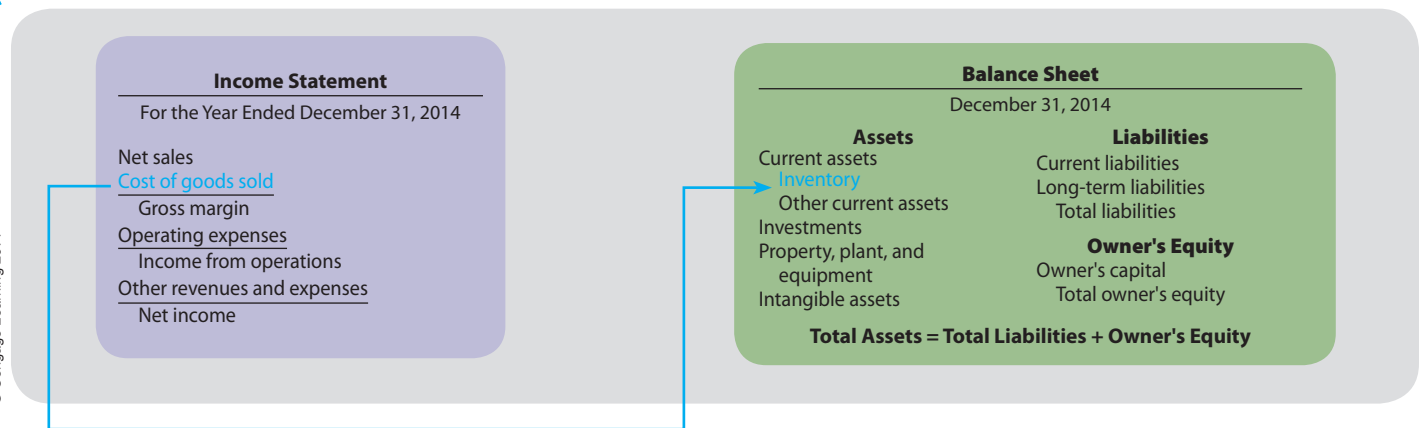
## Inventory and the Financial Statements

Cost of goods sold is created by the transfer from the balance sheet the cost of the inventories sold to the income statement during the period. The amount of the transfer depends on the *valuation* of inventories using one of the methods illustrated in this chapter. The transfer is depicted in Exhibit 9.

**Exhibit 9**

Valuation of Inventory on the Balance Sheet Impacts  
Cost of Goods Sold on the Income Statement

© Cengage Learning 2014



## APPLY IT!

Tommy's Vintage Shop had net retail sales of \$195,000 during the current year. The following additional information was obtained from the company's accounting records:

	At Cost	At Retail
Beginning inventory	\$ 40,000	\$ 60,000
Net purchases (excluding freight-in)	130,000	210,000
Freight-in	5,500	

Using the retail method, estimate the company's ending inventory at cost. Assuming that a physical count taken at year-end revealed an inventory of \$66,000 at retail value, what is the estimated amount of inventory shrinkage (loss due to theft, damage, etc.) at cost using the retail method?

### SOLUTION

	Cost	Retail
Beginning inventory	\$ 40,000	\$ 60,000
Net purchases for the period (excluding freight-in)	130,000	210,000
Freight-in	5,500	
Goods available for sale	<u>\$175,500</u>	<u>\$270,000</u>

$$\text{Ratio of cost to retail price} = \frac{\$175,500}{\$270,000} = 65\%$$

Net sales during the period		195,000
Estimated ending inventory at retail		<u>\$ 75,000</u>
Ratio of cost to retail	65%	
Estimated cost of ending inventory	\$ 48,750	

$$\begin{aligned} \text{Estimated Inventory Loss} &= \text{Estimated Cost} - (\text{Retail Inventory Count} \times 65\%) \\ &= \$48,750 - (\$66,000 \times 65\%) = \$48,750 - \$42,900 \\ &= \$5,850 \end{aligned}$$

**TRY IT! SE10, E8A, E9A, E8B, E9B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Evaluate the level of inventory
  - Inventory turnover
  - Days' inventory on hand
- Manage the level of inventory
  - Supply-chain management
  - Just-in-time operating environment
- Evaluate the effects of inventory misstatements on income measurement

## RELEVANT LEARNING OBJECTIVE

- LO 6** Evaluate inventory level, and demonstrate the effects of inventory misstatements on income measurement.

## LO 6 Management Issues Related to Inventory

The ability to control inventory levels is a critical skill in managing a business. Further, misstatements in *valuing* inventory will have significant effects on reported net income and income taxes.

### Evaluating the Level of Inventory

The level of inventory a company maintains has important economic consequences, and it involves conflicting goals. One goal is to have a great variety and quantity of goods on hand so that customers have a choice and do not have to wait for an item to be restocked. But this goal conflicts with the goal of controlling costs, which favors keeping the level of inventory low. Handling and storage costs and the interest cost of the funds needed to maintain high inventory levels are usually substantial. Some of the costs of carrying inventory are insurance, property tax, and storage costs. Other costs may result from spoilage and theft. However, low inventory levels can result in disgruntled customers and lost sales. Managers control inventory by closely observing two ratios: inventory turnover and days' inventory on hand.

**Inventory Turnover** **Inventory turnover** is the average number of times a company sells an amount equal to its average level of inventory during a period. For example, using **Nike's** annual report, we can compute the company's inventory turnover for 2011 as follows (figures are in millions).

## RATIO

### Inventory Turnover: How Many Times Did the Company Sell Its Inventory During an Accounting Period?

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

$$\text{Nike Inventory Turnover} = \frac{\$11,354}{(\$2,715 + \$2,041) \div 2}$$

$$= \frac{\$11,354}{\$2,378} = 4.8 \text{ times}$$



Based on Bizmin Industry Financial Report, December 2011.



**Days' Inventory on Hand** Days' inventory on hand is the average number of days it takes a company to sell an amount equal to its average inventory. It is computed using the inventory turnover. For Nike, it is computed as follows.

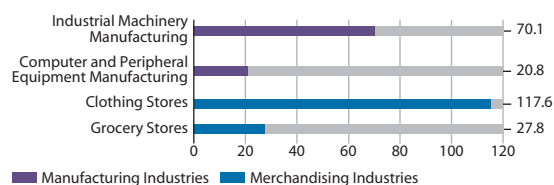
**STUDY NOTE:** Inventory turnover will be systematically higher if year-end levels are low. For example, many merchandisers' year-end is in January when inventories are lower than at any other time of the year.

**RATIO**

**Days' Inventory on Hand: How Many Days Did It Take the Company to Sell Its Inventory?**

$$\text{Days' Inventory on Hand} = \frac{365}{\text{Inventory Turnover}}$$

$$\text{Nike Days' Inventory on Hand} = \frac{365}{4.8} = 76 \text{ days}$$



Based on Bizmin Industry Financial Report, December 2011.

Harley-Davidson uses a just-in-time operating environment when producing its legendary motorcycles—often with only 8 to 10 hours of inventory on hand. A lack of supply can therefore shut down assembly lines, so the company is careful when considering where to source parts because of the longer lead times and customs delays that can occur.



Hupeng/Dreamstime

Nike turned its inventory over 4.8 times in 2011 or, on average, about every 76 days. Thus, on average, products are held in inventory for almost three months before being sold. Until the products are sold, Nike either has to tie up its own money or obtain outside financing.

**Inventory Management**

To reduce their levels of inventory, many merchandisers and manufacturers use supply-chain management in conjunction with a just-in-time operating environment. With **supply-chain management**, a company uses the Internet to order and track goods that it needs immediately. A **just-in-time (JIT) operating environment** is one in which goods arrive just at the time they are needed.

Nike uses supply-chain management to increase inventory turnover. It manages its inventory purchases through business-to-business transactions that it conducts over the Internet. It also uses a JIT operating environment in which it works closely with suppliers to coordinate and schedule shipments. Thus, Nike has less money tied up in inventory and its cost of carrying inventory is reduced.





## Business Perspective

### A Whirlwind Inventory Turnover—How Does Dell Do It?

**Dell Computer Corporation** turns its inventory over every 10 days. How can it do this when other computer companies have inventory on hand for 60 days or even longer? Technology and good inventory management are a big part of the answer.

Dell's speed from order to delivery sets the standard for the computer industry. Consider that a computer ordered by 9 A.M. can be delivered the next day by 9 P.M. How can Dell do this when it does not start ordering components and assembling computers until a customer places an order? First, Dell's suppliers keep components warehoused just minutes from Dell's factories, making efficient, just-in-time operations possible. Dell also saves time by sending an e-mail message for some finished products to a shipper, such as **United Parcel Service**, and the shipper picks up the product from a supplier and schedules it to arrive with the PC. In addition to contributing to a high inventory turnover, this practice saves Dell in freight costs. Dell is showing the world how to run a business in the cyber age by selling more than \$39 million worth of computers a day on its website.<sup>6</sup>

© Allia / iStockphoto.com

## Effects of Inventory Misstatements on Income Measurement

The reason inventory accounting is so important to income measurement is the way income is measured. Recall that gross margin is the difference between net sales and the cost of goods sold, and that the cost of goods sold depends on the portion of the cost of goods available for sale assigned to the ending inventory. These relationships lead to the following conclusions:

- The higher the value of the ending inventory, the lower the cost of goods sold and the higher the gross margin.
- Conversely, the lower the value of the ending inventory, the higher the cost of goods sold and the lower the gross margin.

Because the amount of gross margin has a direct effect on net income, the value assigned to the ending inventory also affects net income. In effect, the value of the ending inventory determines what portion of the cost of goods available for sale is assigned to the cost of goods sold and what portion is assigned to inventory.

The basic issue in separating goods sold and goods not sold is to assign a value to the goods not sold, the ending inventory. The goods not assigned to the ending inventory are used to determine the cost of goods sold. Because the figures for the ending inventory and the cost of goods sold are related, a misstatement in the inventory figure at the end of a period will cause an equal misstatement in gross margin and income before income taxes. The amount of assets and owner's equity will be misstated by the same amount.

**Inventory Misstatements and Fraud** Inventory is particularly susceptible to fraudulent financial reporting. For example, it is easy to overstate or understate inventory by including end-of-the-year purchase and sales transactions in the wrong fiscal year or by simply misstating inventory by mistake. A misstatement can also occur because of deliberate manipulation of operating results motivated by a desire to enhance the market's perception of the company, obtain bank financing, or achieve compensation incentives.

In one case, **Rite Aid Corporation**, the large drugstore chain, falsified income by manipulating its computerized inventory system to cover losses from shoplifting, employee theft, and spoilage.<sup>7</sup> In another case, bookkeepers at **Rent-Way, Inc.**, which rents furniture to apartment dwellers, boosted income artificially over several years by overstating inventory in small increments.<sup>8</sup>

**Inventory Misstatements Illustrated** Whatever the causes of an overstatement or understatement of inventory, the three examples that follow illustrate the effects. In each case, the beginning inventory, the net cost of purchases, and the cost of goods available for sale are stated correctly. In Example 1, the ending inventory is correctly stated; in Example 2, it is overstated by \$3,000; and in Example 3, it is understated by \$3,000.

Example 1. Ending Inventory Correctly Stated at \$5,000			
<b>Cost of Goods Sold for the Year</b>		<b>Income Statement for the Year</b>	
Beginning inventory	\$ 6,000	Net sales	\$50,000
Net cost of purchases	29,000	Cost of goods sold	30,000
Cost of goods available for sale	\$35,000	Gross margin	\$20,000
Ending inventory	5,000	Operating expenses	16,000
Cost of goods sold	\$30,000	Income before income taxes	\$ 4,000

Example 2. Ending Inventory Overstated by \$3,000			
<b>Cost of Goods Sold for the Year</b>		<b>Income Statement for the Year</b>	
Beginning inventory	\$ 6,000	Net sales	\$50,000
Net cost of purchases	29,000	Cost of goods sold	27,000
Cost of goods available for sale	\$35,000	Gross margin	\$23,000
Ending inventory	8,000	Operating expenses	16,000
Cost of goods sold	\$27,000	Income before income taxes	\$ 7,000

Example 3. Ending Inventory Understated by \$3,000			
<b>Cost of Goods Sold for the Year</b>		<b>Income Statement for the Year</b>	
Beginning inventory	\$ 6,000	Net sales	\$50,000
Net cost of purchases	29,000	Cost of goods sold	33,000
Cost of goods available for sale	\$35,000	Gross margin	\$17,000
Ending inventory	2,000	Operating expenses	16,000
Cost of goods sold	\$33,000	Income before income taxes	\$ 1,000

In all three examples, the cost of goods available for sale was \$35,000. The difference in income before income taxes resulted from how this \$35,000 was divided between the ending inventory and the cost of goods sold.

**STUDY NOTE:** A misstatement of inventory has the opposite effect in two successive accounting periods.

Because the ending inventory in one period becomes the beginning inventory in the following period, a misstatement in inventory *valuation* affects both the current period and the following period. Over two periods, the errors in income before income taxes will offset, or counterbalance, each other. For instance, in Example 2, the overstatement of the ending inventory will cause a \$3,000 overstatement of the beginning inventory in the following year, which will result in a \$3,000 understatement of income. Because the total income before income taxes for the two periods is the same, it may appear that one need not worry about inventory misstatements. However, the misstatements violate the *accrual accounting*. In addition, management, creditors, and investors base many decisions on the accountant’s determination of net income. The accountant has an obligation to make the net income figure for each period as useful as possible.

The effects of inventory misstatements on income before income taxes are as follows.

Year 1	Year 2
<b>Ending inventory overstated</b>	<b>Beginning inventory overstated</b>
Cost of goods sold understated	Cost of goods sold overstated
Income before income taxes overstated	Income before income taxes understated
<b>Ending inventory understated</b>	<b>Beginning inventory understated</b>
Cost of goods sold overstated	Cost of goods sold understated
Income before income taxes understated	Income before income taxes overstated

## APPLY IT!

During 2014, Tom's Sporting Goods had beginning inventory of \$500,000, ending inventory of \$700,000, and cost of goods sold of \$2,100,000. Compute the inventory turnover and days' inventory on hand.

### SOLUTION

$$\begin{aligned} \text{Inventory Turnover} &= \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}} \\ &= \frac{\$2,100,000}{(\$700,000 + \$500,000)/2} = \frac{\$2,100,000}{\$600,000} \\ &= 3.5 \text{ times} \end{aligned}$$

$$\begin{aligned} \text{Day's Inventory on Hand} &= \frac{365}{\text{Inventory Turnover}} \\ &= \frac{365}{3.5} = 104.3^* \text{ days} \end{aligned}$$

\*Rounded

**TRY IT! SE11, SE12, E10A, E11A, E12A, E10B, E11B, E12B**

## TriLevel Problem



Blue Jean Images/Alamy Limited

The beginning of this chapter focused on Grabs Company, a merchandising company facing decisions about which inventory system and costing method to use, how to value inventory, and how much inventory to keep in stock. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*Why is the relationship between accrual accounting and valuation important for inventory accounting?*

### Section 2: Accounting Applications

*How would Grabs Company account for merchandising inventory using (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method under periodic and perpetual inventory systems?*

### Grabs Company

The following data about Grabs' inventory and purchases from May are available:

	A	B	C	D	E	F	G
1				<b>Beginning Inventory and Purchases</b>			
2	<b>Date</b>			<b>Units</b>	<b>Cost</b>	<b>Total</b>	<b>Sales Units</b>
3	May	1	Inventory	2,800	\$20	\$ 56,000	
4		8	Purchase	1,200	22	26,400	
5		10	Sale				3,200
6		24	Purchase	1,600	24	38,400	
7							
8	Totals			5,600		\$120,800	3,200
9							

1. Assuming that Grabs uses the periodic inventory system, compute the cost that should be assigned to the ending inventory and to the cost of goods sold, using (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method.
2. Assuming that Grabs uses the perpetual inventory system, compute the cost that should be assigned to the ending inventory and to the cost of goods sold, using (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method.

## RATIO

**Section 3: Business Applications**

*How do decisions about inventory valuation and inventory levels affect operating results?*

To better understand the situation, compute Grab's inventory turnover and days' inventory on hand under each of the inventory cost flow assumptions in Accounting Applications requirement 1. What conclusion can you draw from this comparison?

**SOLUTION****Section 1: Concepts**

*Accrual accounting* requires that costs associated with goods that are sold be transferred from the balance sheet to cost of goods sold on the income statement. To determine what dollar amount will be transferred, one of various acceptable *valuation* methods must be chosen.

**Section 2: Accounting Applications**

	Units	Amount
Beginning inventory	2,800	\$ 56,000
Purchases	2,800	64,800
Available for sale	<u>5,600</u>	<u>\$120,800</u>
Sales	<u>3,200</u>	
Ending inventory	<u>2,400</u>	

## 1. Periodic inventory system:

## a. Average-cost method

Cost of goods available for sale	\$120,800
Less ending inventory consisting of 2,400 units at \$21.57*	<u>51,768</u>
Cost of goods sold	<u>\$ 69,032</u>

\*\$120,800 ÷ 5,600 units = \$21.57 (rounded)

## b. FIFO method

Cost of goods available for sale	\$120,800
Less ending inventory consisting of	
May 24 purchase (1,600 × \$24)	\$38,400
May 8 purchase (800 × \$22)	<u>17,600</u>
Cost of goods sold	<u>\$ 64,800</u>

## c. LIFO method

Cost of goods available for sale	\$120,800
Less ending inventory consisting of beginning inventory (2,400 × \$20)	<u>48,000</u>
Cost of goods sold	<u>\$ 72,800</u>

## 2. Perpetual inventory system:

## a. Average-cost method

Date		Units	Cost	Amount
May 1	Inventory	2,800	\$20.00	\$ 56,000
8	Purchase	1,200	22.00	26,400
8	Balance	4,000	20.60	\$ 82,400
10	Sale	(3,200)	20.60	(65,920)
10	Balance	800	20.60	\$ 16,480
24	Purchase	1,600	24.00	38,400
31	Inventory	2,400	22.87*	\$ 54,880
	Cost of goods sold			<u>\$ 65,920</u>

\*Rounded

## b. FIFO method

Date		Units	Cost	Amount
May 1	Inventory	2,800	\$20	\$ 56,000
8	Purchase	1,200	22	26,400
8	Balance	2,800	20	\$ 82,400
		1,200	22	
10	Sale	(2,800)	20	
		(400)	22	(64,800)
10	Balance	800	22	\$ 17,600
24	Purchase	1,600	24	38,400
31	Inventory	800	22	
		1,600	24	\$ 56,000
	Cost of goods sold			<u>\$ 64,800</u>

## c. LIFO method

Date		Units	Cost	Amount
May 1	Inventory	2,800	\$20	\$ 56,000
8	Purchase	1,200	22	26,400
8	Balance	2,800	20	\$ 82,400
		1,200	22	
10	Sale	(1,200)	22	
		(2,000)	20	(66,400)
10	Balance	800	20	\$ 16,000
24	Purchase	1,600	24	38,400
31	Inventory	800	20	
		1,600	24	\$ 54,400
	Cost of goods sold			<u>\$ 66,400</u>

**Section 3: Business Applications**

The decisions that Darcy Ming or any other manager makes about the evaluation of inventory affect a company's net income, the amount of taxes it pays, and its cash flows. Decisions about inventory levels also have important economic consequences: too low a level can result in disgruntled customers and too high a level can result in substantial storage, handling, and interest costs.

	Average-Cost	FIFO	LIFO
Cost of Goods Sold	\$69,032	\$64,800	\$72,800
Average Inventory	$(\$51,768 + \$56,000)/2 =$	$(\$56,000 + \$56,000)/2 =$	$(\$48,000 + \$56,000)/2 =$
	$\frac{\$69,032}{\$53,884} = 1.3$	$\frac{\$64,800}{\$56,000} = 1.2$	$\frac{\$72,800}{\$52,000} = 1.4$
Inventory Turnover:	1.3 times	1.2 times	1.4 times
Days' Inventory on Hand:	$(365 \text{ days} \div 1.3 \text{ times})$ 280.8 days*	$(365 \text{ days} \div 1.2 \text{ times})$ 304.2 days*	$(365 \text{ days} \div 1.4 \text{ times})$ 260.7 days*

\*Rounded

In periods of rising prices, the LIFO method will always result in a higher inventory turnover and lower days' inventory on hand than the other costing methods. When comparing inventory ratios for two or more companies, their inventory methods should be considered.

## Chapter Review

Explain the concepts underlying inventory accounting. **Lo 1**

Inventory cost includes the invoice price less purchases discounts; freight-in, including insurance in transit; and applicable taxes. Goods flow refers to the actual physical flow of merchandise in a business, whereas cost flow refers to the assumed flow of costs. The lower-of-cost-or-market rule states that if the replacement cost (market cost) of the inventory is lower than the original cost, the lower figure should be used.

The objective of inventory accounting is the proper determination of income through the matching of costs and revenues. Management must choose the type of processing system, costing method, and valuation method the company will use. Because the value of inventory affects a company's net income, management's choices will affect not only external and internal evaluations of the company but also the amount of income taxes the company pays and its cash flows.

Calculate inventory cost under the periodic inventory system using various costing methods. **Lo 2**

The value assigned to the ending inventory is the result of two measurements: quantity and cost. Under the periodic inventory system, quantity is determined by taking a physical inventory. Cost is determined by using one of four inventory methods, each based on a different assumption of cost flow. The specific identification method identifies the actual cost of each item in inventory. The average-cost method assumes that the cost of inventory is the average cost of goods available for sale during the period. The first-in, first-out (FIFO) method assumes that the costs of the first items acquired should be assigned to the first items sold. The last-in, first-out (LIFO) method assumes that the costs of the last items acquired should be assigned to the first items sold.

Explain the effects of inventory costing methods on income determination and income taxes. **Lo 3**

During periods of rising prices, the LIFO method will show the lowest gross margin and thus net income; FIFO, the highest; and average-cost, in between. LIFO and FIFO have the opposite effects in periods of falling prices. The Internal Revenue Service requires a company that uses LIFO for tax purposes to use LIFO in its accounting records. It also does not allow a company that uses LIFO to apply the lower-of-cost-or-market rule.

Calculate inventory cost under the perpetual inventory system using various costing methods. **Lo 4**

Under the perpetual inventory system, the cost of goods sold is accumulated as sales are made and costs are transferred from the Inventory account to the Cost of Goods Sold account. The cost of the ending inventory is the balance of the Inventory account. The specific identification method and the FIFO method produce the same results under both the perpetual and periodic inventory systems. The results differ for the average-cost method because an average is calculated after each sale rather than at the end of the accounting period. Results also differ for the LIFO method because the cost components of inventory change constantly as goods are bought and sold.



Use the retail method and gross profit method to estimate the cost of ending inventory. **LO 5**

Two methods of estimating the value of inventory are the retail method and the gross profit method. Under the retail method, inventory is determined at retail prices and is then reduced to estimated cost by applying a ratio of cost to retail price. Under the gross profit method, the cost of goods sold is estimated by reducing sales by the estimated gross margin. The estimated cost of goods sold is then deducted from the cost of goods available for sale to estimate the cost of the ending inventory.

Evaluate inventory level, and demonstrate the effects of inventory misstatements on income measurement. **LO 6**

The level of inventory has important economic consequences. To evaluate inventory levels, managers commonly use inventory turnover and its related measure, days' inventory on hand. Supply-chain management and a just-in-time operating environment are a means of increasing inventory turnover and reducing inventory carrying costs.

If the value of the ending inventory is understated or overstated, a corresponding error—dollar for dollar—will be made in income before income taxes. Furthermore, because the ending inventory of one period is the beginning inventory of the next, the misstatement affects two accounting periods, although the effects are opposite.

## Key Terms and Ratios

**average-cost method** 269 (LO2)  
**consignment** 265 (LO1)  
**cost flow** 265 (LO1)  
**first-in, first-out (FIFO) method** 269 (LO2)  
**goods flow** 265 (LO1)  
**gross profit method** 278 (LO5)  
**inventory accounting** 264 (LO1)  
**inventory cost** 264 (LO1)

**just-in-time (JIT) operating environment** 281 (LO6)  
**LIFO liquidation** 273 (LO3)  
**last-in, first-out (LIFO) method** 270 (LO2)  
**lower-of-cost-or-market (LCM) rule** 266 (LO1)  
**market** 266 (LO1)  
**retail method** 277 (LO5)

**specific identification method** 268 (LO2)  
**supply-chain management** 281 (LO6)

**RATIOS**  
**days' inventory on hand** 281 (LO6)  
**inventory turnover** 280 (LO6)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1** **DQ1. CONCEPT** ► Which is more important from the standpoint of inventory costing: accrual accounting or valuation?
- LO 2, 4** **DQ2.** Which of the following methods do not require a physical inventory: periodic inventory system, perpetual inventory method, retail method, or gross profit method?
- LO 1, 6** **DQ3. CONCEPT** ► Given that the LCM rule is an application of the conservatism convention in the current accounting period, is the effect of this application also conservative in the next period?
- LO 2, 3, 4** **DQ4.** Under what condition would all four methods of inventory pricing produce exactly the same results?
- LO 4** **DQ5.** Under the perpetual inventory system, why is the cost of goods sold not determined by deducting the ending inventory from goods available for sale, as it is under the periodic method?
- LO 6** **DQ6. BUSINESS APPLICATION** ► Is it good or bad for a retail store to have a large inventory?
- LO 6** **DQ7. BUSINESS APPLICATION** ► Why is misstatement of inventory one of the most common means of financial statement fraud?



## SHORT EXERCISES

### LO 1 Inventory Concepts

**SE1. CONCEPT** ▶ Match the items that follow with their related statements.

- |                                       |  |
|---------------------------------------|--|
| a. Inventory accounting               | 1. Refers to the association of costs with their assumed flow.                                 |
| b. Goods flow                         | 2. Has the objective of matching costs of the period against revenues for the period.          |
| c. Cost flow                          | 3. Requires that the inventory be written down to the lower value and that a loss be recorded. |
| d. Lower-of-cost-or-market (LCM) rule | 4. Refers to the actual physical movement of goods in the operations of a company.             |
| e. Valuation                          | 5. Related to the lower-of-cost-or-market (LCM) rule.  |
| f. Conservatism                       | 6. Can vary depending on the assumptions about the flow of costs.                              |

### LO 2 Specific Identification Method

**SE2.** Assume the following data with regard to inventory for Vegan Company:

Aug. 1	Inventory	40 units @ \$10 per unit	\$ 400
8	Purchase	50 units @ \$11 per unit	550
22	Purchase	35 units @ \$12 per unit	420
	Goods available for sale	125 units	<u>\$1,370</u>
Aug. 15	Sale	45 units	
28	Sale	25 units	
	Inventory, Aug. 31	<u>55 units</u>	

Assuming that the inventory consists of 30 units from the August 8 purchase and 25 units from the purchase of August 22, calculate the cost of ending inventory and cost of goods sold.

### LO 2 Average-Cost Method: Periodic Inventory System

**SE3.** Using the data in **SE2**, calculate the cost of ending inventory and cost of goods sold according to the average-cost method under the periodic inventory system. (Round final answer to the nearest dollar.)

### LO 2 FIFO Method: Periodic Inventory System

**SE4.** Using the data in **SE2**, calculate the cost of ending inventory and cost of goods sold according to the FIFO method under the periodic inventory system.

### LO 2 LIFO Method: Periodic Inventory System

**SE5.** Using the data in **SE2**, calculate the cost of ending inventory and cost of goods sold according to the LIFO method under the periodic inventory system.

### LO 3 Effects of Inventory Costing Methods and Changing Prices

**SE6.** Prepare a table with four columns that shows the ending inventory and cost of goods sold for each of the results from your calculations in **SE2** through **SE5**, including the effects of the different prices at which the merchandise was purchased. Which method(s) would result in the lowest income taxes?

### LO 4 Average-Cost Method: Perpetual Inventory System

**SE7.** Using the data in **SE2**, calculate the cost of ending inventory and cost of goods sold according to the average-cost method under the perpetual inventory system. (Round to the nearest dollar.)

**LO 4 FIFO Method: Perpetual Inventory System**

**SE8.** Using the data in **SE2**, calculate the cost of ending inventory and cost of goods sold according to the FIFO method under the perpetual inventory system.

**LO 4 LIFO Method: Perpetual Inventory System**

**SE9.** Using the data in **SE2**, calculate the cost of ending inventory and cost of goods sold according to the LIFO method under the perpetual inventory system.

**LO 5 Retail Inventory Method**

**SE10.** Blue Jeans Shop had net retail sales of \$390,000 during the current year. The following additional information was obtained from the company's accounting records:

	<b>At Cost</b>	<b>At Retail</b>
Beginning inventory	\$ 80,000	\$120,000
Net purchases		
(excluding freight-in)	260,000	420,000
Freight-in	16,400	

Using the retail method, estimate the company's ending inventory at cost. Assuming that a physical count taken at year-end revealed an inventory of \$132,000 at retail value, what is the estimated amount of inventory shrinkage (loss due to theft, damage, etc.) at cost using the retail method?

**LO 6 Management Issues**

**SE11. BUSINESS APPLICATION** ► Indicate whether each of the following items is associated with (a) allocating the cost of inventories in accordance with the accrual accounting, (b) assessing the impact of inventory decisions, (c) evaluating the level of inventory, or (d) engaging in an unethical practice:

1. Calculating days' inventory on hand.
2. Ordering a supply of inventory to satisfy customer needs.
3. Valuing inventory at an amount to achieve a specific profit objective.
4. Calculating the income tax effect of an inventory method.
5. Deciding the cost to place on ending inventory.

**LO 6 Inventory Turnover and Days' Inventory on Hand****RATIO**

**SE12. BUSINESS APPLICATION** ► During 2014, Victoria's Fashion had beginning inventory of \$480,000, ending inventory of \$560,000, and cost of goods sold of \$2,200,000. Compute the inventory turnover and days' inventory on hand. (Round to one decimal place.)

**EXERCISES: SET A****LO 1, 2, 3 Accounting Conventions and Inventory Valuation**

**E1A. CONCEPT** ► Dynamic Company, a telecommunications equipment company, has used the LIFO method adjusted for lower of cost or market for a number of years. Due to falling prices of its equipment, it has had to adjust (reduce) the cost of inventory to market each year for two years. The company is considering changing its method to FIFO adjusted for lower of cost or market in the future. Explain how the accounting conventions of consistency, full disclosure, and conservatism apply to this decision. If the change were made, why would management expect fewer adjustments to market in the future?

**LO 2 Periodic Inventory System and Inventory Costing Methods**

**E2A.** Portia's Parts Shop recorded the following purchases and sales during the past year:

Jan. 1	Beginning inventory	125 cases @ \$23	\$ 2,875
Feb. 25	Purchase	100 cases @ \$26	2,600
June 15	Purchase	200 cases @ \$28	5,600
Oct. 15	Purchase	150 cases @ \$28	4,200
Dec. 15	Purchase	100 cases @ \$30	3,000
	Goods available for sale	675	<u>\$18,275</u>
	Total sales	500 cases	
Dec. 31	Ending inventory	<u>175 cases</u>	

Assume that the company sold all of the June 15 purchase and 100 cases each from the January 1 beginning inventory, the October 15 purchase, and the December 15 purchase.

Determine the costs that should be assigned to ending inventory and cost of goods sold according to the periodic inventory method under each of the assumptions that follow. (Round to the nearest dollar and assume the periodic inventory system.)

- Costs are assigned by the specific identification method.
- Costs are assigned by the average-cost method.
- Costs are assigned by the FIFO method.
- Costs are assigned by the LIFO method.
- ACCOUNTING CONNECTION** ► What conclusions can be drawn about the effect of each method on the income statement and the balance sheet of Portia's Parts Shop?

## LO 2 Periodic Inventory System and Inventory Costing Methods

**E3A.** During its first year of operation, Lux Company purchased 5,600 units of a product at \$42 per unit. During the second year, it purchased 6,000 units of the same product at \$48 per unit. During the third year, it purchased 5,000 units at \$60 per unit. Lux managed to have an ending inventory each year of 1,000 units. The company uses the periodic inventory system.

Prepare cost of goods sold statements that compare the value of ending inventory and the cost of goods sold for each of the three years using

- the FIFO inventory costing method.
- the LIFO method.
- ACCOUNTING CONNECTION** ► From the resulting data, what conclusions can you draw about the relationships between the changes in unit price and the changes in the value of ending inventory?

## LO 2, 3 Periodic Inventory System and Inventory Costing Methods

**E4A.** In chronological order, the inventory, purchases, and sales of a single product for a recent month are as follows.

			Units	Amount per Unit
June 1	Beginning inventory		150	\$30
4	Purchase		400	33
12	Purchase		800	36
16	Sale		1,300	60
24	Purchase		300	39

- Using the periodic inventory system, compute the cost of ending inventory, cost of goods sold, and gross margin. Use the average-cost, FIFO, and LIFO inventory costing methods. (Round unit costs to cents and totals to dollars.)
- ACCOUNTING CONNECTION** ► Explain the differences in gross margin produced by the three methods.

LO 3 **Effects of Inventory Costing Methods on Cash Flows**

CASH FLOW

**E5A. ACCOUNTING CONNECTION** ► Mills, Inc., sold 120,000 cases of glue at \$20 per case during 2014. Its beginning inventory consisted of 20,000 cases at a cost of \$12 per case. During 2014, it purchased 60,000 cases at \$14 per case and, later, 50,000 cases at \$15 per case. Operating expenses were \$550,000, and the applicable income tax rate was 30 percent.

- Using the periodic inventory system, compute net income using the FIFO method and the LIFO method for costing inventory. Which alternative produces the larger cash flow?
- The company is considering a purchase of 10,000 cases at \$15 per case just before the year end. What effect on net income and on cash flow will this proposed purchase have under each method? (*Hint:* What are the income tax consequences?)

LO 4 **Perpetual Inventory System and Inventory Costing Methods**

**E6A.** Refer to the data provided in **E4A**.

- Using the perpetual inventory system, compute the cost of ending inventory, cost of goods sold, and gross margin. Use the average-cost, FIFO, and LIFO inventory costing methods. (Round unit costs to the nearest cent.)
- ACCOUNTING CONNECTION** ► Explain the reasons for the differences in gross margin produced by the three methods.

LO 2, 4 **Periodic and Perpetual Systems and Inventory Costing Methods**

**E7A.** During July 2014, Micanopy, Inc., sold 500 units of its product Empire for \$8,000. The following units were available:

	Units	Cost
Beginning inventory	200	\$ 2
Purchase 1	80	4
Purchase 2	120	6
Purchase 3	300	9
Purchase 4	180	12

A sale of 500 units was made after purchase 3. Of the units sold, 200 came from beginning inventory and 300 came from purchase 3.

Determine cost of goods available for sale and ending inventory in units. Then determine the costs that should be assigned to cost of goods sold and ending inventory under each of the following assumptions. (For each alternative, show the gross margin. Round unit costs to cents and totals to dollars.)

- Costs are assigned under the periodic inventory system using (a) the specific identification method, (b) the average-cost method, (c) the FIFO method, and (d) the LIFO method.
- Costs are assigned under the perpetual inventory system using (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method.

LO 5 **Retail Method**

**E8A.** Warmer's Dress Shop had net retail sales of \$250,000 during the current year. The following additional information was obtained from the company's accounting records:

	At Cost	At Retail
Beginning inventory	\$ 40,000	\$ 60,000
Net purchases (excluding freight-in)	140,000	220,000
Freight-in	10,400	

1. Using the retail method, estimate the company's ending inventory at cost.
2. Assume that a physical inventory taken at year end revealed an inventory on hand of \$18,000 at retail value. What is the estimated amount of inventory shrinkage (loss due to theft, damage, etc.) at cost using the retail method?

**LO 5 Gross Profit Method**

**E9A.** David Patel was at home when he received a call from the fire department telling him his store had burned. His business was a total loss. The insurance company asked him to prove his inventory loss. For the year, until the date of the fire, Patel's company had sales of \$450,000 and purchases of \$280,000. Freight-in amounted to \$13,700, and beginning inventory was \$45,000. Patel always priced his goods to achieve a gross margin of 40 percent. Compute Patel's estimated inventory loss.

**LO 6 Management Issues**

**E10A. BUSINESS APPLICATION** ► Indicate whether each of the following items is associated with (a) allocating the cost of inventories in accordance with the accrual accounting, (b) assessing the impact of inventory decisions, (c) evaluating the level of inventory, or (d) engaging in an unethical action.

1. Application of the just-in-time operating environment.
2. Determining the effects of inventory methods on income taxes.
3. Computing inventory turnover.
4. Valuing inventory at an amount to meet management's targeted net income.
5. Determining the effects of inventory decisions on cash flows.
6. Apportioning the cost of goods available for sale to ending inventory and cost of goods sold.
7. Determining the assumption about the flow of costs into and out of the company.

**LO 6 Inventory Ratios**

**RATIO**

**E11A. BUSINESS APPLICATION** ► Big Sale Stores is assessing its levels of inventory for 2013 and 2014 and has gathered the following data:

	2014	2013	2012
Ending inventory	\$192,000	\$162,000	\$138,000
Cost of goods sold	960,000	900,000	

Compute the inventory turnover and days' inventory on hand for 2013 and 2014 (round to one decimal place), and comment on the results.

**LO 6 Effects of Inventory Errors**

**E12A. BUSINESS APPLICATION** ► Necessary Toys Company's condensed income statements for two years follow.

	2014	2013
Sales	\$252,000	\$210,000
Cost of goods sold	150,000	108,000
Gross margin	\$102,000	\$102,000
Operating expenses	60,000	60,000
Income before income taxes	\$ 42,000	\$ 42,000

After the end of 2014, the company discovered that an error had resulted in an \$18,000 understatement of the 2013 ending inventory.

Compute the corrected operating income for 2013 and 2014. What effect will the error have on operating income and owner's equity for 2015?

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

LO 2, 6

RATIO

SPREADSHEET

- ✓ 1: Cost of goods available for sale: \$10,560,000
- ✓ 2c: Income before income taxes using LIFO: \$740,000

### Periodic Inventory System and Inventory Costing Methods

**P1.** Midori Company merchandises a single product called Gloss. The following data represent beginning inventory and purchases of Gloss during the past year: January 1 inventory, 68,000 units at \$11.00; February purchases, 80,000 units at \$12.00; March purchases, 160,000 units at \$12.40; May purchases, 120,000 units at \$12.60; July purchases, 200,000 units at \$12.80; September purchases, 160,000 units at \$12.60; and November purchases, 60,000 units at \$13.00. Sales of Gloss totaled 786,000 units at \$20.00 per unit. Selling and administrative expenses totaled \$5,102,000 for the year. Midori uses the periodic inventory system.

#### REQUIRED

- Prepare a schedule to compute the cost of goods available for sale.
- Compute income before income taxes under each of the following inventory cost flow assumptions: (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method. (Round cost to the nearest cent.)
- BUSINESS APPLICATION** ► Compute inventory turnover and days' inventory on hand under each of the inventory cost flow assumptions listed in requirement 2. (Round to one decimal place.) What conclusion can you draw?

LO 2, 3

CASH FLOW

SPREADSHEET

- ✓ 1: Cost of goods sold for average-cost method for April: \$19,320
- ✓ 1: Cost of goods sold for average-cost method for May: \$44,237

### Periodic Inventory System and Inventory Costing Methods

**P2.** The inventory of Wood4Fun and data on purchases and sales for a two-month period follow. The company closes its books at the end of each month. It uses the periodic inventory system.

Apr.	1	Beginning inventory	50 units @ \$204
	10	Purchase	100 units @ \$220
	17	Sale	90 units
	30	Ending inventory	60 units
May	2	Purchase	100 units @ \$216
	14	Purchase	50 units @ \$224
	22	Purchase	60 units @ \$234
	30	Sale	200 units
	31	Ending inventory	70 units

#### REQUIRED

- Compute the cost of ending inventory of Wood4Fun on April 30 and May 31 using the average-cost method. In addition, determine cost of goods sold for April and May. (Round unit costs to the nearest cent.)
- Compute the cost of the ending inventory on April 30 and May 31 using the FIFO method. In addition, determine cost of goods sold for April and May.
- Compute the cost of the ending inventory on April 30 and May 31 using the LIFO method. In addition, determine cost of goods sold for April and May.
- ACCOUNTING CONNECTION** ► Do the cash flows from operations for April and May differ depending on which inventory costing method is used—average-cost, FIFO, or LIFO? Explain.

LO 3, 4, 6

RATIO

### Perpetual Inventory System and Inventory Costing Methods

**P3.** Use the data provided in **P2**, but assume that the company uses the perpetual inventory system. (*Hint:* In preparing the solutions, it is helpful to determine the balance of



- ✓ 3: Cost of goods sold for LIFO method for April: \$19,800
- ✓ 3: Cost of goods sold for LIFO method for May: \$44,680

inventory after each transaction, as shown in the Business Insight: Concepts and Applications feature in this chapter.)

### REQUIRED

- Determine the cost of ending inventory and cost of goods sold for April and May using the average-cost method. (Round unit costs to the nearest cent.)
- Determine the cost of ending inventory and cost of goods sold for April and May using the FIFO method.
- Determine the cost of ending inventory and cost of goods sold for April and May using the LIFO method.
- BUSINESS APPLICATION** ► Assume that this company grows for many years in a long period of rising prices. How realistic do you think the balance sheet value for inventory would be and what effect would it have on the inventory turnover ratio?

### LO 5

- ✓ 3: Estimated inventory shortage at cost: \$24,208
- ✓ 3: Estimated inventory shortage at retail: \$35,600

### Retail Method

**P4.** Quester Company operates a large discount store and uses the retail method to estimate the cost of ending inventory. Management suspects that in recent weeks there have been unusually heavy losses from shoplifting or employee pilferage. To estimate the amount of the loss, the company has taken a physical inventory and will compare the results with the estimated cost of inventory. Data from Quester's accounting records follow.

	At Cost	At Retail
August 1 beginning inventory	\$205,952	\$297,200
Purchases	286,932	434,000
Purchases returns and allowances	(8,172)	(12,800)
Freight-in	3,800	
Sales		436,732
Sales returns and allowances		(3,732)
August 31 physical inventory at retail		249,800

### REQUIRED

- Using the retail method, prepare a schedule to estimate the dollar amount of the store's month-end inventory at cost.
- Use the store's cost to retail ratio to reduce the retail value of the physical inventory to cost.
- Calculate the estimated amount of inventory shortage at cost and at retail.
- ACCOUNTING CONNECTION** ► Many retail chains use the retail method because it is efficient. Why do you think using this method is an efficient way for these companies to operate?

### LO 5

- ✓ 1: Estimated loss of inventory in fire: \$326,513.50

### Gross Profit Method

**P5.** Groh Brothers is a large retail furniture company that operates in two adjacent warehouses. One warehouse is a showroom, and the other is used to store merchandise. On the night of June 22, 2014, a fire broke out in the storage warehouse and destroyed the merchandise stored there. Fortunately, the fire did not reach the showroom, so all the merchandise on display was saved.

Although the company maintained a perpetual inventory system, its records were rather haphazard, and the last reliable physical inventory had been taken on December 31. In addition, there was no control of the flow of goods between the showroom and the warehouse. Thus, it was impossible to tell what goods should have been in either place. As a result, the insurance company required an independent estimate of the amount of loss. The insurance company examiners were satisfied when they received the following information:

*(Continued)*



Merchandise inventory on December 31, 2013	\$363,700.00
Purchases, January 1 to June 22, 2014	603,050.00
Purchases returns, January 1 to June 22, 2014	(2,676.50)
Freight-in, January 1 to June 22, 2014	13,275.00
Sales, January 1 to June 22, 2014	989,762.50
Sales returns, January 1 to June 22, 2014	(7,450.00)
Merchandise inventory in showroom on June 22, 2014	100,740.00
Average gross margin	44%

**REQUIRED**

1. Prepare a schedule that estimates the amount of the inventory lost in the fire.
2. **ACCOUNTING CONNECTION** ► What are some other reasons management might need to estimate the amount of inventory?

**ALTERNATE PROBLEMS**

LO 2, 6

RATIO

SPREADSHEET

- ✓ 1: Cost of goods available for sale: \$157,980
- ✓ 1c: Income before income taxes using LIFO: \$101,850

**Periodic Inventory System and Inventory Costing Methods**

**P6.** Aberdeen Company sold 2,200 cabinets during 2014 at \$160 per cabinet. Its beginning inventory on January 1 was 130 cabinets at \$56. Purchases made during the year were as follows.

February	225 cabinets @ \$62.00
April	350 cabinets @ \$65.00
June	700 cabinets @ \$70.00
August	300 cabinets @ \$66.00
October	400 cabinets @ \$68.00
November	250 cabinets @ \$72.00

The company's selling and administrative expenses for the year were \$101,000. The company uses the periodic inventory system.

**REQUIRED**

1. Prepare a schedule to compute the cost of goods available for sale.
2. Compute income before income taxes under each of the following inventory cost flow assumptions: (a) the average-cost method, (b) the FIFO method, and (c) the LIFO method. (Round unit cost to the nearest cent, and total costs to the nearest dollar.)
3. **BUSINESS APPLICATION** ► Compute inventory turnover and days' inventory on hand under each of the inventory cost flow assumptions in requirement 2. (Round to one decimal place.) What conclusion can you draw from this comparison?

LO 2, 3

CASH FLOW

SPREADSHEET

- ✓ 1: Cost of goods sold for average-cost method for March: \$4,578
- ✓ 1: Cost of goods sold for average-cost method for April: \$10,660

**Periodic Inventory System and Inventory Costing Methods**

**P7.** DiPaolo's inventory, purchases, and sales for March and April follow. The company closes its books at the end of each month. It uses the periodic inventory system.

Mar.	1	Beginning inventory	60 units @ \$49
	10	Purchase	100 units @ \$52
	19	Sale	90 units
	31	Ending inventory	70 units
Apr.	4	Purchase	120 units @ \$53
	15	Purchase	50 units @ \$54
	23	Sale	200 units
	25	Purchase	100 units @ \$55
	30	Ending inventory	140 units

**REQUIRED**

1. Compute the cost of the ending inventory on March 31 and April 30 using the average-cost method. In addition, determine cost of goods sold for March and April. (Round unit costs to the nearest cent.)
2. Compute the cost of the ending inventory on March 31 and April 30 using the FIFO method. Also determine cost of goods sold for March and April.
3. Compute the cost of the ending inventory on March 31 and April 30 using the LIFO method. Also determine cost of goods sold for March and April.
4. **ACCOUNTING CONNECTION** ► Do the cash flows from operations for March and April differ depending on which inventory costing method is used—average-cost, FIFO, or LIFO? Explain.

LO 3, 4, 6

RATIO

- ✓ 3: Cost of goods sold for LIFO method for March: \$4,680
- ✓ 3: Cost of goods sold for LIFO method for April: \$10,560

**Perpetual Inventory System and Inventory Costing Methods**

**P8.** Use the data provided in P7, but assume that the company uses the perpetual inventory system. (*Hint:* In preparing the solutions, it is helpful to determine the balance of inventory after each transaction, as shown in the Business Insight: Concepts and Applications feature in this chapter.)

**REQUIRED**

1. Determine the cost of ending inventory and cost of goods sold for March and April using the average-cost method. (Round unit costs to the nearest cent.)
2. Determine the cost of ending inventory and cost of goods sold for March and April using the FIFO method.
3. Determine the cost of ending inventory and cost of goods sold for March and April using the LIFO method.
4. **BUSINESS APPLICATION** ► Assume that this company grows for many years in a long period of rising prices. How realistic do you think the balance sheet value for inventory would be and what effect would it have on the inventory turnover ratio?

LO 5

- ✓ 3: Estimated inventory shortage at cost: \$3,456
- ✓ 3: Estimated inventory shortage at retail: \$4,800

**Retail Method**

**P9.** Alberta Company operates a large discount store and uses the retail method to estimate the cost of ending inventory. Management suspects that in recent weeks there have been unusually heavy losses from shoplifting or employee pilferage. To estimate the amount of the loss, the company has taken a physical inventory and will compare the results with the estimated cost of inventory. Data from Alberta's accounting records follow.

	At Cost	At Retail
October 1 beginning inventory	\$184,000	\$239,200
Purchases	261,500	383,300
Purchases returns and allowances	(7,360)	(10,500)
Freight-in	2,500	
Sales		514,300
Sales returns and allowances		(2,700)
October 31 physical inventory at retail		95,600

**REQUIRED**

1. Using the retail method, prepare a schedule to estimate the dollar amount of the store's month-end inventory at cost.
2. Use the store's cost to retail ratio to reduce the retail value of the physical inventory to cost.
3. Calculate the estimated amount of inventory shortage at cost and at retail.
4. **ACCOUNTING CONNECTION** ► Many retail chains use the retail method because it is efficient. Why do you think using this method is an efficient way for these companies to operate?

## LO 5

✓ 1: Estimated loss of inventory in fire: \$1,306,054

**Gross Profit Method**

**P10.** Zubac Company is a large retail furniture company that operates in two adjacent warehouses. One warehouse is a showroom, and the other is used to store merchandise. On the night of April 22, 2014, a fire broke out in the storage warehouse and destroyed the merchandise stored there. Fortunately, the fire did not reach the showroom, so all the merchandise on display was saved.

Although the company maintained a perpetual inventory system, its records were rather haphazard, and the last reliable physical inventory had been taken on December 31. In addition, there was no control of the flow of goods between the showroom and the warehouse. Thus, it was impossible to tell what goods should have been in either place. As a result, the insurance company required an independent estimate of the amount of loss. The insurance company examiners were satisfied when they received the following information:

Merchandise inventory on December 31, 2013	\$1,454,800
Purchases, January 1 to April 22, 2014	2,412,200
Purchases returns, January 1 to April 22, 2014	(10,706)
Freight-in, January 1 to April 22, 2014	53,100
Sales, January 1 to April 22, 2014	3,959,050
Sales returns, January 1 to April 22, 2014	(29,800)
Merchandise inventory in showroom on April 22, 2014	402,960
Average gross margin	44%

**REQUIRED**

1. Prepare a schedule that estimates the amount of the inventory lost in the fire.
2. **ACCOUNTING CONNECTION** ► What are some other reasons management might need to estimate the amount of inventory?

**CASES**

## LO 2, 3

CASH FLOW

**Conceptual Understanding: LIFO Inventory Method**

**C1.** Sixty-eight percent of chemical companies use the LIFO inventory method for the costing of inventories, whereas only 13 percent of computer equipment companies use LIFO.<sup>9</sup>

Describe the LIFO inventory method. What effects does it have on reported income, cash flows, and income taxes during periods of price changes? Why do you think so many chemical companies use LIFO and most companies in the computer industry do not?

## LO 1

**Interpreting Financial Reports: LCM and Conservatism**

**C2. CONCEPT** ► **ExxonMobil Corporation**, the world's second-largest company, uses the LIFO inventory method for most of its inventories. Its inventory costs are heavily dependent on the cost of oil. When the price of oil was down, ExxonMobil, following the lower-of-cost-or-market (LCM) rule, wrote down its inventory by \$325 million. In the next year, when the price of oil recovered, the company reported that market price exceeded the LIFO carrying values by \$6.8 billion.<sup>10</sup> Explain why the LCM rule resulted in a write-down in the first year. What is the inconsistency between the first- and second-year treatments of the change in the price of oil? How does the accounting convention of conservatism explain the inconsistency? If the price of oil declined substantially in a third year, what would be the likely consequence?

## LO 2, 3

**Interpreting Financial Reports: FIFO and LIFO**

**C3. ExxonMobil Corporation** had net income of \$41.0 billion in 2011. Inventories under the LIFO method used by the company were \$11.7 billion in 2011. Inventory

would have been \$25.6 billion higher if the company had used FIFO.<sup>11</sup> Why do you suppose ExxonMobil's management chooses to use the LIFO inventory method? On what economic conditions, if any, do those reasons depend?

LO 1, 3, 5, 6

RATIO

### Annual Report Case: Inventory Costing Methods and Ratios

**C4. BUSINESS APPLICATION** ▶ Refer to the note related to inventories in the **CVS** annual report in the Supplement to Chapter 16 to answer the following questions: What inventory method(s) does CVS use? Do you think many of the company's inventories are valued at market? Why or why not? Few companies use the retail method, so why do you think CVS uses it? Compute and compare the inventory turnover and days' inventory on hand for CVS for 2011 and 2010. Ending inventories in 2009 were \$10,343 million. (Round to one decimal place.)

LO 6

RATIO

### Comparison Analysis: Inventory Efficiency

**C5. BUSINESS APPLICATION** ▶ Refer to **CVS's** annual report in the Supplement to Chapter 16 and to the following data (in millions) for **Walgreens**: cost of goods sold, \$51,692 and \$48,444 for 2011 and 2010, respectively; inventories, \$8,044, \$7,378, and \$6,789 for 2011, 2010, and 2009, respectively.<sup>12</sup> Ending inventories for 2009 for CVS were \$10,343 million.

Calculate inventory turnover and days' inventory on hand for 2010 and 2011. (Round to one decimal place.) If you did **C4**, refer to your answer there for CVS. Has either company improved its performance in these areas over the past two years? If so, what advantage does this give the company? Which company appears to make the most efficient use of inventories? Explain your answers.

LO 6

RATIO

### Evaluation of Inventory Levels

**C6. BUSINESS APPLICATION** ▶ **JCPenney**, a large retail company with many stores, has an inventory turnover of about 3.8 times. **Dell Computer Corporation**, an Internet mail-order company, has an inventory turnover of about 36.0. Dell achieves its high turnover through supply-chain management in a just-in-time operating environment. Why is inventory turnover important to companies like JCPenney and Dell? Why are comparisons among companies important? Are JCPenney and Dell a good match for comparison? Describe supply-chain management and a just-in-time operating environment. Why are they important to achieving a favorable inventory turnover?

LO 3, 6

### Ethical Dilemma: Inventories, Income Determination, and Ethics

**C7.** Lady, Inc., whose fiscal year ends on December 31, designs and sells fashions for young professional women. Margaret Lutz, president of the company, fears that the forecasted profitability goals for 2014 will not be reached. She is pleased when Lady, Inc., receives a large order on December 30, 2014, from The Executive Woman, a retail chain of upscale stores for businesswomen. Lutz immediately directs the controller to record the sale, which represents 13 percent of Lady's annual sales. At the same time, she directs the inventory control department not to separate the goods for shipment until after January 1, 2015. Separated goods are not included in inventory because they have been sold.

On December 31, 2014, the company's auditors arrive to observe the year-end taking of the physical inventory under the periodic inventory system. How will Lutz's actions affect Lady's profitability in 2014? How will they affect Lady's profitability in 2015? Were Lutz's actions ethical? Why or why not?

### Continuing Case: Annual Report Project

RATIO

**C8.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine inventory(ies) on the balance sheet and accompanying note on inventory(ies) of your company. Answer the following questions:

*(Continued)*

1. What percentage is inventory(ies) to total current assets? Do you think this percentage represents the importance of inventory(ies) to the company's operations?
2. Find the note about inventory(ies) in the notes to the financial statements. Does the company have more than one type of inventory? If so, what are they? What method(s) are used to value inventory(ies)? What other facts, if any, are disclosed about inventory(ies) in the note?
3. **BUSINESS APPLICATION** ► Calculate inventory turnover and days' inventory on hand for the most recent two years. (Round to one decimal place.) Has the company improved its performance in these areas over the past two years?



# CHAPTER 8

## Cash and Internal Control

### BUSINESS INSIGHT

#### Sung's Grill

Sung's Grill is a popular neighborhood restaurant. Its business has increased substantially over the past year, and Emma Sung, the restaurant's owner, has had to hire more cashiers, waiters, and kitchen help. She has become concerned about possible theft of cash and food inventory, and she is looking for ways to prevent it. She is also concerned about whether the restaurant's sales and other transactions are being recorded properly. She is particularly concerned about the accuracy of the restaurant's financial statements, because she is considering applying for a bank loan so that she can open a second restaurant. To obtain a loan, she will have to present Sung's Grill's financial statements to the bank.

- 1. CONCEPT** ▶ *Why is each of the five components of internal control important to the faithful representation of a company's operations in its financial statements?*
- 2. ACCOUNTING APPLICATION** ▶ *How can Sung's Grill maintain control over its cash?*
- 3. BUSINESS APPLICATION** ▶ *How can Sung's Grill's bank and other users of its financial statements be confident that the restaurant has an adequate system of internal control?*

### LEARNING OBJECTIVES

- LO 1** Describe the components of internal control, control activities, and limitations on internal control.
- LO 2** Apply internal control activities to common merchandising transactions.
- LO 3** Define *cash equivalents*, and explain methods of controlling cash, including bank reconciliations.
- LO 4** Demonstrate the use of a simple imprest (petty cash) system.
- LO 5** Identify the internal control roles of management and the auditor.



## SECTION 1

## CONCEPTS

## CONCEPT

- Faithful representation

## RELEVANT LEARNING OBJECTIVE

- Lo 1 Describe the components of internal control, control activities, and limitations on internal control.

## Lo 1 Concepts Underlying Internal Control

It is important that a company's financial statements *faithfully represent* the company's operations. This means, for instance, that the financial statements are *free from material error*. **Internal control** is a process that achieves this goal by establishing the *reliability* of the accounting records and financial statements and ensures that the company's assets are protected.<sup>1</sup>

### The Need for Internal Controls

Buying and selling, the principal transactions of merchandising businesses, involve assets—cash, accounts receivable, and merchandise inventory—that are vulnerable to theft and embezzlement. This potential for embezzlement exists because the large number of transactions that are usually involved in a merchandising business (e.g., cash receipts, receipts on account, payments for purchases, and receipts and shipments of inventory) makes monitoring the accounting records difficult. If a merchandising company does not take steps to protect its assets, it can suffer high losses of both cash and inventory. Management's responsibility is to establish an environment, accounting systems, and internal control procedures that will protect the assets.

A company's merchandise inventory includes the following:

- all goods intended for sale regardless of where they are located—on shelves, in storerooms, in warehouses, or in trucks between warehouses and stores
- goods in transit from suppliers if title to the goods has passed to the merchandiser

Ending inventory does not include the following:

- merchandise that a company has sold but not yet delivered to customers
- goods that it cannot sell because they are damaged or obsolete

Taking a **physical inventory** facilitates control over merchandise inventory. This process involves an actual count of all merchandise on hand. A physical inventory must be taken under both the periodic and the perpetual inventory systems. Merchandisers usually take a physical inventory after the close of business on the last day of their fiscal year. To facilitate the process, they often end the fiscal year in a slow season, when inventories are at relatively low levels. For example, many department stores end their fiscal year in January or February. After hours—at night, on a weekend, or when the store closes for taking inventory—employees count all items and record the results on numbered inventory tickets or sheets, following procedures to ensure that no items will be missed. Using bar coding to take inventory electronically has greatly facilitated the process in many companies.

Most companies experience losses of merchandise inventory from spoilage, shoplifting, and theft. Inventory shortages can also result from honest mistakes, such as accidentally tagging inventory with the wrong number. The periodic inventory system provides no means of identifying these losses because the costs are automatically included in the cost of goods sold. For example, suppose a company has lost \$1,250 in stolen merchandise during a period. When the physical inventory is taken, the missing items are not in stock, so they cannot be counted. Because the ending inventory does not contain these items, the amount subtracted from the cost of goods available for sale is less than it would be if the goods were in stock. The cost of goods sold, then, is overstated by \$1,250.





Merchandise inventory includes all goods intended for sale wherever they are located—on store shelves, in warehouses, on car lots, or in transit from suppliers if title to the goods has passed to the merchandiser. To prevent loss of inventory, a merchandiser must have an effective system of internal control.

**STUDY NOTE:** An adjustment to the Merchandise Inventory account will be needed if the physical inventory reveals a difference between the actual inventory and the amount in the records.

The perpetual inventory system makes it easier to identify such losses. Because the Merchandise Inventory account is continuously updated for sales, purchases, and returns, the loss will show up as the difference between the inventory records and the physical inventory taken at the end of the accounting period. Once the amount of the loss has been identified, the ending inventory is updated by crediting the Merchandise Inventory account. The offsetting debit is usually an increase in Cost of Goods Sold because the loss is considered a cost that reduces the company's gross margin.

## Components of Internal Control

An effective system of internal control has five interrelated components.<sup>2</sup>

**Control Environment** The **control environment** is created by management's overall attitude, awareness, and actions. It encompasses the following:

- a company's ethics, philosophy and operating style
- organizational structure
- method of assigning authority and responsibility
- personnel policies and practices

Personnel should be qualified to handle responsibilities, which means that they must be trained and informed about what is expected of them. For example, the manager of a retail store should train employees to follow prescribed procedures for handling cash sales, credit card sales, and returns and refunds.

**Risk Assessment** **Risk assessment** involves identifying areas in which risks of loss of assets or inaccuracies in accounting records are high so that adequate controls can be implemented. Among the greater risks in a retail store are that employees or customers may steal cash or goods.

**Control Activities** The policies and procedures management puts in place to see that its directives are carried out are called **control activities**.

**Information and Communication** **Information and communication** pertains to the way the accounting system gathers and treats information about the company's transactions and to how it communicates individual responsibilities within the system.

**Monitoring** Management's regular assessment of the quality of internal control, including periodic review of compliance with all policies and procedure, is part of **monitoring**. Large companies often have a staff of internal auditors who review the system of internal control to determine if it is working properly and if procedures are being followed. In smaller businesses, owners and managers conduct these reviews.

## Control Activities

The goal of control activities is to safeguard a company's assets and ensure the reliability of its accounting records. Some standard control activities follow.

**Authorization** **Authorization** is the approval of certain transactions and activities. In a retail store, for example, cashiers customarily authorize cash sales; but other transactions, such as issuing a refund, may require a manager's approval.

**Recording Transactions** To establish accountability for assets, all transactions should be recorded. For example, if a retail store uses a cash register that records sales, refunds, and other transactions on a paper tape or computer disk, the cashier can be held accountable for the cash received and the merchandise removed during his or her shift.



## Business Perspective

### Shoplifters: Beware!

© Aljia / iStockphoto.com

With theft from shoplifting approaching \$30 billion per year, retailers are increasing their use of physical controls beyond the usual electronic warning if a customer tries to walk out without paying. Companies, such as **Macy's** and **Babies 'R' Us**, have installed more than 6 million video cameras in stores across the country. Advanced surveillance software can compare a shopper's movements between video images and recognize unusual activity. For instance, removing 10 items from a shelf or opening a drawer that normally is closed would trigger the system to alert a security guard.<sup>3</sup>

**Documents and Records** Well-designed documents help ensure that transactions are properly recorded. For example, using prenumbered invoices and other documents is a way of ensuring that all transactions are recorded.

**Physical Controls** **Physical controls** limit access to assets. For example, in a retail store, only the person responsible for the cash register should have access to it. Other employees should not be able to open the cash drawer when the cashier is not present. Similarly, only authorized personnel should have access to warehouses and storerooms. Access to accounting records, including those stored in company computers, should also be controlled.

**Periodic Independent Verification** **Periodic independent verification** means that someone other than the people responsible for the accounting records and assets should periodically check the records against the assets. For example, at the end of each shift or day in a retail store, the owner or manager should count the cash in the cash drawer and compare the amount with the amount recorded on the tape or computer disk in the cash register. Other examples of independent verification are periodic counts of physical inventory and reconciliations of monthly bank statements.

**Separation of Duties** **Separation of duties** means that no one person should authorize transactions, handle assets, and keep records of assets. For example, in a well-managed electronics store, each employee oversees only a single part of a transaction. A sales employee takes the order and creates an invoice. Another employee receives the customer's cash or credit card payment and issues a receipt. Once the customer has a receipt, and only then, a third employee obtains the item from the warehouse and gives it to the customer. A person in the accounting department subsequently compares all sales recorded in the cash register with the sales invoices and updates the inventory in the accounting records. The separation of duties means that a mistake, careless or not, cannot be made without being seen by at least one other person.

**Sound Personnel Practices:** Personnel practices that promote internal control include the following:

- adequate supervision
- rotation of key people among different jobs
- insistence that employees take vacations
- bonding of personnel who handle cash or inventory

**Bonding** is the process of carefully checking an employee's background and insuring the company against theft by that person. Bonding does not guarantee against theft, but it does prevent or reduce loss if theft occurs. Prudent personnel practices help ensure that employees know their jobs, are honest, and will find it difficult to carry out and conceal embezzlement over time.

## Internal Control and Achieving Control Objectives

A system of internal control applied effectively to merchandising transactions can achieve important management objectives. As noted, it can prevent losses of cash and inventory

due to theft or fraud, and it can ensure that records of transactions and account balances are accurate. It can also help managers achieve the following broader objectives:

- Keep enough inventory on hand to sell to customers without overstocking merchandise.
- Keep sufficient cash on hand to pay for purchases in time to receive discounts.
- Keep credit losses as low as possible by making credit sales only to customers who are likely to pay on time.

### Limitations on Internal Control

No system of internal control is without weaknesses. As long as people perform control procedures, an internal control system will be vulnerable to human error. Errors can arise from misunderstandings, mistakes in judgment, carelessness, distraction, or fatigue. Separation of duties can be defeated through collusion by employees who secretly agree to deceive a company. In addition, established procedures may be ineffective against employees' errors or dishonesty, and controls that were initially effective may become ineffective when conditions change.

In some cases, the costs of establishing and maintaining elaborate control systems may exceed the benefits. In a small business, for example, active involvement by the owner can be a practical substitute for the separation of some duties.

**STUDY NOTE:** While no control procedure can guarantee the prevention of theft, the more that are in place, the less likely it is that theft will occur.



## Business Perspective

### Which Frauds Are Most Common in Retail?

The frauds commonly facing retailers are credit card, check fraud, false invoices and phantom vendors, and expense account abuse. The most common reasons for the occurrences of these frauds are poor internal controls over cashiers, management override of internal controls, and collusion. The most common methods of detecting them are good control procedures over cash receipts at the cash register, internal auditor review, notification by a customer, and accidental discovery. Companies that are successful in preventing fraud have a good system of internal control, a formal code of ethics, and a program to monitor compliance that includes a system for reporting incidents of fraud. These companies routinely communicate the existence of the program to their employees.<sup>4</sup>

© Allija / iStockphoto.com

## APPLY IT!

Match the internal control components with the related statements that follow.

- |   |  |
|---|--|
| a. Control environment                                | 3. Has an internal audit department.                     |
| b. Risk assessment                                    | 4. Periodic independent verification of employees' work. |
| c. Control activities                                 | 5. Assesses the possibility of losses.                   |
| d. Information and communication                      | 6. Instructs and trains employees.                       |
| e. Monitoring   | 7. Has well-designed documents and records.              |
| 1. Establishes separation of duties.                  | 8. Limits physical access to authorized personnel.       |
| 2. Communicates appropriate information to employees. |  |

### SOLUTION

1. c; 2. d; 3. e; 4. c; 5. b; 6. a; 7. c; 8. c

**TRY IT! SE1, SE2, SE3, SE4, E1A, E2A, E3A, E1B, E2B, E3B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Account for merchandising transactions
- Implement control of cash
- Prepare a bank reconciliation
- Use petty cash

## RELEVANT LEARNING OBJECTIVES

**LO 2** Apply internal control activities to common merchandising transactions.

**LO 3** Define *cash equivalents*, and explain methods of controlling cash, including bank reconciliations.

**LO 4** Demonstrate the use of a simple imprest (petty cash) system.

## LO 2 Internal Control over Merchandising Transactions

It's clear that sound internal control activities are needed when assets are involved. We now turn our attention to how merchandising companies apply internal control activities to business transactions. Maintaining internal control is especially difficult for a merchandiser because management must not only establish controls for cash sales, receipts, purchases, and cash payments, but also protect its inventory. Service and manufacturing businesses use similar procedures.

One control that managers use is the cash budget, which projects future cash receipts and disbursements. By maintaining adequate cash balances, a company is able to take advantage of discounts on purchases, prepared to borrow money when necessary, and able to avoid the damaging effects of being unable to pay bills when they are due. By investing excess cash, the company can earn interest until the cash is needed.

A more specific control is the separation of duties that involve the handling of cash. Such separation makes theft without detection extremely unlikely unless two or more employees conspire. The separation of duties is easier in large businesses than in small ones, where one person may have to carry out several duties. The effectiveness of internal control over cash varies, based on the size and nature of the company. Most firms, however, should use the following procedures:

- Separate the functions of authorization, recordkeeping, and custodianship of cash.
- Limit the number of people who have access to cash, and designate who those people are.
- Bond all employees who have access to cash.
- Keep the amount of cash on hand to a minimum by using banking facilities as much as possible.
- Physically protect cash on hand by using cash registers, cashiers' cages, and safes.
- Record and deposit all cash receipts promptly, and make payments by check rather than by currency.
- Have a person who does not handle or record cash make unannounced audits of the cash on hand.
- Have a person who does not authorize, handle, or record cash transactions reconcile the Cash account each month.

Each of these procedures helps safeguard cash by making it more difficult for any one individual to steal or misuse it without being detected.



### Business Perspective

#### Are Money Market Funds Always a Safe Bet?

When companies have more cash than they need for current operations, they often earn interest on their excess cash by investing it in money market funds. Investments in money market funds have traditionally been considered safe because these funds have usually invested in very safe securities. However, in recent years, in an attempt to earn a slightly higher interest rate, a few money market funds invested in batches of subprime mortgages. This turned out to be a very poor decision. **Bank of America**, for instance, had to shut down its \$34 billion money market fund—called Columbia Strategic Cash Portfolio—when investors pulled out \$21 billion because the fund was losing a great deal of money due to its investment in subprime loans.<sup>5</sup>

© Aljia / Stockphoto.com

## Control of Cash Receipts

Cash payments for sales of goods and services can be received by mail or over the counter in the form of checks, credit or debit cards, or currency. Whatever the source of the cash, it should be recorded immediately in a cash receipts journal. Such a journal establishes a written record that should prevent errors and make theft more difficult.

**Control of Cash Received by Mail** Cash received by mail is vulnerable to theft by the employees who handle it. For that reason, companies that deal in mail-order sales generally ask customers to pay by credit card, check, or money order instead of with currency.

When cash is received in the mail, two or more employees should handle it. The employee who opens the mail should make a list in triplicate of the money received. The list should contain each customer's name, the purpose for which the money was sent, and the amount. One copy goes with the cash to the cashier, who deposits the money. The second copy goes to the accounting department for recording. The person who opens the mail keeps the third copy. Errors can be easily caught because the amount deposited by the cashier must agree with the amount received and the amount recorded in the cash receipts journal.

**STUDY NOTE:** The cashier should not be allowed to remove the cash register tape or to record the day's cash receipts.

**Control of Cash Received Over the Counter** Cash registers and prenumbered sales tickets are common tools for controlling cash received over the counter. The amount of a cash sale is rung up on the cash register at the time of the sale. The register should be placed so that the customer can see the amount recorded. Each cash register should have a locked-in tape on which it prints the day's transactions. At the end of the day, the cashier counts the cash in the register and turns it in to the cashier's office. Another employee takes the tape out of the cash register and records the cash receipts for the day in the cash receipts journal. The amount of cash turned in and the amount recorded on the tape should agree; if not, any differences must be explained.

Large retail chains like **Costco** commonly monitor cash receipts by having each cash register tied directly into a computer that records each transaction. Whether the elements are performed manually or with a computer, separating responsibility for cash receipts, cash deposits, and recordkeeping is necessary to ensure good internal control.

In some stores, internal control is further strengthened by the use of prenumbered sales tickets and a central cash register or cashier's office, where all sales are rung up and collected by a person who does not participate in the sale. The salesperson completes a prenumbered sales ticket at the time of the sale, giving one copy to the customer and keeping a copy. At the end of the day, all sales tickets must be accounted for, and the sales total computed from the sales tickets must equal the total sales recorded on the cash register.

## Control of Purchases and Cash Disbursements

Cash disbursements are particularly vulnerable to fraud and embezzlement. In one case, the treasurer of one of the nation's largest jewelry retailers was charged with stealing



### Business Perspective

#### How Do Computers Promote Internal Control?

Building good internal controls into accounting programs is a difficult challenge for computer programmers. These programs must include controls that prevent unintentional errors, as well as unauthorized access and tampering. They prevent errors through reasonableness checks (such as not allowing any transactions over a specified amount), mathematical checks that verify the arithmetic of transactions, and sequence checks that require documents and transactions to be in proper order. They typically use passwords and questions about randomly selected personal data to prevent unauthorized access to computer records. They may also use *firewalls*, which are strong electronic barriers to unauthorized access, and *data encryption*, which is a way of coding data so that if they are stolen, they are useless to the thief.



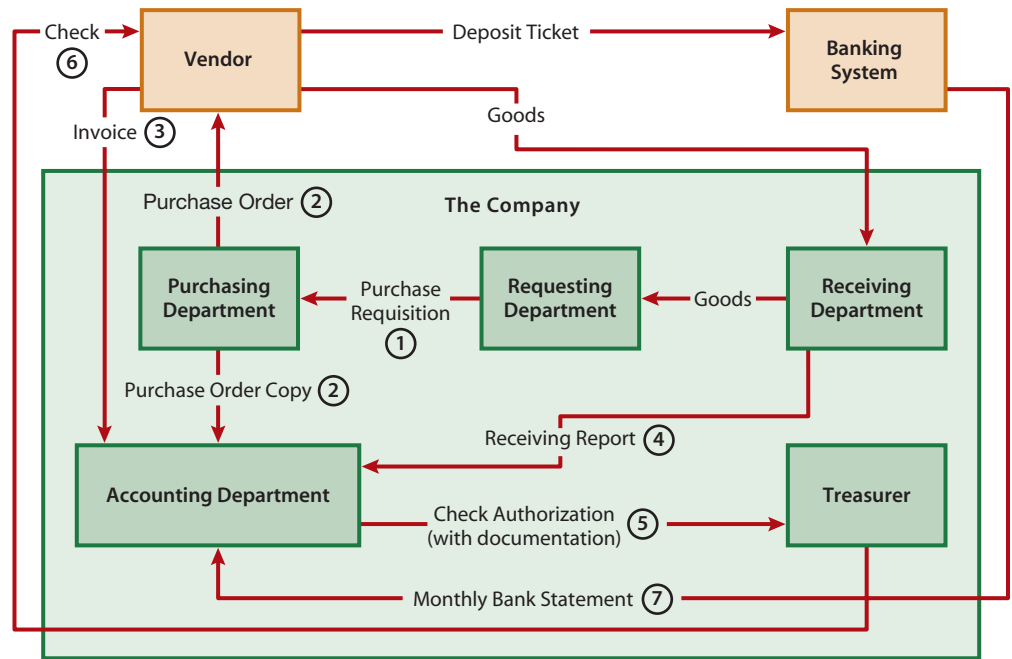
over \$500,000 by systematically overpaying the company’s federal income taxes and keeping the refund checks.

To avoid this type of theft, cash payments should be made only after they have been specifically authorized and supported by documents that establish the validity and amount of the claims. A company should also separate the duties involved in purchasing goods and services and the duties involved in paying for them. The degree of separation that is possible varies, depending on the size of the business.

Exhibit 1 shows how a large company can maximize the separation of duties. Five internal units (the requesting department, the purchasing department, the accounting department, the receiving department, and the treasurer) and two firms outside the company (the vendor and the bank) play a role in this control plan. Notice that business documents are crucial components of the plan.

**Exhibit 1**  
Internal Controls in a Large Company: Separation of Duties and Documentation

**STUDY NOTE:** Every business document must have a number for purposes of reference.



Note: Circled numbers refer to documents in Exhibit 2.

Exhibit 2 illustrates the typical sequence in which documents are used in a company’s internal control plan for purchases and cash disbursements.

**Exhibit 2**  
Internal Control Plan for Purchases and Cash Disbursements

**1 PURCHASE REQUISITION** No. 7077  
Wagon Sportswear Corporation

From: Credit Office Date: July 1, 2014  
To: Purchasing Department Suggested Vendor: Henderson Supply Company

Please purchase the following items:

Quantity	Number	Description
20 boxes	X 144	Office supplies

Reason for Request: Six months' supply for office  
To be filled in by Purchasing Department  
Date ordered 7/2/2014 P.O. No. J 102  
Approved J.P.

**2 PURCHASE ORDER** No. J 102  
Wagon Sportswear Corporation  
8428 Rocky Island Avenue  
Chicago, Illinois 60643

To: Henderson Supply Company  
2525 25th Street  
Mesa, Illinois 61611

Date: July 2, 2014  
FOB: Destination  
Ship by: July 5, 2014  
Terms: 2/10, n/30

Ship to: Laboda Sportswear Corporation  
Above Address

Please ship the following:

Quantity	✓	Number	Description	Price	Per	Amount
20 boxes		X 144	Office Supplies	260.00	box	\$5,200.00

Purchase order number must appear on all shipments and invoices.  
Ordered by Masha Owen

**3 INVOICE** No. 0468  
Henderson Supply Company  
2525 25th Street  
Mesa, Illinois 61611

Date: July 5, 2014  
Your Order No.: J 102

Sold to: Wagon Sportswear Corporation  
8428 Rocky Island Avenue  
Chicago, Illinois 60643

Ship to: Same  
Sales Representative: Joe Jacobs

Quantity		Description	Price	Per	Amount
Ordered	Shipped				
20	20	Office Supplies	260.00	box	\$5,200.00

FOB Destination Terms: 2/10, n/30 Date Shipped: 7/5/2014 Via: Self

**4 RECEIVING REPORT** No. JR065  
Wagon Sportswear Corporation  
8428 Rocky Island Avenue  
Chicago, Illinois 60643

Date: July 5, 2014

Quantity	Number	Description	Condition
20 boxes	X 144	Office Supplies	O.K.

Received by B.M.

**5 CHECK AUTHORIZATION**

	NO.	CHECK
Purchase Order	J 102	✓
Receiving Report	JR065	✓
INVOICE	0468	✓
Price		✓
Calculations		✓
Terms		✓

Approved for Payment J. Joseph

**6**  
Wagon Sportswear Corporation  
8428 Rocky Island Avenue  
Chicago, Illinois 60643

NO. 2570  
61-153/313

7/14 20 14  
PAY TO THE ORDER OF Henderson Supply Company \$ 5,096.00  
Five thousand ninety-six and 00/100 ----- Dollars

THE LAKE PARK NATIONAL BANK Wagon Sportswear Corporation  
Chicago, Illinois

by Arthur Mastor

Remittance Advice

Date	P.O. No.	DESCRIPTION	AMOUNT
7/14/2010	J 102	20 X 144 office supplies Supplier Inv. No. 0468	\$5,200.00
		Less 2% discount	<u>104.00</u>
		Net	<u>\$5,096.00</u>

Wagon Sportswear Corporation

**7 Statement of Account with THE LAKE PARK NATIONAL BANK Chicago, Illinois**

Wagon Sportswear Corporation  
8428 Rocky Island Avenue  
Chicago, Illinois 60643

Checking Acct No  
8030-647-4  
Period covered  
June 30-July 31, 2014

CHECKS/DEBITS		DEPOSITS/CREDITS		DAILY BALANCES		
Posting Date	Check No.	Amount	Posting Date	Amount	Date	Amount
7/14	2570	5,096.00				

(Continued)



Business Document	Description	Prepared by	Sent to	Verification and Related Procedures
① Purchase requisition	To begin, the credit office (requesting department) of Wagon Sportswear Corporation fills out a formal request for a purchase, or <b>purchase requisition</b> , for office supplies. The head of the requesting department approves it and forwards it to the purchasing department.	Requesting department	Purchasing department	Purchasing verifies authorization.
② Purchase order	The purchasing department prepares a <b>purchase order</b> . The purchase order indicates that Wagon Sportswear will not pay any bill that does not include a purchase order number. The purchase order is addressed to the vendor (seller) and contains a description of the quantity and type of items ordered, the expected price, the shipping date and terms, and other instructions.	Purchasing department	Vendor	Vendor sends goods or services in accordance with purchase order.
③ Invoice	After receiving the purchase order, the vendor, Henderson Supply Company, ships the goods and sends an <b>invoice</b> to Wagon Sportswear. The invoice shows the quantity of goods delivered, describes what they are, and lists the price and terms of payment. If all the goods cannot be shipped immediately, the invoice indicates the estimated date of shipment for the remaining goods.	Vendor	Accounting department	Accounting receives invoice from vendor.
④ Receiving report	When the goods reach Wagon Sportswear's receiving department, an employee notes the quantity, type of goods, and their condition on a <b>receiving report</b> . The receiving department does not receive a copy of the purchase order or the invoice, so its employees don't know what should be received or its value. Thus, they are not tempted to steal any excess that may be delivered.	Receiving department	Accounting department	Accounting compares invoice, purchase order, and receiving report. Accounting verifies prices.
⑤ Check authorization	The receiving report goes to the accounting department, where it is compared to the purchase order and the invoice. If everything is correct, the accounting department completes a <b>check authorization</b> and attaches it to the three supporting documents. The check authorization form shown in Exhibit 2 has a space for each item to be checked off as it is examined. Notice that the accounting department has all the documentary evidence for the transaction, but it does not have access to the assets purchased, nor does it write the check for payment. Thus, the accounting department cannot conceal fraud by falsifying documents.	Accounting department	Treasurer	Accounting attaches check authorization to invoice, purchase order, and receiving report.
⑥ Check	The treasurer examines all the documents. If the treasurer approves them, he or she signs or authorizes an electronic <b>check</b> , which is an authorization for the bank to pay the vendor in the amount of the invoice less any applicable discount. The check is then sent to the vendor or the vendor's bank, with a remittance advice showing what the check is for. A vendor that is not paid the proper amount will complain, thus providing a form of outside control over the payment.	Treasurer	Vendor	Treasurer verifies all documents before preparing check.
⑦ Bank statement	The vendor deposits the check in its bank, and the canceled check appears in Wagon Sportswear's monthly <b>bank statement</b> , which may be in either paper or electronic form. If the treasurer has made the check out for the wrong amount (or altered an amount that was already filled in), the problem will show up in the company's bank reconciliation.	Buyer's bank	Accounting department	Accounting compares amount and payee's name on returned check with check authorization.

Note: Circled numbers refer to documents on the previous page.

## APPLY IT!

Items **a–e** below are a company’s departments. Items **f** and **g** are firms with which the company has transactions.

- a. Requesting department
- b. Purchasing department
- c. Receiving department
- d. Accounting department
- e. Treasurer
- f. Vendor
- g. Bank

Use the letter of the department or firm to indicate which one prepares and sends the business documents that follow.

	Prepared by	Received by
1. Receiving report	_____	_____
2. Purchase order	_____	_____
3. Purchase requisition	_____	_____
4. Check	_____	_____
5. Invoice	_____	_____
6. Check authorization	_____	_____
7. Bank statement	_____	_____

### SOLUTION

	Prepared by	Received by
1. Receiving report	<u>c</u>	<u>d</u>
2. Purchase order	<u>b</u>	<u>f</u>
3. Purchase requisition	<u>a</u>	<u>b</u>
4. Check	<u>d, e</u>	<u>f</u>
5. Invoice	<u>f</u>	<u>d</u>
6. Check authorization	<u>d</u>	<u>e</u>
7. Bank statement	<u>g</u>	<u>d</u>

**TRY IT! SE4, SE5, SE6, SE7, E2A, E3A, E4A, E5A, E2B, E3B, E4B, E5B**

## LO 3 Cash Equivalents and Cash Control

### Cash Equivalents

**STUDY NOTE:** *The statement of cash flows explains the change in the balance of cash and cash equivalents from one period to the next.*

At times, a company may have more cash than it needs to pay its debts. Excess cash should not remain idle, especially during periods of high interest rates. Management may decide to invest the excess cash in short-term interest-bearing accounts or certificates of deposit (CDs) at banks and other financial institutions, in government securities (such as U.S. Treasury notes), or in other securities. If these investments have a term of 90 days or less when they are purchased, they are called **cash equivalents** because the funds revert to cash so quickly they are treated as cash on the balance sheet.

**Nike** describes its treatment of cash and cash equivalents as follows.

*Cash and equivalents represent cash and short-term, highly liquid investments with maturities of three months or less at date of purchase. The carrying amounts reflected in the consolidated balance sheet for cash and equivalents approximate fair value.<sup>6</sup>*

Like Nike, most companies record cash equivalents at their approximate fair value, that is, their market value.

According to a survey of large U.S. corporations, 2.5 percent use the term *cash* as the balance sheet caption, and 96 percent use either *cash and cash equivalents* or *cash and equivalents*. The rest either combine cash with marketable securities or have no cash.<sup>7</sup>

## Cash Control Methods

Earlier in the chapter, we discussed the concept of internal control and how it applies to cash transactions. Here, we address additional ways of controlling cash.

**Imprest Systems** Most companies need to keep some currency and coins on hand. Currency and coins are needed for cash registers, for paying expenses that are impractical to pay by check, and for situations that require cash advances—for example, when sales representatives need cash for travel expenses. One way to control a cash fund and cash advances is by using an **imprest system**. A common form of imprest system is a *petty cash fund*, which is discussed in more depth later in the chapter.

**Banking Services** Banks provide safe depositories for cash, negotiable instruments, and other valuable business documents such as stocks and bonds. The checking accounts that they provide improve control by minimizing the amount of currency a company needs to keep on hand and by supplying permanent records of all cash payments. Banks also serve as agents in a variety of transactions, such as the collection and payment of certain kinds of debts and the exchange of foreign currencies.

**Electronic funds transfer (EFT)** is a method of conducting business transactions that does not involve the actual transfer of cash. With EFT, a company electronically transfers cash from its bank to another company's bank. For the banks, the electronic transfer is simply a bookkeeping entry. Companies today rely heavily on this method of payment. **Wal-Mart**, for example, makes 75 percent of its payments to suppliers through EFT.

Automated teller machines (ATMs) allow bank customers to make deposits, withdraw cash, transfer funds among accounts, and pay bills. Large consumer banks like **Citibank**, **Chase**, and **Bank of America** process hundreds of thousands of ATM transactions each week. Many banks also give customers the option of paying bills online or over the telephone with debit cards. In 2011, debit cards accounted for more than \$1.5 trillion in transactions.<sup>8</sup> When a customer makes a retail purchase using a debit card, the amount of the purchase is deducted directly from the buyer's bank account. The bank usually documents debit card transactions for the retailer, but the retailer must develop new internal controls to ensure that the transactions are recorded properly and that unauthorized transfers do not occur.

**STUDY NOTE:** Bank reconciliations are an important factor in internal control. If carried out by someone who cannot access the company's bank account, they provide an independent check on people who do have access.

**Bank Reconciliations** Rarely does the balance of a company's Cash account exactly equal the cash balance on its bank statement. The bank may not yet have recorded certain transactions that appear in the company's records, and the company may not yet have recorded certain bank transactions. A **bank reconciliation** is the process of accounting for the difference between the balance on a company's bank statement and the balance in its Cash account.

The following transactions commonly appear in a company's records but not on its bank statement:

- **Outstanding checks:** Checks that a company has issued and recorded but that do not yet appear on its bank statement.
- **Deposits in transit:** Deposits a company has sent to its bank but that the bank did not receive in time to enter on the bank statement.

Transactions that may appear on the bank statement but not in the company's records include the following:

- **Service charges (SC):** Banks often charge a fee for the use of a checking account. Many banks base this service charge on a number of factors, such as the average balance of the account during the month or the number of checks drawn.
- **NSF (nonsufficient funds) checks:** An NSF check is a check that a company has deposited but that is not paid when the bank presents it to the issuer's bank. The bank charges the company's account and returns the check so that the company can try to collect the amount due. If the bank has deducted the NSF check on the bank statement but the company has not deducted it from its book balance, an adjustment

**STUDY NOTE:** A credit memorandum means that an amount was added to the bank balance; a debit memorandum means that an amount was deducted.

**STUDY NOTE:** The ending balance on a company's bank statement does not represent the amount of cash that should appear on its balance sheet. At the balance sheet date, deposits may be in transit to the bank, and some checks may be outstanding. That is why companies must prepare a bank reconciliation.

### Exhibit 3 Bank Reconciliation

**STUDY NOTE:** It is possible to place an item in the wrong section of a bank reconciliation and arrive at equal adjusted balances that are not correct. The correct (and equal) adjusted balances must be obtained.

must be made in the bank reconciliation. The company usually reclassifies the NSF check from Cash to Accounts Receivable because it must now collect from the person or company that wrote the check.

- **Miscellaneous debits and credits:** Banks also charge for other services, such as stopping payment on checks and printing checks. The bank notifies the depositor of each deduction by including a debit memorandum with the monthly statement. A bank also sometimes serves as an agent in collecting on promissory notes for the depositor. When it does, it includes a credit memorandum in the bank statement, along with a debit memorandum for the service charge.
- **Interest income:** Banks commonly pay interest on a company's average balance. Accounts that pay interest are sometimes called NOW or money market accounts.

An error by either the bank or the depositor will require immediate correction.

To illustrate the preparation of a bank reconciliation, suppose that Kalita Services Company's bank statement for August shows a balance of \$1,735.53 on August 31 and that on the same date, the company's records show a cash balance of \$1,207.95. Exhibit 3 shows Kalita Services' bank reconciliation for August.

<b>Kalita Services Company</b>	
<b>Bank Reconciliation</b>	
<b>August 31, 2014</b>	
Balance per bank, August 31	\$ 1,735.53
① Add deposit of August 31 in transit	<u>138.00</u>
	\$ 1,873.53
② Less outstanding checks:	
No. 551, issued on July 14	\$ 75.00
No. 576, issued on Aug. 30	20.34
No. 578, issued on Aug. 31	250.00
No. 579, issued on Aug. 31	185.00
No. 580, issued on Aug. 31	<u>65.25</u>
	<u>595.59</u>
<b>Adjusted bank balance, August 31</b>	<b><u>\$1,277.94</u></b>
Balance per books, August 31	\$ 1,207.95
Add:	
④ Note receivable collected by bank	\$140.00
④ Interest income on note	10.00
⑦ Interest income	<u>7.81</u>
	<u>157.81</u>
	\$ 1,365.76
Less:	
③ Overstatement of deposit of August 6	\$ 15.00
④ Collection fee	2.50
⑤ NSF check of Austin Chase	64.07
⑥ Service charge	<u>6.25</u>
	<u>87.82</u>
<b>Adjusted book balance, August 31</b>	<b><u>\$1,277.94</u></b>

Note: Circled numbers refer to documents in Exhibit 2.

© Cengage Learning 2014

The circled numbers in the exhibit refer to the following:

1. The bank has not recorded a deposit in the amount of \$138.00 that the company mailed to the bank on August 31.
2. The bank has not paid the five checks that the company issued in July and August. Even though the July 14 check was deducted in the July 30 reconciliation, it must be deducted again in each subsequent month in which it remains outstanding.
3. The company incorrectly recorded a \$150.00 deposit from cash sales as \$165.00. On August 6, the bank received the deposit and correctly recorded the amount.
4. Among the returned checks was a credit memorandum showing that the bank had collected a promissory note from K. Diaz in the amount of \$140.00, plus

\$10.00 in interest on the note. A debit memorandum was also enclosed for the \$2.50 collection fee. The company had not entered these amounts in its records.

5. Also returned with the bank statement was an NSF check for \$64.07 that the company had received from a customer named Austin Chase. The NSF check was not reflected in the company's records.
6. A debit memorandum was enclosed for the regular monthly service charge of \$6.25. The company had not yet recorded this charge.
7. Interest earned on the company's average balance was \$7.81.

In Exhibit 3, starting from their separate balances, both the bank and book amounts are adjusted to the amount of \$1,277.94. This adjusted balance is the amount of cash the company owns on August 31 and thus is the amount that should appear on its August 31 balance sheet.

When outstanding checks are presented to the bank for payment and the bank receives and records the deposit in transit, the bank balance will automatically become correct. However, the company must update its book balance by recording all the items reported by the bank. Thus, Kalita Services would record an increase (debit) in Cash with the following items:

- ▼ *Decrease* (credit) in *Notes Receivable*, \$140.00
- ▲ *Increase* (credit) in *Interest Income*, \$10.00 (interest on note)
- ▲ *Increase* (credit) in *Interest Income*, \$7.81 (interest on average bank balance)

The company would record a reduction (credit) in Cash with the following items:

- ▼ *Decrease* (debit) in *Sales*, \$15.00 (error in recording deposit)
- ▲ *Increase* (debit) in *Accounts Receivable*, \$64.07 (return of NSF check)
- ▲ *Increase* (debit) in *Bank Service Charges*, \$8.75 (\$6.25 + \$2.50)

## APPLY IT!

At year end, Binsu Company had currency and coins in cash registers of \$1,100, money orders from customers of \$2,000, deposits in checking accounts of \$12,000, U.S. Treasury bills due in 80 days of \$50,000, certificates of deposit at the bank that mature in six months of \$200,000, and U.S. Treasury bonds due in one year of \$100,000. Calculate the amount of cash and cash equivalents that will be shown on the company's year-end balance sheet.

### SOLUTION

Currency and coins	\$ 1,100
Money orders	2,000
Checking accounts	12,000
U.S. Treasury bills (due in 80 days)	<u>50,000</u>
Cash and cash equivalents	<u>\$65,100</u>

The certificates of deposit and U.S. Treasury Bonds mature in more than 90 days and thus are not cash equivalents.

**TRY IT! SE8, SE9, E6A, E7A, E6B, E7B**

## LO 4 Petty Cash Funds

It is not always practical to use checks. For example, it is sometimes necessary to make small payments of cash for postage stamps, shipping charges due, or minor purchases of pens, paper, and other office supplies. For situations in which it is inconvenient to pay by check, most companies set up a **petty cash fund**. One of the best ways to control a petty cash fund is through an imprest system, in which the fund is established for a fixed amount. A voucher documents each cash payment made from the fund. The fund is periodically reimbursed, based on the vouchers, by the exact amount necessary to restore its original cash balance.

### Establishing the Petty Cash Fund

Some companies have a regular cashier or other employee who administers the petty cash fund.

### Establishing the Petty Cash Fund

**Transaction** On October 14, Davis Company establishes the petty cash fund by issuing a check for \$100 intended to cover two to four weeks of small expenditures. The check is cashed and the money placed in the petty cash box, drawer, or envelope.

**Analysis** The journal entry to establish the petty cash fund

- ▲ increases the *Petty Cash* account
- ▼ decreases the *Cash* account

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>							
Dr.	Cr.						
	Oct. 14	100					
<b>Petty Cash</b>							
Dr.	Cr.						
Oct. 14	100						

**Journal Entry**

	Oct. 14	Petty Cash		Dr.		
		Cash		100	Cr.	
		To establish the petty cash fund				100

**Comment** The only entry required when the fund is established is to record the check.

## Making Disbursements from the Petty Cash Fund

The custodian of the petty cash fund should prepare a **petty cash voucher**, or written authorization, for each expenditure, as shown in Exhibit 4. On each petty cash voucher, the custodian enters the date, amount, and purpose of the expenditure. The person who receives the payment signs the voucher.

**Exhibit 4**  
Petty Cash Voucher

**PETTY CASH VOUCHER**

No. X 744

Date Oct. 23, 2014

For Postage due

Charge to Postage Expense

Amount \$2.86

W.S.
Tom L.

Approved by
Received by

**STUDY NOTE:** Even though withdrawals from petty cash are generally small, the cumulative total over time can represent a substantial amount. Accordingly, an effective system of internal control must be established for the fund.

The custodian should be informed that unannounced audits of the fund will be made occasionally. The cash in the fund plus the sum of the petty cash vouchers should at all times equal the amount shown in the Petty Cash account.

## Reimbursing the Petty Cash Fund

At specified intervals, when the fund becomes low, and at the end of a period, the petty cash fund is replenished by a check issued to the custodian for the exact amount of the



expenditures. From time to time, there may be minor discrepancies in the amount of cash left in the fund at the time of reimbursement. In those cases, the amount of the discrepancy is recorded in a Cash Short or Over account—as a debit if short or as a credit if over.

### Reimbursing the Petty Cash Fund

**Transaction** On October 28 (after two weeks), Davis Company replenishes its petty cash fund, established earlier, which has a cash balance of \$14.27 and petty cash vouchers as follows: postage, \$25.00; supplies, \$30.55; and freight-in, \$30.00.

**Analysis** The journal entry to replenish the fund

- ▲ increases the *Postage Expense* account
- ▲ increases the *Supplies Expense* account
- ▲ increases the *Freight-In* account
- ▲ increases the *Cash Short or Over* account
- ▼ decreases the *Cash* account

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>						<b>Postage Expense</b>	
Dr.	Cr.					Dr.	Cr.
	Oct. 28 85.73					Oct. 28 25.00	
						<b>Supplies Expense</b>	
						Dr.	Cr.
						Oct. 28 30.55	
<b>Freight-In</b>							
Dr.	Cr.						
Oct. 28 30.00							
<b>Cash Short or Over</b>							
Dr.	Cr.						
Oct. 28 0.18							

Journal Entry		Dr.	Cr.
Oct. 28	Postage Expense	25.00	
	Supplies Expense	30.55	
	Freight-In	30.00	
	Cash Short or Over	0.18	
	Cash		85.73
To replenish the petty cash fund			

**Comment** The Petty Cash account is debited when the fund is established or the fund level is changed. It is not affected by the entry to replenish the fund. Expense or asset accounts are debited each time the fund is replenished, including in this case \$0.18 to Cash Short or Over for a small cash shortage. In most cases, no further entries to the Petty Cash account are needed unless the firm wants to change the fixed amount of the fund.

The petty cash fund should be replenished at the end of a period to bring it up to its fixed amount and ensure that changes in the other accounts involved are reflected in the current period's financial statements. If the petty cash fund is not replenished at the end of the period, expenditures are shown through an adjusting entry debiting the expense accounts and crediting Petty Cash. The result is a reduction in the petty cash fund and the Petty Cash account by the amount of the adjusting entry. In the financial statements, the balance of the Petty Cash account is usually combined with other cash accounts.



# Internal Control and the Financial Statements

Internal control applies to all transactions and ensures the fair presentation of the financial statements as shown in Exhibit 5.

**Exhibit 5**  
Internal Control and the Income Statement and Balance Sheet

**Income Statement**

---

For the Year Ended April 30, 2014

Net sales

Cost of goods sold

Gross margin

Operating expenses

Operating income

Other revenues and expenses

Interest income

Net income

**Balance Sheet**

---

April 30, 2014

Assets	Liabilities
Cash and cash equivalents	Current liabilities
Accounts receivable, net	Long-term liabilities
Merchandise inventory	Total liabilities
Notes receivable	
Property, plant, and equipment	<b>Owner's Equity</b>
	Owner's capital
	Total owner's equity
<b>Total Assets = Total Liabilities + Owner's Equity</b>	

© Cengage Learning 2014

## APPLY IT!

A petty cash fund is established at \$150 on July 1. At the end of July, the fund has a cash balance of \$59 and petty cash vouchers for postage, \$37, and office supplies, \$52. Prepare the journal entry to establish the fund on July 1 and the entry on July 31 to replenish the fund.

**SOLUTION**

July 1	Petty Cash	150	
	Cash		150
	To establish petty cash fund		
July 31	Postage Expense	37	
	Office Supplies Expense	52	
	Cash Over or Short	2	
	Cash		91
	To replenish petty cash fund		

**TRY IT! SE10, E8A, E9A, E8B, E9B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Management's responsibility
- Independent auditor's audit

RELEVANT  
LEARNING OBJECTIVE

- LO 5** Identify the internal control roles of management and the auditor.

## LO 5 Management Issues Related to Internal Control

A company's management and its auditor have important responsibilities for the internal control of a company.

### Management's Responsibility for Internal Control

Management is responsible for establishing a satisfactory system of internal controls. In other words, management must safeguard the firm's assets, ensure the reliability of its accounting records, and see that its employees comply with all legal requirements and operate the firm to the best advantage of its owners.

Section 404 of the Sarbanes-Oxley Act requires that the chief executive officer, the chief financial officer, and the auditors of a public company fully document and certify the company's system of internal controls. For example, in its annual report, **Costco's** management acknowledges its responsibility for internal control as follows.

*Our management is responsible for establishing and maintaining adequate internal control over financial reporting.<sup>9</sup>*

### Independent Accountant's Audit of Internal Control

Although privately owned companies usually are not required to have an independent certified public accountant audit their financial statements, many companies choose to do so. These companies are also not required to have their internal control systems audited. Public companies like **Costco**, on the other hand, are required to not only have an independent audit of their financial statements, they must also have an audit of their internal control. For instance, Costco's auditors state:

*In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting...<sup>10</sup>*



## Business Perspective

### Will Sarbanes-Oxley Stop Fraud?

Although the Sarbanes-Oxley Act has heightened awareness of internal control and has required increased diligence, it will never stop fraud from occurring. For instance, a recent study of 350 alleged accounting fraud cases investigated by the SEC found that fraud affects companies of all sizes. The average fraud was \$12.1 million, and more than 30 cases involved fraud over \$500 million. Additional guidance with regard to internal controls are expected to be issued.<sup>11</sup>

© Aljia / iStockphoto.com

**APPLY IT!**

Match the items with the related statements that follow.

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>a. Internal control</li> <li>b. A need of internal control</li> <li>c. Management's responsibility</li> <li>d. Independent accountant's audit</li> </ul> | <ul style="list-style-type: none"> <li>1. Provides reasonable assurance to outside parties that management maintains internal control over financial reporting.</li> <li>2. Established by management to ensure the reliability of accounting records and financial statements in accordance with GAAP.</li> <li>3. Human error can cause errors in the financial statements.</li> <li>4. To assure the establishment of a system of internal control and assess its effectiveness.</li> </ul> |
|---|--|

**SOLUTION**

1. d; 2. a; 3. b; 4. c

**TRY IT! SE1, E10A, E10B**

**TriLevel Problem**

Sung's Grill

Blend\_Images/Stockphoto.com

The beginning of this chapter focused on Emma Sung, the owner of Sung's Grill, who was looking for ways to ensure that the restaurant's assets were protected and that all its transactions were recorded properly. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

**Section 1: Concepts**

*Why is each of the five components of internal control important to the faithful representation of a company's operations in its financial statements?*

**Section 2: Accounting Applications**

*How can Sung's Grill maintain control over its cash?*

In order to have better control over cash, Emma Sung has established several rules for cashiers. Match each of the internal controls with the control activities that follow. (*Hint: Some may have more than one answer.*)

- |  |   |
|--|---|
| <ul style="list-style-type: none"> <li>a. Authorization</li> <li>b. Recording transactions</li> <li>c. Documents and records</li> <li>d. Physical controls</li> <li>e. Periodic independent verification</li> <li>f. Separation of duties</li> <li>g. Sound personnel practices</li> </ul> | <ul style="list-style-type: none"> <li>1. Emma Sung hires experienced cashiers who are bonded and checks the references of all new employees.</li> <li>2. New cashiers are trained in all procedures before being allowed to handle cash.</li> <li>3. All food bills are prenumbered sequentially.</li> <li>4. When a customer finishes a meal, the waiter writes up a bill that describes the food items purchased, including the total price.</li> <li>5. The waiters are not allowed to access the cash register.</li> <li>6. If the sale is by credit card, the cashier runs the credit card through a scanner that verifies the customer's credit. The scanner prints out a receipt and a slip for the customer to sign. The signed slip is put in the cash register, and the customer is given the receipt and a copy of the sales invoice.</li> <li>7. All sales, whether cash or credit, are rung up on the cash register.</li> <li>8. The cash register must be locked when the cashier is not present. The cashier is the only person other than Emma Sung who has a key.</li> <li>9. Refunds or discounts are made only with Emma Sung's approval.</li> <li>10. At the end of each day, Emma counts the cash and checks in the cash register and compares the total with the amount recorded on the tape inside the register. She totals all the signed credit card slips and ensures that the total equals the amount recorded by the scanner.</li> </ul> |
|--|---|

**Section 3: Business Applications**

How can Sung's Grill's bank and other users of its financial statements be confident that the restaurant has an adequate system of internal control?

**SOLUTION****Section 1: Concepts**

An effective system of internal control contributes to the *faithful representation* of a company's operations through five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. Since internal control is a process, all of these components need to be present if the company wants to have an effective internal control system; for example, management needs to create an environment that encourages compliance with laws, regulations, and standards. Management has to also identify and assess possible risks and implement control activities that will ensure safeguard of its assets and reliability of its accounting records. Information and communication is also crucial because it encompasses the accounting system and how information and data are communicated within the company and to the external parties. Finally, an effective system of internal control requires continuous monitoring, which means that management reviews compliance with required laws and regulations to make sure everything works as planned and takes necessary actions when problems arise.

**Section 2: Accounting Applications**

- |         |         |
|---------|---------|
| 1. g    | 6. b, c |
| 2. g    | 7. b, d |
| 3. c    | 8. d    |
| 4. a, c | 9. a, f |
| 5. d, f | 10. e   |

**Section 3: Business Applications**

As the owner of Sung's Grill, Emma Sung is responsible for establishing an effective system of internal control which is essential for reliable financial reporting. Emma, as the top executive, certifies the restaurant's system of internal control. However, the best way for any business to assure users of the integrity of its financial statements is to have an independent auditor assess the reliability of its internal control system. Thus, Emma can hire independent auditors to audit its financial statements and to audit its system of internal control. The auditor's report will be a credible source of information for banks and any other users of Sung's Grill's financial statements.

**Chapter Review**

Describe the components of internal control, control activities, and limitations on internal control. **LO 1**

Internal control establishes the reliability of the accounting records and financial statements in accordance with generally accepted accounting principles (GAAP) and ensures that the company's assets are protected. Internal control consists of all the policies and procedures a company uses to ensure the reliability of financial reporting, compliance with laws and regulations, and the effectiveness and efficiency of operations. Internal control has five components: the control environment, risk assessment, control activities, information and communication, and monitoring. Control activities include having managers authorize certain transactions, recording all transactions to establish accountability for assets, using well-designed documents to ensure proper recording of transactions, instituting physical controls, periodically checking records and assets, separating duties, and using sound personnel practices. A system of internal control relies on the

**Apply internal control activities to common merchandising transactions.** **Lo 2**

people who implement it. Human error, collusion, and failure to recognize changed conditions can contribute to a system's failure.

To implement internal control over cash sales, receipts, purchases, and disbursements, the functions of authorization, recordkeeping, and custodianship of cash should be kept separate. The people who have access to cash should be specifically designated and their number limited. Employees who have access to cash should be bonded. The control system should also provide for the use of banking services, physical protection of assets, prompt recording and deposit of cash receipts, and payment by check. A person who does not authorize, handle, or record cash transactions should make unannounced audits of the cash on hand, and the Cash account should be reconciled each month.

**Define cash equivalents, and explain methods of controlling cash, including bank reconciliations.** **Lo 3**

Cash equivalents are investments that have a term of 90 days or less. Most companies record cash equivalents at their approximate fair value. Methods of controlling cash include imprest systems; banking services, including electronic funds transfer; and bank reconciliations. A bank reconciliation accounts for the difference between the balance on a company's bank statement and the balance in its Cash account. It involves adjusting for outstanding checks, deposits in transit, service charges, NSF checks, miscellaneous debits and credits, and interest income.

**Demonstrate the use of a simple imprest (petty cash) system.** **Lo 4**

An imprest system is a method of controlling small cash expenditures by setting up a fund at a fixed amount and periodically reimbursing the fund to restore the original balance. A petty cash fund, one example of an imprest system, is established by a debit to Petty Cash and a credit to Cash. It is replenished by debits to various expense or asset accounts and a credit to Cash. Each expenditure should be supported by a petty cash voucher.

**Identify the internal control roles of management and the auditor.** **Lo 5**

Management's responsibility is to establish an environment, accounting systems, and internal control procedures that will protect the assets. Public companies must engage an independent CPA to verify that management is indeed meeting these goals.

## Key Terms

**authorization** 303 (LO1)  
**bank reconciliation** 312 (LO3)  
**bank statement** 310 (LO2)  
**bonding** 304 (LO1)  
**cash equivalents** 311 (LO3)  
**check** 310 (LO2)  
**check authorization** 310 (LO2)  
**control activities** 303 (LO1)  
**control environment** 303 (LO1)  
**deposits in transit** 312 (LO3)  
**electronic funds transfer (EFT)** 312 (LO3)

**imprest system** 312 (LO3)  
**information and communication** 303 (LO1)  
**internal control** 302 (LO1)  
**invoice** 310 (LO2)  
**monitoring** 303 (LO1)  
**NSF (nonsufficient funds) checks** 312 (LO3)  
**outstanding checks** 312 (LO3)  
**periodic independent verification** 304 (LO1)  
**petty cash fund** 314 (LO4)

**petty cash voucher** 315 (LO4)  
**physical controls** 304 (LO1)  
**physical inventory** 302 (LO1)  
**purchase order** 310 (LO2)  
**purchase requisition** 310 (LO2)  
**receiving report** 310 (LO2)  
**risk assessment** 303 (LO1)  
**separation of duties** 304 (LO1)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1.** Why is a system of internal control not able to overcome collusion by employees?
- LO 1 **DQ2. CONCEPT** ► In what way does internal control contribute to faithful representation in its financial statements?
- LO 2 **DQ3.** Which of the following accounts would be assigned a higher level of risk: Building or Merchandising Inventory?
- LO 2 **DQ4.** Why is it important to record the amount of cash received through the mail or over the counter?
- LO 3 **DQ5.** What role does a bank reconciliation play in internal control over cash?
- LO 3 **DQ6.** Name some businesses whose needs for cash fluctuate during the year. Name some whose needs for cash are relatively stable over the year.
- LO 5 **DQ7. BUSINESS APPLICATION** ► Why is it important for public companies to have an audit of management's assessment of internal control?

### SHORT EXERCISES

#### LO 1, 5 **Internal Control**

**SE1.** Match the items with the related statements that follow.

- |                                   |   |
|-----------------------------------|---|
| a. Internal control               | 1. Evaluates management's assessment of internal control over financial reporting.                                |
| b. A need of internal control     | 2. A process that establishes reliability of accounting records and financial statements in accordance with GAAP. |
| c. Management's responsibility    | 3. Many assets such as cash and inventories are at risk of loss.  |
| d. Independent accountant's audit | 4. Establishes a system of internal control and assesses its effectiveness  |

#### LO 1, 2 **Components of Internal Control**

**SE2.** Match the items with the related statements that follow.

- |                                  |   |
|----------------------------------|---|
| a. Control environment           | 1. Policies and procedures management puts in place to see that its directives are carried out. |
| b. Risk assessment               | 2. Identifying areas where losses may occur.  |
| c. Control activities            | 3. Regular assessment of the quality of internal controls.                                      |
| d. Information and communication | 4. Management's overall attitude, awareness, and actions.                                       |
| e. Monitoring                    | 5. Pertains to the accounting system.   |

#### LO 1 **Limitations of Internal Control**

**SE3.** Internal control is subject to several inherent limitations. Indicate whether each of the following situations is an example of (a) human error, (b) collusion among employees, (c) changed conditions, or (d) cost-benefit considerations:

1. Effective separation of duties in a restaurant is impractical because the business is too small.
2. The cashier and the manager of a retail shoe store work together to avoid the internal controls for the purpose of embezzling funds.
3. The cashier in a pizza shop does not understand the procedures for operating the cash register and thus fails to ring up all the sales and count the cash at the end of the day.
4. At a law firm, computer supplies are mistakenly delivered to the reception area instead of the receiving area because the supplier began using a different system of shipment. As a result, the receipt of supplies is not recorded.

**LO 1, 2 Separation of Duties**

**SE4.** Match the functions for collecting cash by Sonja Cleaners with the statements that follow.

- |                  |   |
|------------------|---|
| a. Authorization | 1. The cashier is responsible for funds in the cash register.                       |
| b. Custody       | 2. All sales are recorded on prenumbered invoices and rung up on the cash register. |
| c. Recordkeeping | 3. All refunds must be approved by the manager.                                     |

**LO 2 Physical Controls**

**SE5.** Match the assets of a small retail store with the related physical controls that follow.

- |                          |   |
|--------------------------|---|
| a. Cash                  | 1. An alarm that signals if unsold items leave the store. |
| b. Merchandise inventory | 2. Cash register.   |
| c. Supplies              | 3. A locked cabinet in the supplies closet.               |
| d. Computers             | 4. A cable with a lock.                                   |
|                          | 5. A locked showcase.                                     |

**LO 1, 2 Internal Control Activities**

**SE6.** Match the check-writing policies for a small business to the control activities that follow.

- |                                      |   |
|--------------------------------------|---|
| a. Authorization                     | 1. The person who writes the checks to pay bills is different from the people who authorize the payments and keep records of the payments.    |
| b. Recording transactions            | 2. The checks are kept in a locked drawer. The only person who has the key is the person who writes the checks.                               |
| c. Documents and records             | 3. The person who writes the checks is bonded.  |
| d. Physical controls                 | 4. Once each month the owner compares and reconciles the amount of money shown in the accounting records with the amount in the bank account. |
| e. Periodic independent verification | 5. The owner of the business approves each check before it is mailed.   |
| f. Separation of duties              | 6. Information pertaining to each check is recorded on the check stub.  |
| g. Sound personnel practices         | 7. Every day, all checks are recorded in the accounting records, using the information on the check stubs.                                    |

**LO 2 Business Documents**

**SE7.** Arrange the following business documents in the normal order in which they would be prepared:

- |                     |                         |
|---------------------|-------------------------|
| 1. Invoice          | 5. Bank statement       |
| 2. Purchase order   | 6. Purchase requisition |
| 3. Check            | 7. Check authorization  |
| 4. Receiving report |                         |



**LO 3 Cash and Cash Equivalents**

**SE8.** Compute the amount of cash and cash equivalents on Steen Wash Company's balance sheet if, on the balance sheet date, it has currency and coins on hand of \$250, deposits in checking accounts of \$1,500, U.S. Treasury bills due in 80 days of \$15,000, and U.S. Treasury bonds due in 200 days of \$25,000.

**LO 3 Bank Reconciliation**

**SE9.** Prepare a bank reconciliation from the following information:

- a. Balance per bank statement as of June 30, \$4,862.77
- b. Balance per books as of June 30, \$2,479.48
- c. Deposits in transit, \$654.24
- d. Outstanding checks, \$3,028.89
- e. Interest on average balance, \$8.64

**LO 4 Petty Cash Fund**

**SE10.** A petty cash fund is established at \$100. At the end of May, the fund has a cash balance of \$36 and petty cash vouchers for postage, \$29, and office supplies, \$34. Prepare the journal entry on May 31, 2014, to replenish the fund.

**EXERCISES: SET A****LO 1 Components of Internal Control**

**E1A.** Match the items with the related statements that follow.

- |                                  |  |
|----------------------------------|--|
| a. Control environment           | 1. Management encourages employees to follow the rules.  |
| b. Risk assessment               | 2. The company has an internal audit department.   |
| c. Control activities            | 3. Management regularly considers what losses the company might face.                            |
| d. Information and communication | 4. The company gathers appropriate information and communicates it to employees.                 |
| e. Monitoring                    | 5. Management puts separation of duties in place.  |
|                                  | 6. Personnel are well trained and instructed in their duties.                                    |
|                                  | 7. The company employs good physical controls.   |
|                                  | 8. The company has a good accounting system.   |
|                                  | 9. Managers are observant and review how procedures by those who report to them are carried out. |

**LO 1,2 Control Procedures**

**E2A.** Some conditions for internal control follow.

- a. Transactions are executed in accordance with management's general or specific authorization.
- b. Transactions are recorded as necessary to permit preparation of financial statements and maintain accountability for assets.
- c. Access to assets is permitted only as allowed by management.
- d. At reasonable intervals, the records of assets are compared with the existing assets.

Marika Jonssen, who operates a small grocery store, has established the following policies with regard to the checkout cashiers:

1. Cashiers may accept checks for purchases under \$100 with proper identification. For checks over \$100, they must receive approval from Jonssen.
2. Each cashier has his or her own cash drawer, to which no one else has access.
3. Every sale must be rung up on the cash register and a receipt given to the customer. Each sale is recorded on a tape inside the cash register.

4. At the end of each day, Jonssen counts the cash in the drawer and compares it with the amount on the tape inside the cash register.

Match the conditions for internal control to each of the policies listed.

### LO 1,2 Internal Control Procedures

**E3A.** A list of control procedures follows.

- |                           |                                      |
|---------------------------|--------------------------------------|
| a. Authorization          | e. Periodic independent verification |
| b. Recording transactions | f. Separation of duties              |
| c. Documents and records  | g. Sound personnel practices         |
| d. Physical controls      |                                      |

Real Video Store maintains the following policies with regard to purchases of new DVDs at each of its branch stores:

1. Once each month a person from the home office visits each branch store to examine the receiving records and to compare the inventory of DVDs with the accounting records.
2. Employees are required to take vacations, and the duties of employees are rotated periodically.
3. Purchases of new DVDs must be authorized by purchase order in the home office and paid for by the treasurer in the home office. Receiving reports are prepared in each branch and sent to the home office.
4. All new personnel receive one hour of training in how to receive and catalogue new DVDs.
5. The company maintains a perpetual inventory system that keeps track of all DVDs purchased, sold, and on hand.

Match the control procedures to each of the policies listed. (*Hint:* Some may have more than one answer.)

### LO 2 Business Documents

**E4A.** Items **a–e** below are a company's departments. Items **f** and **g** are firms with which the company has transactions.

- |                          |              |
|--------------------------|--------------|
| a. Requesting department | e. Treasurer |
| b. Purchasing department | f. Vendor    |
| c. Receiving department  | g. Bank      |
| d. Accounting department |              |

Use the letter of the department or firm to indicate which one prepares and sends the following business documents:

	Prepared by	Received by
1. Purchase requisition	_____	_____
2. Bank statement	_____	_____
3. Purchase order	_____	_____
4. Check authorization	_____	_____
5. Invoice	_____	_____
6. Check	_____	_____
7. Receiving report	_____	_____

### LO 2 Use of Accounting Records in Internal Control

**E5A. ACCOUNTING CONNECTION** ► Careful scrutiny of accounting records and financial statements can lead to the discovery of fraud or embezzlement. Each of the situations that follow may indicate a breakdown in internal control. Indicate the nature of the possible fraud or embezzlement in each of these situations.

1. Wages expense for a branch office was 15 percent higher in 2014 than in 2013, even though the office was authorized to employ only the same four employees and raises were only 2.5 percent in 2014.

(Continued)

2. Sales returns and allowances increased from 2.5 percent to 10 percent of sales in the first two months of 2014, after record sales in 2013 resulted in large bonuses for the sales staff.
3. Gross margin decreased from 20 percent of net sales in 2013 to 10 percent in 2014, even though there was no change in pricing. Ending inventory was 25 percent less at the end of 2014 than it was at the beginning of the year. There is no immediate explanation for the decrease in inventory.
4. A review of daily records of cash register receipts shows that one cashier consistently accepts more discount coupons for purchases than do the other cashiers.

**LO 3 Cash and Cash Equivalents**

**E6A.** At year end, Bottle Water Company had currency and coins in cash registers of \$5,600, money orders from customers of \$10,000, deposits in checking accounts of \$64,000, U.S. Treasury bills due in 80 days of \$180,000, certificates of deposit at the bank that mature in six months of \$200,000, and U.S. Treasury bonds due in one year of \$100,000. Calculate the amount of cash and cash equivalents that will be shown on the company's year-end balance sheet.

**LO 3 Bank Reconciliation**

**E7A.** Prepare a bank reconciliation from the following information:

- a. Balance per bank statement as of May 31, \$16,655.44
- b. Balance per books as of May 31, \$12,091.94
- c. Deposits in transit, \$2,234.81
- d. Outstanding checks, \$6,808.16
- e. Bank service charge, \$9.85

**LO 4 Imprest System**

**E8A. ACCOUNTING CONNECTION** ► Developing a convenient means of providing sales representatives with cash for their incidental expenses, such as entertaining a client at lunch, is a problem many companies face. Under one company's plan, the sales representatives receive advances in cash from the petty cash fund. Each advance is supported by an authorization from the sales manager. The representative returns the receipt for the expenditure and any unused cash, which is replaced in the petty cash fund. The cashier of the petty cash fund is responsible for seeing that the receipt and the cash returned equal the advance. When the petty cash fund is reimbursed, the amount of the representative's expenditure is debited to Direct Sales Expense.

What is the weak point in this system? What fundamental principle of internal control is being ignored? What improvement in the procedure can you suggest?

**LO 4 Petty Cash Transactions**

**E9A.** A small company maintains a petty cash fund for minor expenditures. In February and March 2014, the following transactions took place:

- a. The fund was established in the amount of \$200.00 on Feb. 1 from the proceeds of check no. 2717.
- b. On Feb. 28, the petty cash fund had cash of \$30.92 and the following receipts on hand: postage, \$80.00; supplies, \$49.88; delivery service, \$24.80; and rubber stamp, \$14.40. Check no. 2748 was drawn to replenish the fund.
- c. On March 31, the petty cash fund had cash of \$44.12 and these receipts on hand: postage, \$68.40; supplies, \$65.68; and delivery service, \$12.80. The petty cash custodian could not account for the shortage. Check no. 2897 was drawn to replenish the fund.

Prepare the journal entries necessary to record each transaction.

## LO 5 Management and Auditor Responsibility for Internal Control

- E10A. BUSINESS APPLICATION** ► Match the items with the related statements that follow.
- |  |   |
|--|---|
| a. Management's responsibility             | 1. Provides reasonable assurance to outside parties that management maintains internal control over financial reporting.  |
| b. Section 404 of Sarbanes-Oxley Act       | 2. Established by management to ensure the reliability of accounting records and financial statements in accordance with GAAP.  |
| c. Independent accountant's responsibility | 3. Requires that the chief executive officer, the chief financial officer, and the auditors of a public company fully document and certify the company's system of internal controls. |
| d. Internal control                        | 4. To assure the establishment of a system of internal control and assess its effectiveness.  |

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 1 Internal Control Components

**P1.** Arcadia Company, a small retail bookstore, has experienced losses of inventory over the past year. Jason Arcadia, the owner, on the advice of his accountant, has adopted a set of internal controls in an effort to stop the losses. Arcadia has taken the following steps:

1. He regularly considers ways in which inventory losses might occur.
2. He had his accountant set up an accounting system over inventory.
3. He requires all new and existing employees to attend a training session in which they are instructed in their duties.
4. He makes sure that different employees perform the duties of authorization, custody, and recordkeeping.
5. He spends time "on the floor" encouraging employees to follow the procedures.
6. He periodically gathers appropriate information about inventory situations and communicates his findings to employees.
7. He had all items in inventory marked with an electronic bar code that signals an alarm if someone tries to take an item out of the store without paying for it.
8. He observes and reviews how internal control procedures are carried out.
9. He hires his accountant to periodically conduct internal audit work.

#### REQUIRED

1. Show that Arcadia's new system engages all the components of internal control by matching each of the steps with the internal control components that follow. (*Hint:* Some may have more than one answer.)
 

a. Control environment	d. Information and communication
b. Risk assessment	e. Monitoring
c. Control activities	
2. **BUSINESS APPLICATION** ► As the owner of a small company, why is it important that Jason Arcadia take an active part in the management of the internal control system?

### LO 1, 2 Internal Control Procedures

**P2.** Transco Printers makes printers for personal computers and maintains a factory outlet showroom through which it sells its products to the public. The company's management has set up a system of internal controls over the inventory of printers to prevent theft and to ensure the accuracy of the accounting records.

(Continued)

All printers in inventory at the factory outlet are kept in a secured warehouse behind the showroom, except for the sample printers on display. Only authorized personnel may enter the warehouse. When a customer buys a printer, a sales invoice is written in triplicate by the cashier and is marked “paid.” The sales invoices are sequentially numbered, and all must be accounted for. The cashier sends the pink copy of the completed invoice to the warehouse, gives the blue copy to the customer, and keeps the green copy. The customer drives around to the warehouse entrance. The warehouse attendant takes the blue copy of the invoice from the customer and gives the customer the printer and the pink copy of the invoice.

The company maintains a perpetual inventory system for the printers at the outlet. The warehouse attendant at the outlet signs an inventory transfer sheet for each printer received. An accountant at the factory is assigned responsibility for maintaining the inventory records based on copies of the inventory transfer sheets and the sales invoices. The records are updated daily and may be accessed by computer but not modified by the sales personnel and the warehouse attendant. The accountant also sees that all pre-numbered inventory transfer sheets are accounted for and compares copies of them with the ones signed by the warehouse attendant. Once every three months, the company’s internal auditor takes a physical count of the printer inventory and compares the results with the perpetual inventory records.

All new employees are required to read a sales and inventory manual and attend a two-hour training session about the internal controls. They must demonstrate that they can perform the functions required of them.

#### REQUIRED

1. Give an example of how each of the following control activities is applied to internal control over inventory at Transco Printers:
 

a. Authorization	e. Periodic independent verification
b. Recording transactions	f. Separation of duties
c. Documents and records	g. Sound personnel practices
d. Physical controls	
2. **ACCOUNTING CONNECTION** ► Can the described system protect against an employee who picks up a printer and carries it off when leaving work?

#### LO 1,2 Internal Control Activities

**P3.** East-West Sports Shop is a small neighborhood sporting goods store. The shop’s owner, Sunny Hazel, has set up a system of internal control over sales to prevent theft and to ensure the accuracy of the accounting records.

When a customer buys a product, the cashier writes up a sales invoice that describes the purchase, including the total price. All sales invoices are pre-numbered sequentially.

If the sale is by credit card, the cashier runs the credit card through a scanner that verifies the customer’s credit. The scanner prints out a receipt and a slip for the customer to sign. The signed slip is put in the cash register, and the customer is given the receipt and a copy of the sales invoice.

If the sale is by cash or check, the cashier rings it up on the cash register and gives change, if appropriate. Checks must be written for the exact amount of the purchase and must be accompanied by identification. The sale is recorded on a tape inside the cash register that cannot be accessed by the cashier. The cash register may be locked with a key. The cashier is the only person other than Hazel who has a key. The cash register must be locked when the cashier is not present. Refunds are made only with Hazel’s approval, are recorded on pre-numbered credit memorandum forms, and are rung up on the cash register.

At the end of each day, Hazel counts the cash and checks in the cash register and compares the total with the amount recorded on the tape inside the register. Hazel totals all the signed credit card slips and ensures that the total equals the amount recorded by the scanner. Hazel also makes sure that all sales invoices and credit memoranda are accounted for. Hazel prepares a bank deposit ticket for the cash, checks, and signed

credit card slips, less \$40 in change to be put in the cash register the next day, and removes the record of the day's credit card sales from the scanner. All the records are placed in an envelope that is sealed and sent to the company's accountant for verification and recording in the company records. On the way home, Hazel places the bank deposit in the night deposit box.

The company hires experienced cashiers who are bonded. Hazel spends the first half-day with new cashiers, showing them the procedures and overlooking their work.

### REQUIRED

- Give an example of how each of the following control activities is applied to internal control over sales and cash at East-West Sports Shop: (Do not address controls over inventory.)
  - Authorization
  - Recording transactions
  - Documents and records
  - Physical controls
  - Periodic independent verification
  - Separation of duties
  - Sound personnel practices
- ACCOUNTING CONNECTION** ► Can the system as described protect against a cashier who accepts cash for a sale but does not ring up the sale and pockets the cash? If so, how does it prevent this action?

### LO 3

### Bank Reconciliation

GENERAL LEDGER

SPREADSHEET

✓ 1: Adjusted book balance,  
May 31: \$54,485.60

**P4.** The following information is available for Sedona, Inc., as of May 31, 2014:

- Cash on the books as of May 31 amounted to \$42,754.16. Cash on the bank statement for the same date was \$52,351.46.
- A deposit of \$5,220.94, representing cash receipts of May 31, did not appear on the bank statement.
- Outstanding checks totaled \$3,936.80.
- A check for \$1,920.00 returned with the statement was recorded incorrectly in the check register as \$1,380.00. The check was for a cash purchase of merchandise.
- The bank service charge for May amounted to \$25.
- The bank collected \$12,360.00 for Sedona, on a note. The face value of the note was \$12,000.00.
- An NSF check for \$183.56 from a customer, Eva Mendez, was returned with the statement.
- The bank mistakenly charged to the company account a check for \$850.00 drawn by another company.
- The bank reported that it had credited the account for \$120.00 in interest on the average balance for May.

### REQUIRED

- Prepare a bank reconciliation for Sedona as of May 31, 2014.
- Prepare the journal entries necessary to adjust the accounts.
- What amount of cash should appear on Sedona's balance sheet as of May 31?
- ACCOUNTING CONNECTION** ► Why is a bank reconciliation considered an important control over cash?

### LO 4

### Imprest (Petty Cash) Transaction

SPREADSHEET

✓ 1: June 30 credit to Cash: \$507.24

**P5.** A small company maintains a petty cash fund for minor expenditures. The following transactions occurred in June and July 2014:

- The fund was established in the amount of \$600.00 on June 1 from the proceeds of check no. 30.
- On June 30, the petty cash fund had cash of \$92.76 and the following receipts on hand: postage, \$240.00; supplies, \$149.64; delivery service, \$74.40; and rubber stamp, \$43.20. Check no. 1577 was drawn to replenish the fund.
- On July 31, the petty cash fund had cash of \$132.36 and the following receipts on hand: postage, \$205.20; supplies, \$197.04; and delivery service, \$38.40. The petty

(Continued)



cash custodian could not account for the shortage. Check no. 1628 was written to replenish the fund.

#### REQUIRED

1. Prepare the journal entries necessary to record each of these transactions.
2. **ACCOUNTING CONNECTION** ► A charity reimburses volunteers for small out-of-pocket expenses such as parking and gasoline when the volunteers are carrying out the business of the charity. How might an imprest (petty cash) fund be helpful in controlling these expenditures?

## ALTERNATE PROBLEMS

### LO 1 Internal Control Components

**P6.** Faubert Company, a small electronics distributor, has experienced losses of inventory over the past year. Melissa Faubert, the owner, on the advice of her accountant, has adopted a set of internal controls in an effort to stop the losses. Faubert has taken the following steps:

1. She encourages employees to follow the rules.
2. She regularly considers ways in which inventory losses might occur.
3. She puts separation of duties in place.
4. She gathers appropriate information and communicates it to employees.
5. She sees that new and existing employees are well trained and instructed in their duties.
6. She makes sure inventories are physically protected with locked storage and electronic monitors.
7. She observes and reviews how procedures by those who report to her are carried out.
8. She had her accountant install a better accounting system over inventory.
9. She trains new employees in how to properly carry out control procedures.

#### REQUIRED

1. Show that Faubert's new system engages all the components of internal control by matching each of the steps with the internal control components that follow. (*Hint:* Some may have more than one answer.)
 

a. Control environment	d. Control activities
b. Risk assessment	e. Monitoring
c. Information and communication	
2. **BUSINESS APPLICATION** ► As the owner of a small company, why is it important that Melissa take an active part in the management of the internal control system?

### LO 1, 2 Control Activities

**P7.** Midori Cabinet Company provides maintenance services to factories in and around Boca-Raton, Florida. The company, which buys a large amount of cleaning supplies, consistently has been over budget in its expenditures for these items. In the past, supplies were left out in the open in the warehouse to be taken each evening as needed by the onsite supervisors. A clerk in the accounting department periodically ordered additional supplies from a long-time supplier. No records were maintained other than to record purchases. Once a year, an inventory of supplies was made for the preparation of the financial statements.

To solve the budgetary problem, management decides to implement a new system for purchasing and controlling supplies. The following actions take place:

1. Management places a supplies clerk in charge of a secured storeroom for cleaning supplies.
2. Supervisors use a purchase requisition to request supplies for the jobs they oversee.
3. Each job receives a predetermined amount of supplies based on a study of each job's needs.



4. In the storeroom, the supplies clerk notes the levels of supplies and completes the purchase requisition when new supplies are needed.
5. The purchase requisition goes to the purchasing clerk, a new position. The purchasing clerk is solely responsible for authorizing purchases and preparing the purchase orders.
6. Supplier prices are monitored constantly by the purchasing clerk to ensure that the lowest price is obtained.
7. When supplies are received, the supplies clerk checks them in and prepares a receiving report. The supplies clerk sends the receiving report to accounting, where each payment to a supplier is documented by the purchase requisition, the purchase order, and the receiving report.
8. The accounting department also maintains a record of supplies inventory, supplies requisitioned by supervisors, and supplies received.
9. Once each month, the warehouse manager takes a physical inventory of cleaning supplies in the storeroom and compares it against the supplies inventory records that the accounting department maintains.

**REQUIRED**

1. Indicate which of the control activities that follow applies to each of the improvements in the internal control system. (*Hint:* More than one may apply.)
 

a. Authorization	e. Periodic independent verification
b. Recording transactions	f. Separation of duties
c. Documents and records	g. Sound personnel practices
d. Physical controls	
2. **ACCOUNTING CONNECTION** ► Explain why each new control activity (a through g) is an improvement over the activities of the old system.

LO 1, 2 **Internal Control Activities**

**P8. ACCOUNTING CONNECTION** ► Fuentes is a retail store with several departments. Its internal control procedures for cash sales and purchases are as follows.

*Cash sales.* The sales clerk in each department rings up every cash sale on the department's cash register. The cash register produces a sales slip, which the clerk gives to the customer along with the merchandise. A continuous tape locked inside the cash register makes a carbon copy of the sales ticket. At the end of each day, the sales clerk presses a "total" key on the register, and it prints the total sales for the day on the continuous tape. The sales clerk then unlocks the tape, reads the total sales figure, and makes the entry in the accounting records for the day's cash sales. Next, she counts the cash in the drawer, places the \$200 change fund back in the drawer, and gives the cash received to the cashier. Finally, she files the cash register tape and is ready for the next day's business.

*Purchases.* At the request of the various department heads, the purchasing agent orders all goods. When the goods arrive, the receiving clerk prepares a receiving report in triplicate. The receiving clerk keeps one copy; the other two copies go to the purchasing agent and the department head. Invoices are forwarded immediately to the accounting department to ensure payment before the discount period elapses. After payment, the invoice is forwarded to the purchasing agent for comparison with the purchase order and the receiving report and is then returned to the accounting office for filing.

**REQUIRED**

1. Identify the significant internal control weaknesses in each of the above situations.
2. In each case identified in requirement 1, recommend changes that would improve the system.

## LO 3

**Bank Reconciliation**

GENERAL LEDGER

SPREADSHEET

✓ 1: Adjusted book balance,  
April 30: \$149,473.28

**P9.** The following information is available for Delta Company as of April 30, 2014:

- Cash on the books as of April 30 amounted to \$114,175.28. Cash on the bank statement for the same date was \$141,717.08.
- A deposit of \$14,249.84, representing cash receipts of April 30, did not appear on the bank statement.
- Outstanding checks totaled \$7,293.64.
- A check for \$2,420.00 returned with the statement was recorded as \$2,024.00. The check was for advertising.
- The bank service charge for April amounted to \$26.00.
- The bank collected \$36,400.00 for Delta Company on a note. The face value of the note was \$36,000.00.
- An NSF check for \$1,140.00 from a customer, Hasan Ali, was returned with the statement.
- The bank mistakenly deducted a check for \$800.00 that was drawn by Alpha Corporation.
- The bank reported a credit of \$460.00 for interest on the average balance.

**REQUIRED**

- Prepare a bank reconciliation for Delta as of April 30, 2014.
- Prepare the necessary journal entries from the reconciliation.
- State the amount of cash that should appear on Delta's balance sheet as of April 30.
- ACCOUNTING CONNECTION** ► Why is a bank reconciliation a necessary internal control?

## LO 4

**Imprest (Petty Cash) Fund Transactions**

SPREADSHEET

✓ July 31 credit to Cash: \$737.16

**P10.** On July 1, 2014, Acting Company established an imprest (petty cash) fund in the amount of \$800.00 in cash from a check drawn for the purpose of establishing the fund. On July 31, the petty cash fund has cash of \$62.84 and the following receipts on hand: for merchandise received, \$408.60; freight-in, \$131.48; laundry service, \$168.00; and miscellaneous expense, \$29.08. A check was drawn to replenish the fund.

On Aug. 31, the petty cash fund has cash of \$110.00 and the following receipts on hand: merchandise, \$393.68; freight-in, \$152.60; laundry service, \$168.00; and miscellaneous expense, \$15.72. The petty cash custodian is not able to account for the excess cash in the fund. A check is drawn to replenish the fund.

**REQUIRED**

- Prepare the journal entries necessary to record each of these transactions. The company uses the periodic inventory system.
- ACCOUNTING CONNECTION** ► What are two examples of why a local semiprofessional baseball team might have need for an imprest (petty cash) system?

**CASES**

## LO 1, 2

**Conceptual Understanding: Control Systems**

**C1.** In the spring of each year, Steinbrook College's theater department puts on a contemporary play. Before the performance, the theater manager instructs student volunteers in their duties as cashier, ticket taker, and usher.

The cashier, who is located in a box office at the entrance to the auditorium, receives cash from customers and enters the number of tickets and the amount paid into a computer, which prints out serially numbered tickets. The cashier puts the cash in a locked cash drawer and gives the tickets to the customer.

Customers give their tickets to the ticket taker. The ticket taker tears each ticket in half, gives one half to the customer, and puts the other half in a locked box.

When customers present their ticket stubs to an usher, the usher shows them to their seats.

1. Describe how each of the control activities discussed in this chapter (authorization, recording transactions, documents and records, physical controls, periodic independent verification, separation of duties, and sound personnel practices) apply to the control system that includes the cashier, ticket taker, and usher.
2. Could the cashier issue a ticket to a friend without taking in cash? Could the ticket taker allow friends to enter without a ticket? If so, how might they be caught?

**LO 1, 2 Interpreting Financial Reports: Internal Control Lapse**

**C2. Starbucks Corporation** accused an employee and her husband of embezzling \$3.7 million by billing the company for services from a fictitious consulting firm. The couple created a phony company called RAD Services Inc. and charged Starbucks for work they never provided. The employee worked in Starbucks' Information Technology Department.<sup>12</sup> RAD Services charged Starbucks as much as \$492,800 for consulting services in a single week. For such a fraud to have taken place, certain control activities were likely not implemented. Identify and describe these activities.

**LO 1, 2 Conceptual Understanding: Internal Controls**

**C3.** Go to a local retail business, such as a bookstore, clothing shop, gift shop, grocery store, hardware store, or car dealership. Ask to speak to someone who is knowledgeable about the store's methods of internal control. After you and other members of the class have completed this step individually, your instructor will divide the class into groups. Group members will compare their findings and develop answers to the questions that follow. A member of each group will then present the group's answers to the class.

1. How does the company protect itself against inventory theft and loss?
2. What control activities, including authorization, recording transactions, documents and records, physical controls, periodic independent verification, separation of duties, and sound personnel practices, does the company use?
3. Can you see these control procedures in use?

**LO 1, 5 Annual Report Case: Internal Control Responsibilities**

**C4. BUSINESS APPLICATION** ► To answer the questions that follow, refer to "Management's Report on Internal Control Over Financial Reporting" and the "Report of Independent Registered Public Accounting Firm" in **CVS's** annual report in the Supplement to Chapter 16.

1. What is management's responsibility with regard to internal control over financial reporting?
2. What is management's conclusion regarding its assessment of internal control over financial reporting?
3. Does CVS's auditor agree with management's assessment?
4. What does the auditor say about the limitations or risks associated with internal control?

**LO 1 Comparison Analysis: Contrasting Internal Control Needs**

**C5. BUSINESS APPLICATION** ► In a typical **CVS** store, customers wheel carts down aisles to select items for purchase and take them to a checkout counter where they pay with cash or credit card. The company is concerned that customers might leave the store with merchandise that they have not paid for. Typically, customers of **Southwest Airlines** have already paid for their tickets when they arrive at the gate. The company is concerned that customers who do not have tickets might be allowed on the plane. (Southwest does not have assigned seating.) Compare the risks for each company in the situations just described and the internal control process.

**LO 1, 2 Ethical Dilemma: Personal Responsibility for Mistakes**

**C6.** Suppose you have a part-time sales position over the winter break in a small clothing store that is part of a national chain. The store's one full-time employee, with whom you have become friendly, hired you. Explain what you would do in the situations described below, and identify two internal control problems that exist in each situation.

1. You arrive at the store at 6 p.m. to take over the evening shift from the full-time employee who hired you. You notice that this person takes a coat from a rack, puts it on, and leaves by the back door. You are not sure if the coat is one that was for sale or if it belonged to the employee.
2. You are the only person in the store on a busy evening. At closing time, you total the cash register and the receipts and discover that the cash register is \$20 short of cash. You consider replacing the \$20 out of your pocket because you think you may have made a mistake and are afraid you might lose your job if the company thinks you took the money.

**Continuing Case: Annual Report Project**

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the balance sheet and accompanying notes of your company. Answer the following questions:

1. What percentage is cash to total current assets? Do you think this percentage represents the importance of cash to the company's operations?
2. Find the note about cash in the notes to the financial statements. What is included in cash?
3. Given the industry your company is in, what do you think are some of its most important internal control issues?

# CHAPTER 9

## Receivables

### BUSINESS INSIGHT

#### Smart Computer Company

Smart Computer Company sells computer products for cash or on credit. The company's peak sales occur in August and September, when students are shopping for computers and computer-related supplies, and during the pre-holiday season in November and December. It is now January, and Jimmy Smart, the company's owner, has been reviewing the company's performance over the past two years. He has determined that in those years, approximately 1.5 percent of net sales have been uncollectible. He is concerned that, this year, the company may not have enough cash to cover operations before sales begin to increase again in late summer. In this chapter, we discuss concepts and techniques that would help Smart maintain its liquidity and manage its receivables.

- 1. CONCEPT** ► *How do companies like Smart Computer apply accrual accounting to their receivables, and how do they properly disclose the value of their receivables?*
- 2. ACCOUNTING APPLICATION** ► *How can Smart Computer estimate the value of its receivables?*
- 3. BUSINESS APPLICATION** ► *How can the company evaluate the effectiveness of its credit policies and the level of its accounts receivable?*

### LEARNING OBJECTIVES

- LO 1** Define receivables, and explain the allowance method for valuation of receivables as an application of accrual accounting.
- LO 2** Apply the allowance method of accounting for uncollectible accounts.
- LO 3** Make common calculations for notes receivable.
- LO 4** Show how to evaluate the level of receivables, and identify alternative means of financing receivables.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Accrual accounting (matching principle)
- Valuation
- Disclosure

## RELEVANT LEARNING OBJECTIVE

**LO 1** Define receivables, and explain the allowance method for valuation of receivables as an application of accrual accounting.

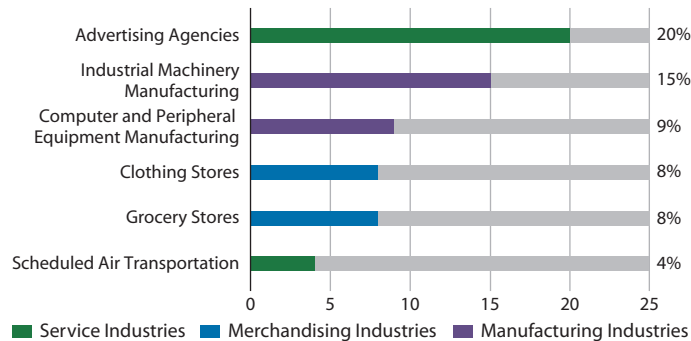
## LO 1 Concepts Underlying Notes and Accounts Receivable

The most common receivables are accounts receivable and notes receivable. The *allowance method* is used to apply *accrual accounting* to the *valuation* of accounts receivable. Proper *disclosure* in the financial statements and the notes to them is important for users of the statements to interpret them.

### Accounts Receivable

**Accounts receivable** are short-term financial assets that arise from sales on credit and are often called **trade credit**. Terms of trade credit usually range from 5 to 60 days, depending on industry practice, and may allow customers to pay in installments. Credit sales or loans not made in the ordinary course of business, such as those made to employees, officers, or owners, should appear separately under asset titles like Receivables from Employees. Exhibit 1 shows the level of accounts receivable in selected industries.

**Exhibit 1**  
Accounts Receivable as a Percentage of Total Assets for Selected Industries



Companies that sell on credit do so to be competitive and to increase sales. In setting credit terms, a company must keep in mind the credit terms of its competitors and the needs of its customers. Obviously, any company that sells on credit wants customers who will pay their bills on time. To increase the likelihood of selling only to customers who will pay on time, most companies develop control procedures and maintain a credit department. The credit department's responsibilities include examining each person or company that applies for credit and approving or rejecting a credit sale to that customer. Typically, the credit department asks for information about the customer's financial resources and debts. It may also check personal references and credit bureaus for further information. Based on the information it has gathered, it decides whether to extend credit to the customer.

Companies that are too lenient in granting credit can run into difficulties when customers don't pay. For example, **Sprint**, one of the weaker companies in the competitive cell phone industry, targeted customers with poor credit histories. It attracted so many who failed to pay their bills that its stock dropped by 50 percent, to \$2.50, because of the losses that resulted.<sup>1</sup>



Design Pics/Jupiter Images

You may already be familiar with promissory notes if you have taken out student loans or car loans. When you take out these loans, you sign a contract with a lender promising to repay the loan under certain terms.

**STUDY NOTE:** *Accounts receivable and accounts payable are distinguished from notes receivable and notes payable because the former were not created by a formal promissory note.*

Companies that extend credit to customers know that some of these customers cannot or will not pay. The accounts of such customers are called **uncollectible accounts** (or *bad debts*), and they are expenses of selling on credit. In accordance with *accrual accounting*, to match these expenses to the revenues they help generate, they should be recognized at the time credit sales are made.

Some companies recognize a loss when they determine that an account is uncollectible by reducing Accounts Receivable and increasing Uncollectible Accounts Expense. Federal regulations require companies to use this method—called the **direct charge-off method**—in computing taxable income. However, because a direct charge-off is usually recorded in a different period from the one in which the sale takes place, this method is not in accord with *accrual accounting*. Generally accepted accounting principles, therefore, require the use of the allowance method of accounting for uncollectible accounts.

## Notes Receivable

**Notes receivable** are short-term financial assets supported by written agreements called promissory notes. A **promissory note** is an unconditional promise to pay a definite sum of money on demand or at a future date. The person or company that signs the note and, thereby, promises to pay is the *maker* of the note. The entity to whom payment is to be made is the *payee*. The promissory note shown in Exhibit 2 is an unconditional promise by the maker, Samuel Mason, to pay a definite sum—or principal (\$1,000)—to the payee, Cook County Bank & Trust, on August 18, 2014. The note is dated May 20, 2014, and bears an interest rate of 8 percent. This interest accrues by a small amount each day the note is outstanding, increasing the payee’s interest receivable and interest income.

**Exhibit 2**  
A Promissory Note

**PROMISSORY NOTE**

\$1,000.00	May 20, 2014
Amount	Date

For value received, I promise to pay to the order of

Cook County Bank & Trust  
Chicago, Illinois

One thousand and no/100 - - - - Dollars

on August 18, 2014

plus interest at the annual rate of 8 percent.

Samuel Mason

Principal →

Interest Period Starts →

Payee →

Interest Period Ends on the Maturity Date →

Interest Rate →

Maker →

© Cengage Learning 2014

The nature of a company’s business generally determines how frequently it receives promissory notes from customers. Firms that sell durable goods of high value, such as farm machinery and automobiles, often accept promissory notes. Among the advantages of these notes are that they produce interest income and represent a stronger legal claim against a debtor than accounts receivable do. In addition, selling—or discounting—promissory notes to banks is a common financing method. Almost all companies occasionally accept promissory notes, and many companies obtain them in settlement of past-due accounts receivable.



## The Allowance Method: Using Accrual Accounting to Value Receivables

**STUDY NOTE:** The allowance method relies on an estimate of uncollectible accounts; but unlike the direct charge-off method, it is in accord with accrual accounting.

The **allowance method** is an application of *accrual accounting*, which requires estimated losses from bad debts to be matched with the revenues they help to produce. Further, they serve to *value* accounts receivable on the balance sheet. As mentioned earlier, when management extends credit to increase sales, it knows it will incur some losses from uncollectible accounts. Losses from credit sales should be recognized when the sales are made. Of course, at that time, management cannot identify which customers will not pay their debts, nor can it predict the exact amount of money the company will lose. Therefore, to follow accrual accounting (*the matching principle*), losses from uncollectible accounts must be estimated, and the estimate becomes an expense in the period in which the sales are made.

### Uncollectible Accounts: The Allowance Method

**Transaction** Mandy Sales Company made most of its sales on credit during its first year of operation, 2014. At the end of the year, accounts receivable amounted to \$200,000. On December 31, 2014, management reviewed the collectible status of the accounts receivable. Approximately \$12,000 of the \$200,000 of accounts receivable were estimated to be uncollectible.

**Analysis** The adjusting entry to record estimated uncollectible accounts

- ▲ increases the *Uncollectible Accounts Expense* account
- ▲ increases the *Allowance for Uncollectible Accounts* account

### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Allowance for Uncollectible Accounts</b>						<b>Uncollectible Accounts Expense</b>	
<i>Dr.</i>	<i>Cr.</i>					<i>Dr.</i>	<i>Cr.</i>
	Dec. 31 12,000					Dec. 31 12,000	

### Journal Entry

$$\begin{array}{r} \mathbf{A} \\ -12,000 \end{array} = \begin{array}{r} \mathbf{L} \\ \phantom{-12,000} \end{array} + \begin{array}{r} \mathbf{OE} \\ -12,000 \end{array}$$

	<i>Dr.</i>	<i>Cr.</i>
Dec. 31	Uncollectible Accounts Expense	
	→ Allowance for Uncollectible Accounts	12,000
	To record the estimated uncollectible accounts expense for the year	

**Comment** This transaction is an application of *accrual accounting* in that uncollectible accounts expense and is used to *value* accounts receivable at the amount that is expected to be collected.



## International Perspective

IFRS

### Can Users Depend on the Allowance for Uncollectible Accounts?

Financial statements contain many estimates, one of which is the allowance for uncollectible accounts. In their effort to converge U.S. GAAP and IFRS, the FASB and the IASB have agreed that estimates must be a faithful representation of what they purport to represent and that they be verifiable. Under their agreement, faithful information is unbiased and contains no errors or omissions. Further, verifiability means that two independent experts could reach agreement as to the estimate.<sup>2</sup> In other words, users can be assured that net accounts receivable (accounts receivable less the allowance) represent the best estimate of the future cash receipts from the receivables.

## Disclosure of Receivables

A payee includes all the promissory notes it holds that are due in less than one year as *notes receivable* in the current assets section of its balance sheet. Any interest accrued on these notes is also included in the current assets section—as **interest receivable**. Because notes are financial instruments, companies may voluntarily *disclose* their fair value. In most cases, fair value approximates the amount in the account records.

**STUDY NOTE:** The allowance account often has other titles, such as Allowance for Doubtful Accounts and Allowance for Bad Debts. Bad Debts Expense is a title often used for Uncollectible Accounts Expense.

Uncollectible Accounts Expense appears on the income statement as an operating expense. **Allowance for Uncollectible Accounts** appears on the balance sheet as a contra account, deducted from accounts receivable in the current assets section. It reduces the accounts receivable to the amount expected to be collectible (net realizable value), as follows.

Current assets:			
Cash			\$ 20,000
Short-term investments			30,000
Notes receivable			15,000
Accounts receivable	\$200,000		
Less allowance for uncollectible accounts	<u>12,000</u>		188,000
Interest receivable			1,000
Inventory			<u>112,000</u>
Total current assets			<u>\$366,000</u>

A variation of the *disclosure* of accounts receivable on the balance sheet follows.

Accounts receivable (net of allowance for uncollectible accounts of \$12,000)      \$188,000

Accounts receivable may also be shown at “net,” with the amount of the allowance for uncollectible accounts identified in a note to the financial statements. For most companies, the “net” amount of accounts receivable approximates fair value. Fair value disclosures are not required for accounts receivable, but 59 percent of large companies made this disclosure voluntarily. Of those, 85 percent indicated that the net accounts receivable approximated fair value.<sup>3</sup>

### APPLY IT!

Match the concepts that follow to the related statements.

1. Preparing an adjusting entry to record the estimated uncollectible accounts expense.
2. Subtracting the allowance for uncollectible accounts from accounts receivable.
3. Preparing an adjusting entry to record interest earned on notes receivable.
4. Reporting the net realizable value of receivables on the balance sheet.
5. Separating accounts receivable from receivables from employees.

- a. valuation
- b. accrual accounting
- c. periodicity
- d. disclosure

### SOLUTION

1. b; 2. a; 3. b; 4. d; 5. d

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Estimate uncollectible accounts and uncollectible accounts expense using
  - Percentage of net sales method
  - Accounts receivable aging method
- Write off uncollectible accounts
- Make common calculations for notes receivable

## RELEVANT LEARNING OBJECTIVES

**LO 2** Apply the allowance method of accounting for uncollectible accounts.

**LO 3** Make common calculations for Notes Receivable

## LO 2 Uncollectible Accounts

The allowance account is necessary because the specific uncollectible accounts will not be identified until later. It is not like another contra account, Accumulated Depreciation, whose purpose is to show how much of the plant and equipment cost has been allocated as an expense to previous periods.

If management takes an optimistic view and projects a small loss from uncollectible accounts, the resulting net accounts receivable will be larger than if management takes a pessimistic view. The net income will also be larger under the optimistic view because the estimated expense will be smaller. The company's accountant makes an estimate based on past experience and current economic conditions. For example, losses from uncollectible accounts are normally expected to be greater in a recession than during a period of economic growth. The final decision on the amount of the expense will depend on objective information, such as the accountant's analyses, and on certain qualitative factors, such as how investors, bankers, creditors, and others view the performance of the debtor company. Regardless of the qualitative considerations, the estimated losses from uncollectible accounts should be realistic.

Two common methods of estimating uncollectible accounts expense are the percentage of net sales method and the accounts receivable aging method.

### Percentage of Net Sales Method

The basis for the **percentage of net sales method** is the amount of this year's *net sales* that will not be collected. The answer determines the amount of uncollectible accounts expense for the year.

#### Uncollectible Accounts: The Percentage of Net Sales Method

**Transaction** The following balances represent Varta Company's ending figures for 2014:

Sales		Sales Returns and Allowances	
Dr.	Cr.	Dr.	Cr.
	Dec. 31	20,000	322,500
Sales Discounts		Allowance for Uncollectible Accounts	
Dr.	Cr.	Dr.	Cr.
	Dec. 31		1,800
2,500			



## Business Perspective

### Cash Collections Can Be Hard to Estimate

Companies must not only sell goods and services but also must generate cash flows by collecting on those sales. When there are changes in the economy, some companies make big mistakes in estimating the amount of accounts they will collect. For example, when the dot-com bubble burst in the early 2000s, companies like **Nortel Networks**, **Cisco Systems**, and **Lucent Technologies** increased their estimates of allowances for uncollectible accounts—actions that eliminated previously reported earnings and caused the companies' stock prices to fall.<sup>4</sup> However, it turned out that these companies had overestimated how bad the losses would be. In later years, they reduced their allowances for credit losses, thereby increasing their reported earnings.<sup>5</sup>

© Aljia / Stockphoto.com

The following are Varta’s actual losses from uncollectible accounts for the past three years:

Year	Net Sales	Losses from Uncollectible Accounts	Percentage
2011	\$260,000	\$ 5,100	1.96
2012	297,500	6,950	2.34
2013	292,500	4,950	1.69
Total	<u>\$850,000</u>	<u>\$17,000</u>	2.00

Varta’s management believes that its uncollectible accounts will continue to average about 2 percent of net sales. The uncollectible accounts expense for the year 2014 is therefore estimated as follows.

$$0.02 \times (\$322,500 - \$20,000 - \$2,500) = 0.02 \times \$300,000 = \$6,000$$

**Analysis** The journal entry to record the estimated uncollectible accounts

- ▲ increases the *Uncollectible Accounts Expense* account
- ▲ increases the *Allowance for Uncollectible Accounts* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner’s Equity	
<b>Allowance for Uncollectible Accounts</b>						<b>Uncollectible Accounts Expense</b>	
<i>Dr.</i>	<i>Cr.</i>					<i>Dr.</i>	<i>Cr.</i>
	Dec. 31 1,800					Dec. 31 6,000	
	31 6,000						
	<b>Bal. 7,800</b>						

**Journal Entry**

A		=	L		+	OE	
	-6,000						-6,000
Dec. 31	Uncollectible Accounts Expense					<i>Dr.</i>	<i>Cr.</i>
	→ Allowance for Uncollectible Accounts					6,000	6,000
	To record uncollectible accounts expense at 2 percent of \$300,000 net sales						

**Comment** This application of *accrual accounting* leaves the Allowance for Uncollectible Accounts with a balance of \$7,800. The balance consists of the \$6,000 estimated uncollectible accounts receivable from 2014 sales and the \$1,800 estimated uncollectible accounts receivable from previous years.

## Accounts Receivable Aging Method

The basis for the **accounts receivable aging method** is the amount of the *ending balance of accounts receivable* that will not be collected. With this method, the ending balance of Allowance for Uncollectible Accounts is determined directly through an analysis of accounts receivable. The difference between the amount determined to be uncollectible and the actual balance of Allowance for Uncollectible Accounts is the expense for the period. In theory, this method should produce the same result as the percentage of net sales method, but in practice it rarely does.

The **aging of accounts receivable** is the process of listing each customer’s receivable account according to the due date of the account. If the customer’s account is

**STUDY NOTE:** An aging of accounts receivable is an important tool in cash management because it helps to determine what amounts are likely to be collected in the months ahead.

past due, there is a possibility that the account will not be paid. And that possibility increases as the account extends further beyond the due date. The aging of accounts receivable helps management evaluate its credit and collection policies and alerts it to possible problems.

To illustrate the accounts receivable aging method, we will use Radko Company. Exhibit 3 illustrates the aging of accounts receivable for Radko. Each account receivable is classified as being not yet due or as being 1–30 days, 31–60 days, 61–90 days, or over 90 days past due. Based on past experience, the estimated percentage for each category is determined and multiplied by the amount in each category to determine the estimated, or target, balance of Allowance for Uncollectible Accounts. In total, it is estimated that \$4,918 of the \$88,800 in accounts receivable will not be collected.

### Exhibit 3

#### Analysis of Accounts Receivable by Age

<b>Radko Company</b>						
<b>Analysis of Accounts Receivable by Age</b>						
<b>December 31, 2014</b>						
<b>Customer</b>	<b>Total</b>	<b>Not Yet Due</b>	<b>1–30 Days Past Due</b>	<b>31–60 Days Past Due</b>	<b>61–90 Days Past Due</b>	<b>Over 90 Days Past Due</b>
K. Lee	\$ 300		\$ 300			
F. Moll	800			\$ 800		
T. Orr	2,000	\$ 1,800	200			
P. Govin	500				\$ 500	
Others	<u>85,200</u>	<u>42,000</u>	<u>28,000</u>	<u>7,600</u>	<u>4,400</u>	<u>\$3,200</u>
Totals	<u>\$88,800</u>	<u>\$43,800</u>	<u>\$28,500</u>	<u>\$8,400</u>	<u>\$4,900</u>	<u>\$3,200</u>
Estimated percentage uncollectible		<u>1.0</u>	<u>2.0</u>	<u>10.0</u>	<u>30.0</u>	<u>50.0</u>
Allowance for Uncollectible Accounts	<u>\$ 4,918</u>	<u>\$ 438</u>	<u>\$ 570</u>	<u>\$ 840</u>	<u>\$1,470</u>	<u>\$1,600</u>

© Cengage Learning 2014

Once the target balance for Allowance for Uncollectible Accounts has been determined, the amount of the adjustment depends on the current balance of the allowance account. We will assume two cases for the balance of Radko's Allowance for Uncollectible Accounts on December 31: (1) a credit balance of \$1,600 and (2) a debit balance of \$1,600.

#### Adjusting the Allowance Account: Credit Balance

**Transaction** In the first case, an adjustment of \$3,318 is needed to bring the balance of the allowance account to a \$4,918 credit balance.

Targeted balance for allowance for uncollectible accounts	\$4,918
Less current credit balance of allowance for uncollectible accounts	1,600
Uncollectible accounts expense	<u>\$3,318</u>

**Analysis** The journal entry to record the estimated uncollectible accounts

- ▲ increases the *Uncollectible Accounts Expense* account
- ▲ increases the *Allowance for Uncollectible Accounts* account

**Application of Double Entry**

Assets		=	Liabilities	+	Owner's Equity	
<b>Allowance for Uncollectible Accounts</b>					<b>Uncollectible Accounts Expense</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
	Dec. 31 1,600				Dec. 31 3,318	
	3,318					
	<b>Bal. 4,918</b>					

**Journal Entry**

$$A = L + OE$$

$$-3,318 = \quad + -3,318$$

Dec. 31	Uncollectible Accounts Expense	Dr.	3,318	Cr.	
	Allowance for Uncollectible Accounts				3,318
	To bring the allowance for uncollectible accounts to the level of estimated losses				

**Comment** This application of *accrual accounting* results in a balance of Allowance for Uncollectible Accounts of \$4,918.

**STUDY NOTE:** When the write-offs in a period exceed the amount of the allowance, a debit balance in Allowance for Uncollectible Accounts results.

**Adjusting the Allowance Account: Debit Balance**

**Transaction** In the second case, because Allowance for Uncollectible Accounts has a debit balance of \$1,600, the estimated uncollectible accounts expense for the year will have to be \$6,518 to reach the targeted balance of \$4,918, calculated as follows.

Targeted balance for allowance for uncollectible accounts	\$4,918
Plus current debit balance of allowance for uncollectible accounts	1,600
Uncollectible accounts expense	<u>\$6,518</u>

**Analysis** The journal entry to record the estimated uncollectible accounts

- ▲ increases the *Uncollectible Accounts Expense* account
- ▲ increases the *Allowance for Uncollectible Accounts* account

**Application of Double Entry**

Assets		=	Liabilities	+	Owner's Equity	
<b>Allowance for Uncollectible Accounts</b>					<b>Uncollectible Accounts Expense</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
Dec. 31 1,600	Dec. 31 6,518				Dec. 31 6,518	
	<b>Bal. 4,918</b>					

**Journal Entry**

$$A = L + OE$$

$$-6,518 = \quad + -6,518$$

Dec. 31	Uncollectible Accounts Expense	Dr.	6,518	Cr.	
	Allowance for Uncollectible Accounts				6,518
	To bring the allowance for uncollectible accounts to the level of estimated losses				

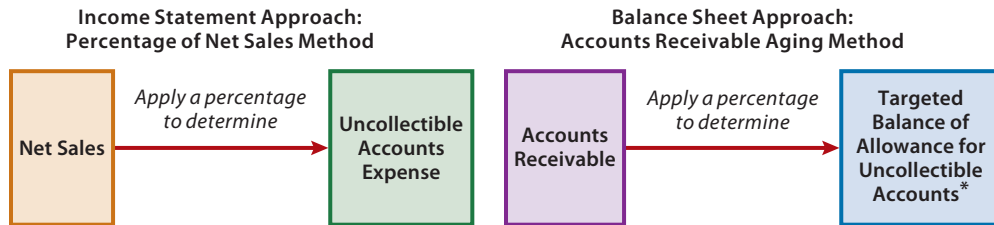
**Comment** After this entry applying *accrual accounting*, Allowance for Uncollectible Accounts has a credit balance *valuation* of \$4,918, which represents the amount of losses expected in the future.

**Comparison of the Two Methods**

Both the percentage of net sales method and the accounts receivable aging method estimate the uncollectible accounts expense in accordance with *accrual accounting*; but as shown in

**STUDY NOTE:** Describing the aging method as the balance sheet approach emphasizes that the computation is based on ending accounts receivable rather than on net sales for the period.

**Exhibit 4**  
Two Methods of Estimating Uncollectible Accounts



\*Add current debit balance or subtract current credit balance to determine uncollectible accounts expense.

© Cengage Learning 2014

### Writing Off Uncollectible Accounts

**STUDY NOTE:** When writing off an individual account, debit Allowance for Uncollectible Accounts, not Uncollectible Accounts Expense.

Regardless of the method used to estimate uncollectible accounts, the total of accounts receivable written off in a period will rarely equal the estimated uncollectible amount. The allowance account will show a credit balance when the total written off is less than the estimated uncollectible amount. It will show a debit balance when the total written off is greater than the estimated uncollectible amount.

When it becomes clear that a specific account receivable will not be collected, the amount should be written off to Allowance for Uncollectible Accounts. Remember that the uncollectible amount was already accounted for as an expense when the allowance was established.

#### Writing Off Uncollectible Accounts

**Transaction** On January 15, 2015, P. Govin, who owes Radko Company \$500, is declared bankrupt by a federal court.

**Analysis** The journal entry to record the write-off of an account receivable as uncollectible

- ▼ decreases the *Accounts Receivable* account
- ▼ decreases the *Allowance for Uncollectible Accounts* account

#### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Accounts Receivable, P. Govin</b>							
Dr.	Cr.						
	Jan. 15	500					
<b>Allowance for Uncollectible Accounts</b>							
Dr.	Cr.						
Jan. 15	500						

#### Journal Entry

		Dr.	Cr.
Jan. 15	Allowance for Uncollectible Accounts	500	
	Accounts Receivable, P. Govin		500
	Write-off of account		

**A = L + OE**  
+500  
-500



**Comment** The application of *accrual accounting* recognized the failure to collect this account through the estimate of uncollectible accounts occurred in a prior period. In the earlier period, it was not possible to identify which accounts would not be received.

Although the write-off removes the uncollectible amount from Accounts Receivable, it does not affect the estimated net realizable value of accounts receivable. It simply reduces P. Govin’s account to zero and reduces Allowance for Uncollectible Accounts by \$500, as shown below.

	Balances Before Write-Off	Balances After Write-Off
Accounts receivable	\$88,800	\$88,300
Less allowance for uncollectible accounts	4,918	4,418
Estimated net realizable value of accounts receivable	<u>\$83,882</u>	<u>\$83,882</u>

Occasionally, a customer whose account has been written off as uncollectible will later be able to pay some or all of the amount owed. When that happens, two entries must be made: one to reverse the earlier write-off (which is now incorrect) and another to show the collection of the account.

**APPLY IT!**

Drums Instruments Co. sells its merchandise on credit. In the company’s last fiscal year, which ended July 31, it had net sales of \$7,000,000. At the end of the fiscal year, it had Accounts Receivable of \$1,800,000 and a credit balance of \$11,200 in Allowance for Uncollectible Accounts. In the past, the company has been unable to collect on approximately 1 percent of its net sales. An aging analysis of accounts receivable has indicated that \$80,000 of current receivables are estimated to be uncollectible.

1. Calculate the amount of uncollectible accounts expense, and use T accounts to determine the resulting balance of Allowance for Uncollectible Accounts under the percentage of net sales method and the accounts receivable aging method.
2. How would your answers change if Allowance for Uncollectible Accounts had a debit balance of \$11,200 instead of a credit balance?

**SOLUTION**

1. Percentage of net sales method:

Allowance for Uncollectible Accounts			
Dr.		Cr.	
	July 31	11,200	
	31 UA Exp.	70,000*	
	<b>July 31 Bal.</b>	<b>81,200</b>	

\*Uncollectible Accounts Expense = \$7,000,000 × 0.01

Aging Method:

Allowance for Uncollectible Accounts			
Dr.		Cr.	
	July 31	11,200	
	31 UA Exp.	68,800*	
	<b>July 31 Bal.</b>	<b>80,000</b>	

\*Uncollectible Accounts Expense = \$80,000 – \$11,200

2. Under the percentage of net sales method, the amount of the expense is the same. However, if the allowance account (before adjustment) has a debit balance, its ending balance will be \$58,800 (\$70,000 – \$11,200). Under the accounts receivable aging method, the ending balance in the allowance account is the same. However, if the allowance account (before adjustment) has a debit balance, the amount of the expense will be \$91,200 (\$80,000 + \$11,200).

**TRY IT! SE3, SE4, SE5, E2A, E3A, E4A, E5A, E6A, E7A, E2B, E3B, E4B, E5B, E6B, E7B**

**LO 3 Common Calculations for Notes Receivable**

As defined previously, notes are promises to pay a definite amount at a definite future date. Such notes typically state a rate of interest that must also be paid at that future date. These features are the basis for several calculations that are common to promissory notes:

- Maturity date
- Duration of a note
- Interest
- Maturity value
- Accrued interest

## Maturity Date

The **maturity date** is the date on which a promissory note must be paid. This date must be stated on the note or be determinable from the facts stated on the note. The following are among the most common statements of maturity date:

- A specific date, such as “November 14, 2014”
- A specific number of months after the date of the note, such as “three months after November 14, 2014”
- A specific number of days after the date of the note, such as “60 days after November 14, 2014”

The maturity date is obvious when a specific date is stated. When the maturity date is a number of months from the date of the note, one simply uses the same day in the appropriate future month. For example, a note dated January 20 that is due in two months would be due on March 20.

When the maturity date is a specific number of days from the date of the note, however, the exact maturity date must be determined. In computing this date, it is important to exclude the date of the note. For example, a note dated May 20 and due in 90 days would be due on August 18, determined as follows.

Days remaining in May (31 – 20)	11
Days in June	30
Days in July	31
Days in August	<u>18</u>
Total days	<u>90</u>

## Duration of a Note

The **duration of a note** is the time between a promissory note’s issue date and its maturity date. Interest is calculated on the basis of the duration of a note. Identifying the duration is easy when the maturity date is a specific number of days from the date of the note. However, when the maturity date is stated as a specific date, the exact number of days must be determined. Assume that a note issued on May 10 matures on August 10. The duration of the note is 92 days.

Days remaining in May (31 – 10)	21
Days in June	30
Days in July	31
Days in August	<u>10</u>
Total days	<u>92</u>

## Interest

**Interest** is the cost of borrowing money or the return on lending money, depending on whether one is the borrower or the lender. The amount of interest is based on three factors:

- Principal (the amount of money borrowed or lent)
- Rate of interest
- Length of the loan

The formula used in computing interest follows.

$$\text{Principal} \times \text{Rate of Interest} \times \text{Time} = \text{Interest}$$

Interest rates are usually stated on an annual basis. For example, the interest on a one-year, 8 percent, \$1,000 note would be:

$$\begin{aligned} \text{Principal} \times \text{Rate of Interest} \times \text{Time} &= \text{Interest} \\ \$1,000 \times 8/100 \times 1 &= \$80 \end{aligned}$$

If the term of the note is three months instead of a year, the interest charge would be calculated as follows.

$$\$1,000 \times 8/100 \times 3/12 = \$20$$

When the term of a note is expressed in days, the exact number of days must be used in computing the interest. Thus, if the term of the note described was 45 days, the interest would be \$9.86, computed as follows.

$$\$1,000 \times 8/100 \times 45/365 = \$9.86^*$$

\*Rounded

## Maturity Value

The **maturity value** is the total proceeds of a promissory note—face value plus interest—at the maturity date. The maturity value of a 90-day, 8 percent, \$1,000 note is computed as follows.

$$\begin{aligned} \text{Maturity Value} &= \text{Principal} + \text{Interest} \\ &= \$1,000 + (\$1,000 \times 8/100 \times 90/365) \\ &= \$1,000 + \$19.73^* \\ &= \$1,019.73 \end{aligned}$$

\*Rounded

Some notes, called *non-interest-bearing notes*, do not specify an interest rate. The maturity value of these notes is the face value, or principal amount. The principal includes an implied interest cost.

## Accrued Interest

Accrued interest must be apportioned to the periods in which it belongs. For example, assume that the \$1,000, 90-day, 8 percent note discussed previously was received on August 31 and that the fiscal year ended on September 30. In this case, interest for 30 days, or \$6.58, is calculated as follows.

$$\begin{aligned} \text{Principal} \times \text{Rate of Interest} \times \text{Time} &= \text{Interest} \\ \$1,000 \times 8/100 \times 30/365 &= \$6.58^* \end{aligned}$$

\*Rounded

The \$6.58 of interest would be earned in the fiscal year that ends on September 30. The remainder of the interest income, \$13.15, would be calculated as follows.

$$\$1,000 \times 8/100 \times 60/365 = \$13.15^*$$

\*Rounded

This amount would be recorded as income, and the interest receivable (\$6.58) would be shown as received when the note is paid. Note that all the cash for the interest is received when the note is paid, but the interest income is apportioned to two fiscal years.

## Dishonored Note

A note not paid at maturity is called a **dishonored note**. The holder, or payee, of a dishonored note should transfer the total amount due (including interest income) from Notes Receivable to an individual account receivable for the debtor. This transfer accomplishes two things:

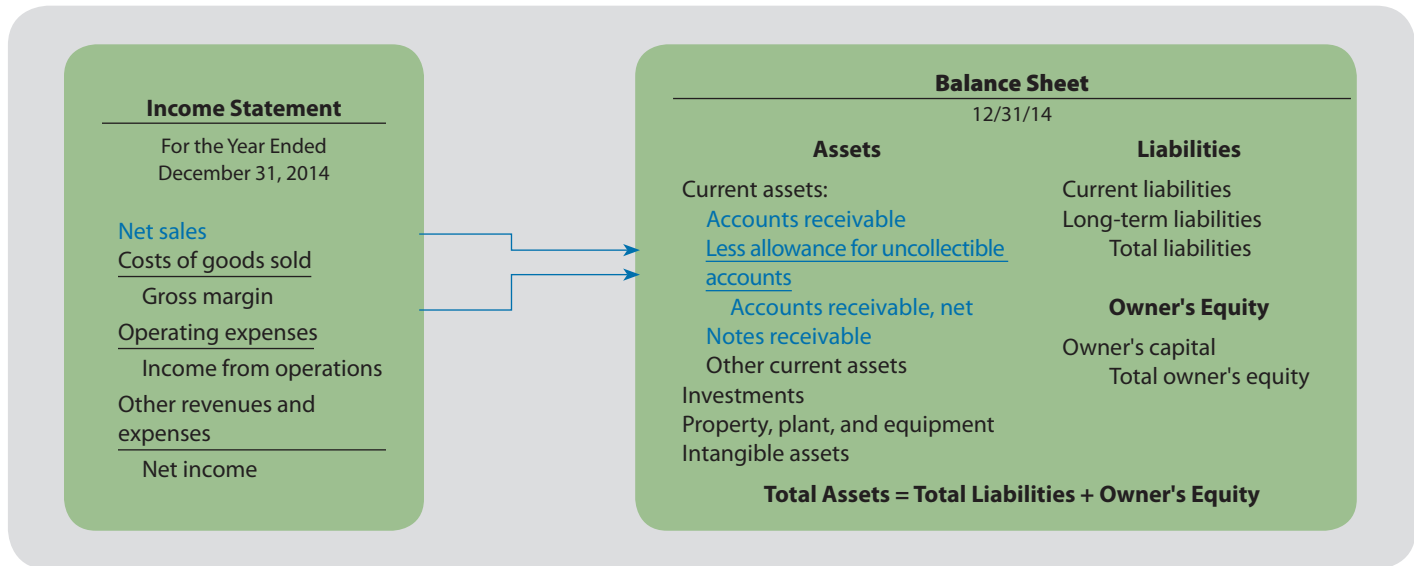
- It leaves only notes that are presumably collectible in the Notes Receivable account.
- It establishes a record showing that the customer has dishonored a note receivable, which may be helpful in deciding whether to extend credit to that customer in the future.

## Receivables and the Financial Statements

Exhibit 5 shows that accounts receivable on the balance sheet is closely related to sales on the income statement. The estimation of uncollectible credit sales affects the amount of net accounts receivable and operating expenses. Interest income on notes receivable affects the amount of assets and revenues.

### Exhibit 5

Valuation of Accounts Receivable on the Balance Sheet Impacts Net Sales on the Income Statement



© Cengage Learning 2014

## APPLY IT!

Assume that on December 1, 2014, a company receives a 90-day, 8 percent, \$5,000 note and that the company prepares financial statements monthly.

1. What is the maturity date of the note?
2. How much interest will be earned on the note if it is paid when due?
3. What is the maturity value of the note?
4. If the company's fiscal year ends on December 31, describe the adjusting entry that would be made, including the amount.
5. How much interest will be earned on this note in 2015?

### SOLUTION

1. Maturity date is March 1, 2015, determined as follows.

Days remaining in December (31 – 1)	30
Days in January	31
Days in February	28
Days in March	1
Total days	<u>90</u>

2. Interest:  $\$5,000 \times 8/100 \times 90/365 = \$98.63^*$
3. Maturity value:  $\$5,000 + \$98.63 = \$5,098.63$
4. An adjusting entry to accrue 30 days of interest income in the amount of  $\$32.88^*$  ( $\$5,000 \times 8/100 \times 30/365$ ) would be needed.
5. Interest earned in 2015:  $\$65.75$  ( $\$98.63 - \$32.88$ )

\* Rounded

**TRY IT! SE6, SE7, SE8, E8A, E9A, E10A, E11A, E8B, E9B, E10B, E11B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Receivables turnover
- Days' sales uncollected
- Financing receivables
  - Factoring of accounts receivable
  - Securitization of accounts receivable
  - Discounting of accounts receivable
- Ethics

RELEVANT  
LEARNING OBJECTIVE

- LO 4** Show how to evaluate the level of receivables, and identify alternative means of financing receivables.

## LO 4 Evaluating the Level of Accounts Receivable and Ethical Ramifications

Receivables are an important asset for any company that sells on credit. For them, it is critical to manage the level of receivables. Two common measures of the effect of a company's credit policies are *receivables turnover* and *days' sales uncollected*. Further, many companies manage their receivables by using various means to finance them. Finally, the judgments in estimating uncollectible accounts are a temptation for unethical behavior.

### Receivables Turnover

The **receivables turnover** shows how many times, on average, a company turned its receivables into cash during a period. It reflects the relative size of a company's accounts receivable and the success of its credit and collection policies. It may also be affected by external factors, such as seasonal conditions and interest rates.

The receivables turnover is computed by dividing net sales by the average accounts receivable (net of allowances). Theoretically, the numerator should be net credit sales; but since the amount of net credit sales is rarely available in public reports, investors use total net sales. Using data from **Nike's** annual report, we can compute the company's receivables turnover in 2011 as follows (dollar amounts are in millions).

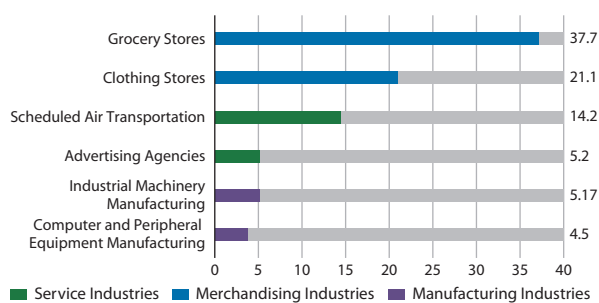
## RATIO

### Receivables Turnover: How Many Times Did the Company Collect Its Accounts Receivable During an Accounting Period?

$$\text{Receivables Turnover} = \frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$$

$$\frac{\$20,962}{(\$3,138 + \$2,650)/2} = \frac{\$20,962}{\$2,894} = 7.2 \text{ times}^*$$

\* Rounded



Based on Bizmin Industry Financial Report, December 2011.

To interpret a company's ratios, you must take into consideration the norms of the industry in which it operates. As shown, the receivables turnover ratio varies substantially from industry to industry. Because grocery stores have few receivables, they have a very high turnover (37.7). The turnover in the industrial machinery manufacturing industry is much lower (5.2) because that industry tends to have longer credit terms.

## Days' Sales Uncollected

**Days' sales uncollected** shows, on average, how long it takes to collect accounts receivable. To determine the days' sales uncollected, the number of days in a year is divided by the receivables turnover. For **Nike**, it is computed as follows.

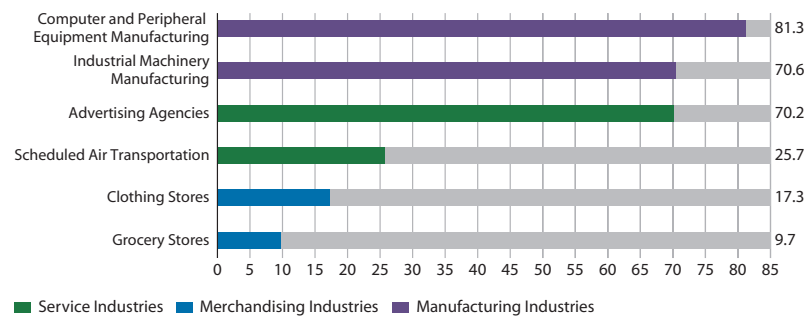
### RATIO

#### Day's Sales Uncollected: How Many Days Does It Take to Collect Accounts Receivable?

$$\text{Days' Sales Uncollected} = \frac{365 \text{ Days}}{\text{Receivables Turnover}}$$

$$\frac{365 \text{ days}}{7.2 \text{ times}} = 50.7 \text{ days}^*$$

\* Rounded



Based on Bizmin Industry Financial Report, December 2011.

**STUDY NOTE:** For many businesses with seasonal sales activity, such as **Nordstrom**, **Dillard's**, and **Macy's**, receivables are highest at the balance sheet date, resulting in an artificially low receivables turnover and a high days' sales uncollected.

As you can see, grocery stores have the lowest days' sales uncollected (9.7 days), and they therefore require the least amount of receivables financing. The industrial machinery manufacturing industry, on the other hand, has more days' sales uncollected (70.6).

## Financing Receivables

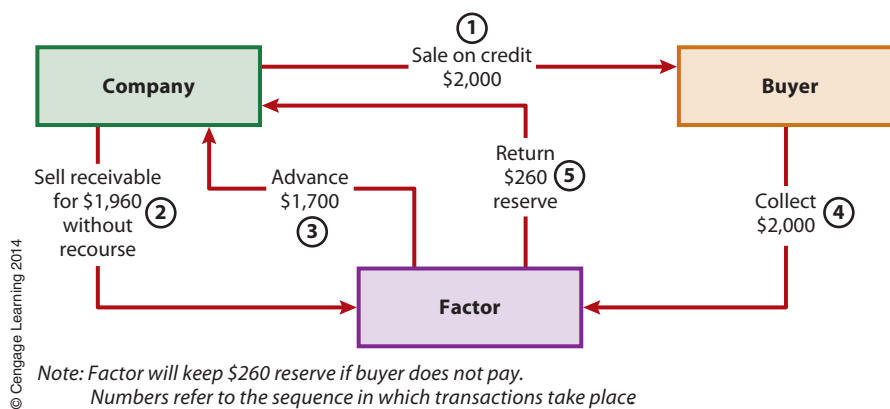
Companies that have significant amounts of assets tied up in accounts receivable may be unwilling or unable to wait until they collect cash from their receivables. Many corporations have set up finance companies to help their customers pay for the purchase of their products. For example, **Ford** has set up Ford Motor Credit Company (FMCC) and **Sears** has set up Sears Roebuck Acceptance Corporation (SRAC). Other companies borrow funds by pledging their accounts receivable as collateral. If a company does not pay back its loan, the creditor can take the collateral (in this case, the accounts receivable) and convert it to cash to satisfy the loan.

**STUDY NOTE:** A company that factors its receivables will have a better receivables turnover and days' sales uncollected than a company that does not.

Companies can also finance their receivables by selling or transferring accounts receivable to another entity. Three methods of financing receivables in this way are factoring, securitization, and discounting.

**Factoring** As illustrated in Exhibit 6, **factoring** is the sale or transfer of accounts receivable to an entity, called a **factor**. Factoring can be done with or without recourse. *With recourse* means that the seller of the receivables is liable to the factor (i.e., the purchaser) if a receivable cannot be collected. *Without recourse* means that the factor bears any losses from unpaid accounts. A company's acceptance of credit cards like **Visa**, **MasterCard**, or **American Express** is an example of factoring without recourse because the issuers of the cards accept the risk of nonpayment.

### Exhibit 6 How Factoring Works



The factor's fee for sales with recourse is usually about 2 percent of the accounts receivable. The fee is higher for sales without recourse because the factor's risk is greater. In accounting terminology, a seller of receivables with recourse is said to be contingently liable. A **contingent liability** is a potential liability that can develop into a real liability if a particular event occurs. In this case, the event would be a customer's nonpayment of a receivable. A contingent liability generally requires *disclosure* in the notes to the financial statements.

**Securitization** **Securitization** is a process in which a company groups its receivables in batches and sells them at a discount to other companies or investors. When the receivables are paid, the buyers get the full amount. Their profit depends on the amount of the discount. **Circuit City** tried to avoid bankruptcy by selling all its receivables without recourse and, therefore, have no further liability. If Circuit City had sold its receivables with recourse and a customer did not pay, it would have had to make good on the debt.<sup>6</sup> However, by selling without recourse, it had to accept a lower price for its receivables, and it still went bankrupt.



## Business Perspective

### Why Are Subprime Loans Bad?

Although subprime loans (home loans to individuals with poor credit ratings and low incomes) represent only a small portion of the mortgage loan market, they have caused huge problems in the real estate market. These loans are a form of securitization in that they are batched together and sold in units as safe investments, when in fact they are quite risky. When people were unable to keep up with their mortgage payments, the investments were marked down to their fair value. This loss of value led to the demise of such venerable firms as **Lehman Brothers**, the sale of **Merrill Lynch**, and ultimately a massive government bailout of several well-known financial institutions.<sup>7</sup>



**Discounting** **Discounting** is a method of financing receivables by selling promissory notes held as notes receivable to a financial lender, usually a bank. The bank derives its profit by deducting the interest from the maturity value of the note. The holder of the note (usually the payee) endorses the note and turns it over to the bank. The bank expects to collect the maturity value of the note (principal plus interest) on the maturity date, but it also has recourse against the note's endorser.

For example, if Company X holds a \$20,000 note from Company Z and the note will pay \$1,200 in interest, a bank may be willing to buy the note for \$19,200. If Company Z pays, the bank will receive \$21,200 at maturity and realize a \$2,000 profit. If it fails to pay, Company X is liable to the bank for payment. In the meantime, Company X has a contingent liability in the amount of the discounted note plus interest that it must *disclose* in the notes to its financial statements.

## Ethics and Estimates in Accounting for Receivables

As noted, companies extend credit to customers because they want to increase their sales and earnings. However, they know they will always have some credit customers who cannot or will not pay. Of course, at the time a company makes credit sales, it cannot identify which customers will not pay their bills, nor can it predict the exact amount of money it will lose. Therefore, to adhere to *accrual accounting*, it must estimate losses from uncollectible accounts. As shown earlier in the chapter, the estimate becomes an expense in the fiscal year in which the sales are made.

Because the amount of uncollectible accounts can only be estimated and the exact amount will not be known until later, a company's earnings can be easily manipulated. Earnings can be overstated by underestimating the amount of losses from uncollectible accounts and understated by overestimating the amount of the losses. Misstatements of earnings can occur simply because of a bad estimate. But, as we have noted elsewhere, they can be deliberately made to meet analysts' estimates of earnings, reduce income taxes, or meet benchmarks for bonuses.

Examples of unethical or questionable practices in dealing with uncollectible accounts include the following cases investigated by the SEC:

- The policy of **Household International**, a large personal finance company, seems to be flexible about when to declare loans delinquent. As a result, the company can vary its estimates of uncollectible accounts from year to year.<sup>8</sup>
- By making large allowances for estimated uncollectible accounts and then gradually reducing them, **Bank One** improved its earnings over several years.<sup>9</sup>
- **HealthSouth** manipulated its income by varying its estimates of the difference between what it charged patients and what it could collect from insurance companies.<sup>10</sup>

Companies with high ethical standards try to be accurate in their estimates of uncollectible accounts, and they *disclose* the basis of their estimates. For example, **Nike**'s management describes, in the statement that follows, the basis for its estimates of uncollectible accounts.

*We make ongoing estimates relating to the ability to collect our accounts receivable and maintain an allowance for estimated losses resulting from the inability of our customers to make required payments. In determining the amount of the allowance, we consider our historical level of credit losses and make judgments about the creditworthiness of significant customers based on ongoing credit evaluations. Since we cannot predict future changes in the financial stability of our customers, actual future losses from uncollectible accounts may differ from our estimates.<sup>11</sup>*

**APPLY IT!**

Toni Company has net accounts receivable of \$60,000 and net sales of \$500,000. Last year's net accounts receivable were \$40,000. Compute Toni's receivables turnover and days' sales uncollected.

**SOLUTION**

$$\begin{aligned} \text{Receivables Turnover} &= \frac{\text{Net Sales}}{\text{Average Accounts Receivable}} \\ &= \frac{\$500,000}{(\$60,000 + \$40,000) \div 2} \\ &= \frac{\$500,000}{\$50,000} = 10.0 \text{ times} \\ \text{Days' Sales Uncollected} &= \frac{365 \text{ days}}{\text{Receivables Turnover}} = \frac{365 \text{ days}}{10.0 \text{ times}} = 36.5 \text{ days} \end{aligned}$$

**TRY IT! SE9, SE10, E12A, E13A, E12B, E13B****TriLevel Problem**

Aldo Murillo/iStockphoto.com

**Smart Computer Company**

The beginning of this chapter focused on Smart Computer Company. The following data (in thousands) are from the company's records for year end of 2014, before adjustments:

	<b>2014</b>
Cash	\$ 100
Accounts receivable	800
Allowance for doubtful accounts	(42)
Net sales	2,400

Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

**Section 1: Concepts**

*How do companies like Smart Computer Company apply accrual accounting to their receivables, and how do they properly disclose the value of their receivables?*

**Section 2: Accounting Applications**

*How can Smart Computer Company estimate the value of its receivables?*

In order to estimate the value of Smart's receivables, compute Uncollectible Accounts Expense for 2014, and determine the ending balance of Allowance for Uncollectible Accounts and Accounts Receivable, Net, under (a) the percentage of net sales method assuming 1.5 percent of net sales to be uncollectible and (b) the accounts receivable aging method, assuming year-end uncollectible accounts to be \$76,000.

**Section 3: Business Applications**

*How can the company evaluate the effectiveness of its credit policies and the level of its accounts receivable?*

To answer this question, management can compare the current year's receivables turnover and days' sales uncollected with those ratios in previous years.

1. Compute the receivables turnover and days' sales uncollected for 2014, using the data from the accounts receivable aging method calculated in the Accounting Applications above and assuming that the prior year's net accounts receivable were \$620,000.
2. Why do the two methods of calculating Uncollectible Accounts Expense produce different results?
3. What are the implications of the receivables turnover and days' sales uncollected results for Smart?

**SOLUTION****Section 1: Concepts**

Companies make credit sales now but collect money on those sales in the future. Some of the customers who purchased a product or service on credit will not pay their bills. Due to the uncertainty in regards to the *value* of receivables, companies need to estimate how much of their receivables will not be collected. U.S. GAAP requires companies to use the allowance method to estimate the level of uncollectible accounts. The allowance method follows *accrual accounting* and results in the proper *valuation* of accounts receivable because it deducts the amount of estimated uncollectible accounts from accounts receivable on the balance sheet. It also *matches* the expense of uncollectible accounts with the revenues generated by the receivables. Accounts receivable are *disclosed* on the balance sheet at their net of allowance amount and notes to the financial statements disclose pertinent information about accounts receivable and notes receivable.

**Section 2: Accounting Applications**

a. Percentage of net sales method:

$$\text{Uncollectible Accounts Expense} = 1.5 \text{ percent} \times \$2,400,000 = \$36,000$$

$$\text{Allowance for Uncollectible Accounts} = \$36,000 + \$42,000 = \$78,000$$

$$\text{Accounts Receivable, Net} = \$800,000 - \$78,000 = \$722,000$$

b. Accounts receivable aging method:

$$\text{Uncollectible Accounts Expense} = \$76,000 - \$42,000 = \$34,000$$

$$\text{Allowance for Uncollectible Accounts} = \$76,000$$

$$\text{Accounts Receivable, Net} = \$800,000 - \$76,000 = \$724,000$$

**Section 3: Business Applications**

$$\begin{aligned} 1. \text{ Receivables Turnover} &= \frac{\text{Net Sales}}{\text{Average Accounts Receivable}} = \frac{\$2,400,000}{(\$724,000 + \$620,000) \div 2} \\ &= \frac{\$2,400,000}{\$672,000} \\ &= \underline{\underline{3.6 \text{ times}^*}} \end{aligned}$$

$$\text{Day's Sales Uncollected} = \frac{365 \text{ days}}{\text{Receivables Turnover}} = \frac{365 \text{ days}}{3.6 \text{ times}} = \underline{\underline{101.4 \text{ days}^*}}$$

\* Rounded

- Both methods of computing Uncollectible Accounts Expense are estimates and thus are likely to give different results. Ideally, the results are similar.
- It takes Smart 101.4 days on average to collect its sales. This is almost four months, which means the company must manage its cash and borrowings carefully or revise its credit terms.

## Chapter Review

**Define receivables, and explain the allowance method for valuation of receivables as an application of accrual accounting.** **LO 1**

Accounts receivable are short-term financial assets that arise from sales on credit. Notes receivable consists of promissory notes. A promissory note is an unconditional promise to pay a definite sum of money on demand or at a future date. The allowance method matches estimated losses from bad debts with the revenues they help to generate. It also aids in valuing the accounts receivable on the balance sheet. Notes receivable that are due in less than one year may be shown at their fair value in the current assets section of the balance sheet. Accounts receivable are also shown in the current assets section at their net realizable value; i.e., reduced by the allowance for uncollectible accounts. Interest receivable is also included in the current assets section. The uncollectible accounts expense is deducted from revenues on the income statement.

**Apply the allowance method of accounting for uncollectible accounts.** **LO 2**

Uncollectible accounts expense is estimated by using either the percentage of net sales method or the accounts receivable aging method. Under the first method, bad debts are judged to be a certain percentage of sales. Under the second method, certain percentages are applied to groups of accounts receivable that have been arranged by due dates.

The estimate of uncollectible accounts is debited to Uncollectible Accounts Expense and credited to the allowance account. When an individual account is determined to be uncollectible, it is removed from Accounts Receivable by debiting the allowance account and crediting Accounts Receivable. If the written-off account is later collected, the earlier entry is reversed and the collection is recorded in the normal way.

**Make common calculations for notes receivable.** **LO 3**

In accounting for promissory notes, common calculations include the maturity date, the duration of a note, the interest and interest rate, and the maturity value.

**Show how to evaluate the level of receivables, and identify alternative means of financing receivables.** **LO 4**

The management of receivables is critical to maintaining adequate liquidity. Management must (1) consider the need for short-term investing and borrowing as cash fluctuates during seasonal cycles, (2) establish credit policies that balance the need for sales with the ability to collect, (3) evaluate the level of receivables using receivables turnover and days' sales uncollected, (4) assess the need to increase cash flows through alternative means of the financing of receivables, and (5) understand the importance of ethics in estimating credit losses.

## Key Terms and Ratios

**accounts receivable** 336 (LO1)  
**accounts receivable aging method** 341 (LO2)  
**aging of accounts receivable** 341 (LO2)  
**Allowance for Uncollectible Accounts** 339 (LO1)  
**allowance method** 338 (LO1)  
**contingent liability** 351 (LO4)  
**direct charge-off method** 337 (LO1)  
**discounting** 352 (LO4)

**dishonored note** 347 (LO3)  
**duration of a note** 346 (LO3)  
**factor** 351 (LO4)  
**factoring** 351 (LO4)  
**interest** 346 (LO3)  
**interest receivable** 339 (LO1)  
**maturity date** 346 (LO3)  
**maturity value** 347 (LO3)  
**notes receivable** 337 (LO1)  
**percentage of net sales method** 340 (LO2)

**promissory note** 337 (LO1)  
**securitization** 351 (LO4)  
**trade credit** 336 (LO1)  
**uncollectible accounts** 337 (LO1)

### RATIOS

**days' sales uncollected** 350 (LO4)  
**receivables turnover** 349 (LO4)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ► What accounting concepts are violated by the direct charge-off method of recognizing uncollectible accounts? Why?
- LO 1,2 **DQ2.** In what ways is Allowance for Uncollectible Accounts similar to Accumulated Depreciation? In what ways is it different?
- LO 3 **DQ3.** Under what circumstances would an accrual of interest income on an interest-bearing note receivable not be required at the end of an accounting period?
- LO 4 **DQ4. BUSINESS APPLICATION** ► Why is it advantageous for a company to finance its receivables?
- LO 4 **DQ5. BUSINESS APPLICATION** ► To increase its sales, a company decides to increase its credit terms from 15 to 30 days. What effect will this change in policy have on receivables turnover and days' sales uncollected?
- LO 4 **DQ6. BUSINESS APPLICATION** ► How might the receivables turnover and days' sales uncollected reveal that management is consistently underestimating the amount of losses from uncollectible accounts? Is this action ethical?

### SHORT EXERCISES

#### LO 1 Accounts Receivable and Notes Receivable

**SE1.** Indicate which of the following is more closely associated with (a) accounts receivable or (b) notes receivable:

1. Backed by a written promissory note.
2. Appears separate from receivables from employees.
3. Requires an estimate of uncollectible accounts.
4. Banks often have this type of receivable.
5. Often referred to as trade credit.

#### LO 1 Evaluating the Level of Accounts Receivable

**SE2.** During its first year of operation in 2014, Browne Sales Corporation made most of its sales on credit. At the end of the year, accounts receivable amounted to \$199,000. On December 31, 2014, management reviewed the collectible status of the accounts receivable. Approximately \$16,500 of the \$199,000 of accounts receivable were estimated to be uncollectible. What adjusting entry would be made December 31, 2014?

#### LO 2 Percentage of Net Sales Method

**SE3.** At the end of October, Santa Fe Company's management estimates the uncollectible accounts expense to be 1 percent of net sales of \$1,385,000. Prepare the journal entry to record the uncollectible accounts expense, assuming the Allowance for Uncollectible Accounts has a debit balance of \$7,000.

#### LO 2 Accounts Receivable Aging Method

**SE4.** An aging analysis on June 30 of the accounts receivable of U-Z Door Corporation indicates that uncollectible accounts amount to \$86,000. Prepare the journal entry to record uncollectible accounts expense under each of the following independent assumptions:

- a. Allowance for Uncollectible Accounts has a credit balance of \$18,000 before adjustment.
- b. Allowance for Uncollectible Accounts has a debit balance of \$14,000 before adjustment.

**LO 2 Write-off of Accounts Receivable**

**SE5.** Chicago Corporation, which uses the allowance method, has accounts receivable of \$25,400 and an allowance for uncollectible accounts of \$4,900. An account receivable from Tom Novak of \$2,200 is deemed to be uncollectible and is written off. What is the amount of net accounts receivable before and after the write-off?

**LO 3 Interest Computations**

**SE6.** Determine the interest on the following notes. (Round to the nearest cent.)

- \$58,940 at 6 percent for 60 days.
- \$14,280 at 9 percent for 30 days.
- \$30,600 at 12 percent for 60 days.
- \$21,070 at 10 percent for 90 days.
- \$46,360 at 15 percent for 120 days.

**LO 3 Notes Receivable Calculations**

**SE7.** Determine the maturity date, interest at maturity, and maturity value for a 120-day, 8 percent, \$34,000 note from Archer Corporation dated July 7. (Round to the nearest cent.)

**LO 3 Notes Receivable Calculations**

**SE8.** On August 25, Intercontinental Company received a 90-day, 9 percent note in settlement of an account receivable in the amount of \$20,000. Determine the maturity date, amount of interest on the note, and maturity value. (Round to the nearest cent.)

**LO 4 Management Issues**

**SE9. BUSINESS APPLICATION** ► Indicate whether each of the following actions is related to (a) managing cash needs, (b) setting credit policies, (c) financing receivables, or (d) ethically reporting receivables:

- Selling accounts receivable to a factor.
- Borrowing funds for short-term needs during slow periods.
- Conducting thorough checks of new customers' ability to pay.
- Making every effort to reflect possible future losses accurately.

**LO 4 Short-Term Liquidity Ratios**

**SE10. BUSINESS APPLICATION** ► Wellman Company has cash of \$80,000, net accounts receivable of \$180,000, and net sales of \$1,440,000. Last year's net accounts receivable were \$140,000. Compute the following ratios: (a) receivables turnover and (b) days' sales uncollected. (Round to the nearest whole day.)

**EXERCISES: SET A****LO 1 Evaluating the Level of Accounts Receivable**

**E1A.** During its first year of operation in 2014, Jameson Sales Corporation made most of its sales on credit. At the end of the year, accounts receivable amounted to \$175,000. On December 31, 2014, management reviewed the collectible status of the accounts receivable. Approximately 7.5% of the \$175,000 of accounts receivable were estimated to be uncollectible. What adjusting entry would be made December 31, 2014?

**LO 2 Percentage of Net Sales Method**

**E2A.** At the end of the year, Bertha Enterprises estimates the uncollectible accounts expense to be 0.7 percent of net sales of \$15,150,000. The current credit balance of Allowance for Uncollectible Accounts is \$25,800. Prepare the entry to record the uncollectible accounts expense. What is the balance of Allowance for Uncollectible Accounts after this adjustment?



## LO 2 Accounts Receivable Aging Method

**E3A.** Security Service Company's Accounts Receivable account shows a debit balance of \$104,000 at the end of the year. An aging analysis of the individual accounts indicates estimated uncollectible accounts to be \$6,700.

Prepare the journal entry to record the uncollectible accounts expense under each of the following independent assumptions: (a) Allowance for Uncollectible Accounts has a credit balance of \$800 before adjustment, and (b) Allowance for Uncollectible Accounts has a debit balance of \$800 before adjustment. What is the balance of Allowance for Uncollectible Accounts after each of these adjustments?

## LO 2 Aging Method and Net Sales Method Contrasted

**E4A.** At the beginning of 2014, the balances for Accounts Receivable and Allowance for Uncollectible Accounts were \$215,000 and \$15,700 (credit), respectively. During the year, credit sales were \$1,600,000 and collections on account were \$1,475,000. In addition, \$17,500 in uncollectible accounts was written off.

Using T accounts, determine the year-end balances of Accounts Receivable and Allowance for Uncollectible Accounts. Then prepare the year-end adjusting entry to record the uncollectible accounts expense under each of the following conditions. Also show the year-end balance sheet presentation of accounts receivable and allowance for uncollectible accounts.

- Management estimates the percentage of uncollectible credit sales to be 1.2 percent of total credit sales.
- Based on an aging of accounts receivable, management estimates the end-of-year uncollectible accounts receivable to be \$19,350.

Post the results of each of the entries to the T account for Allowance for Uncollectible Accounts.

## LO 2 Aging Method and Net Sales Method Contrasted

**E5A. ACCOUNTING CONNECTION** ► During 2014, DeLuca Company had net sales of \$5,700,000. Most of the sales were on credit. At the end of 2014, the balance of Accounts Receivable was \$700,000 and Allowance for Uncollectible Accounts had a debit balance of \$24,000. DeLuca's management uses two methods of estimating uncollectible accounts expense: the percentage of net sales method and the accounts receivable aging method. The percentage of uncollectible sales is 1.5 percent of net sales, and based on an aging of accounts receivable, the end-of-year uncollectible accounts total \$70,000.

Prepare the year-end adjusting entry to record the uncollectible accounts expense under each method. What will the balance of Allowance for Uncollectible Accounts be after each adjustment? Why are the results different? Which method is likely to be more reliable? Why?

## LO 2 Aging Method and Net Sales Method Contrasted

**E6A. ACCOUNTING CONNECTION** ► Dapper Hat Makers Company sells merchandise on credit. During the fiscal year ended July 31, the company had net sales of \$2,300,000. At the end of the year, it had Accounts Receivable of \$600,000 and a debit balance in Allowance for Uncollectible Accounts of \$3,400. In the past, approximately 1.4 percent of net sales have proved to be uncollectible. Also, an aging analysis of accounts receivable reveals that \$30,000 of the receivables appears to be uncollectible.

Prepare journal entries to record uncollectible accounts expense using (a) the percentage of net sales method and (b) the accounts receivable aging method. What is the resulting balance of Allowance for Uncollectible Accounts under each method? How would your answers under each method change if Allowance for Uncollectible Accounts



had a credit balance of \$3,400 instead of a debit balance? Why do the methods result in different balances?

**LO 2 Write-off of Accounts Receivable**

**E7A.** Norcia Company, which uses the allowance method, began the year with Accounts Receivable of \$32,500 and an allowance for uncollectible accounts of \$3,200 (credit). The company sold merchandise to Bruce Willis for \$3,600 and later received \$1,200 from Willis. The rest of the amount due from Willis had to be written off as uncollectible. Using T accounts, show the beginning balances and the effects of the Willis transactions on Accounts Receivable and Allowance for Uncollectible Accounts. What is the amount of net accounts receivable before and after the write-off?

**LO 3 Interest Computations**

**E8A.** Determine the interest on the following notes. (Round to the nearest cent.)

- \$38,760 at 10 percent for 90 days.
- \$27,200 at 12 percent for 60 days.
- \$30,600 at 9 percent for 30 days.
- \$51,000 at 15 percent for 120 days.
- \$18,360 at 6 percent for 60 days.

**LO 3 Notes Receivable Calculations**

**E9A.** Determine the maturity date, interest at maturity, and maturity value for a 90-day, 10 percent, \$18,000 note from Archer Corporation dated February 15. (Round to the nearest cent.)

**LO 3 Notes Receivable Calculations**

**E10A.** Determine the maturity date, interest in 2013 and 2014, and maturity value for a 90-day, 12 percent, \$15,000 note from a customer dated December 1, 2013, assuming a December 31 year end. (Round to the nearest cent.)

**LO 3 Notes Receivable Calculations**

**E11A.** Determine the maturity date, interest at maturity, and maturity value for each of the following notes. (Round to the nearest cent.)

- A 60-day, 10 percent, \$2,400 note dated January 5 received from S. William for granting a time extension on a past-due account.
- A 60-day, 12 percent, \$1,500 note dated March 9 received from E. Watson for granting a time extension on a past-due account.

**LO 4 Management Issues**

**E12A. BUSINESS APPLICATION** ► Indicate whether each of the following actions is primarily related to (a) managing cash needs, (b) setting credit policies, (c) financing receivables, or (d) ethically reporting accounts receivable:

- Selling notes receivable to a financing company.
- Changing the terms for credit sales in an effort to reduce the days' sales uncollected.
- Buying a U.S. Treasury bill with cash that is not needed for a few months.
- Comparing receivable turnovers for two years.
- Setting a policy that allows customers to buy on credit.
- Making careful estimates of losses from uncollectible accounts.
- Establishing a department whose responsibility is to approve customers' credit.
- Borrowing funds for short-term needs in a period when sales are low.
- Revising estimated credit losses in a timely manner when conditions change.

## LO 4 Short-Term Liquidity Ratios

RATIO

**E13A. BUSINESS APPLICATION** ▶ Using the following data from Moontrust Corporation's financial statements, compute the receivables turnover and the days' sales uncollected. (Round to one decimal place or to the nearest whole day.)

Current assets:	
Cash	\$ 70,000
Short-term investments	170,000
Notes receivable	240,000
Accounts receivable, net	400,000
Inventory	500,000
Prepaid assets	50,000
Total current assets	<u>\$1,430,000</u>
Current liabilities:	
Notes payable	\$ 600,000
Accounts payable	150,000
Accrued liabilities	20,000
Total current liabilities	<u>\$ 770,000</u>
Net sales	<u>\$3,200,000</u>
Last year's accounts receivable, net	<u>\$ 360,000</u>

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

LO 2, 4

RATIO

SPREADSHEET

GENERAL LEDGER

**Methods of Estimating Uncollectible Accounts and Receivables Analysis**

**P1.** McLennon Company had an Accounts Receivable balance of \$320,000 and a credit balance in Allowance for Uncollectible Accounts of \$16,700 at January 1, 2014. During the year, the company recorded the following transactions:

- Sales on account, \$1,052,000.
- Sales returns and allowances by credit customers, \$53,400.
- Collections from customers, \$993,000.
- Worthless accounts written off, \$19,800.

The company's past history indicates that 2.5 percent of its net credit sales will not be collected.

## REQUIRED

- Prepare T accounts for Accounts Receivable and Allowance for Uncollectible Accounts. Enter the beginning balances, and show the effects on these accounts of the items listed above, summarizing the year's activity. Determine the ending balance of each account.
- Compute Uncollectible Accounts Expense, determine the ending balance of Allowance for Uncollectible Accounts and net Accounts Receivable under (a) the percentage of net sales method and (b) the accounts receivable aging method, assuming an aging of the accounts receivable shows that \$24,000 may be uncollectible.
- Compute the receivables turnover and days' sales uncollected, using the data from the accounts receivable aging method in requirement 2. (Round to one decimal place or to the nearest whole day.)
- ACCOUNTING CONNECTION** ▶ How do you explain that the two methods used in requirement 2 result in different amounts for Uncollectible Accounts Expense? What rationale underlies each method?

- ✓ 2a: Uncollectible accounts expense, percentage of net sales method: \$24,965  
 ✓ 2b: Accounts receivable aging method: \$27,100

## LO 2

**Accounts Receivable Aging Method**

✓ 3: Amount of uncollectible accounts expense: \$72,714

**P2.** Techno Designs Store uses the accounts receivable aging method to estimate uncollectible accounts. On February 1, 2014, the balance of the Accounts Receivable account was a debit of \$442,341, and the balance of Allowance for Uncollectible Accounts was a credit of \$43,700. During the year, the store had sales on account of \$3,722,000, sales returns and allowances of \$60,000, worthless accounts written off of \$44,300, and collections from customers of \$3,211,000. As part of the end-of-year (January 31, 2015) procedures, an aging analysis of accounts receivable is prepared. The analysis, which is partially complete, follows.

Customer Account	Total	Not Yet Due	1–30 Days Past Due	31–60 Days Past Due	61–90 Days Past Due	Over 90 Days Past Due
Balance						
Forward	\$793,791	\$438,933	\$149,614	\$106,400	\$57,442	\$41,402

To finish the analysis, the following accounts need to be classified:

Account	Amount	Due Date
J. Curtis	\$11,077	Jan. 15
T. Dawson	9,314	Feb. 15 (next fiscal year)
L. Zapata	8,664	Dec. 20
R. Copa	780	Oct. 1
E. Land	14,710	Jan. 4
S. Qadri	6,316	Nov. 15
A. Rosenthal	4,389	Mar. 1 (next fiscal year)
	<u>\$55,250</u>	

From past experience, the company has found that the following rates are realistic for estimating uncollectible accounts:

Time	Percentage Considered Uncollectible
Not yet due	2
1–30 days past due	5
31–60 days past due	15
61–90 days past due	25
Over 90 days past due	50

**REQUIRED**

- Complete the aging analysis of accounts receivable.
- Compute the end-of-year balances (before adjustments) of Accounts Receivable and Allowance for Uncollectible Accounts.
- Prepare an analysis computing the estimated uncollectible accounts. (Round to the nearest whole dollar.)
- How much is Techno Designs Store's estimated uncollectible accounts expense for the year? (Round the adjustment to the nearest whole dollar.)
- ACCOUNTING CONNECTION** ► What role do estimates play in applying the aging analysis? What factors might affect these estimates?

## LO 4

**Notes Receivable Calculations**

CASH FLOW

SPREADSHEET

✓ 2: Total accrued interest income as of June 30: \$3,856.44

- P3.** West Palm Company engaged in the following transactions involving promissory notes:
- |       |  |
|-------|--|
| May 3 | Sold engines to Mittal Company for \$120,000 in exchange for a 90-day, 12 percent promissory note. |
| 16    | Sold engines to Tata Company for \$64,000 in exchange for a 60-day, 13 percent note.               |
| 31    | Sold engines to Arsenal Company for \$60,000 in exchange for a 90-day, 11 percent note.            |

(Continued)

**REQUIRED**

1. For each of the notes, determine the (a) maturity date, (b) interest on the note, and (c) maturity value. (Round to the nearest cent.)
2. Assume that the fiscal year for West Palm ends on June 30. How much interest income should be recorded on that date? (Round to the nearest cent.)
3. **ACCOUNTING CONNECTION** ► What are the effects of the transactions in May on cash flows for the year ended June 30?

**LO 3**

✓ 5: Interest in 2015: \$425.34

**Notes Receivable Calculations**

**P4.** Assume that on December 16, 2014, Harris Company receives a 90-day, 9 percent, \$23,000 note, payable in full with interest at maturity, and that the company prepares monthly financial statements.

**REQUIRED**

1. What is the maturity date of the note?
2. How much interest will be earned on the note if it is paid when due? (Round to the nearest cent.)
3. What is the maturity value of the note?
4. If the company's fiscal year ends on December 31, 2014, calculate the amount of the adjusting entry that would be made for interest.
5. How much interest will be earned on this note in 2015? (Round to the nearest cent.)
6. **ACCOUNTING CONNECTION** ► How much cash will be received for interest in 2014? Why does the amount of cash received for interest differ from the amount of interest earned?

**ALTERNATE PROBLEMS****LO 2, 4**

RATIO

SPREADSHEET

GENERAL LEDGER

- ✓ 2a: Uncollectible accounts expense, percentage of net sales method: \$17,952
- ✓ 2b: Accounts receivable aging method: \$15,700

**Methods of Estimating Uncollectible Accounts and Receivables Analysis**

**P5.** On December 31 of last year, Target System Company's balance sheet had Accounts Receivable of \$298,000 and a credit balance in Allowance for Uncollectible Accounts of \$20,300. During the current year, Target System's records included the following selected activities: (a) sales on account, \$1,195,000; (b) sales returns and allowances, \$73,000; (c) collections from customers, \$1,150,000; and (d) accounts written off as worthless, \$16,000. In the past, 1.6 percent of Target System's net sales have been uncollectible.

**REQUIRED**

1. Prepare T accounts for Accounts Receivable and Allowance for Uncollectible Accounts. Enter the beginning balances, and show the effects on these accounts of the items listed above, summarizing the year's activity. Determine the ending balance of each account.
2. Compute Uncollectible Accounts Expense, determine the ending balance of Allowance for Uncollectible Accounts and net Accounts Receivable under (a) the percentage of net sales method and (b) the accounts receivable aging method. Assume that an aging of the accounts receivable shows that \$20,000 may be uncollectible.
3. Compute the receivables turnover and days' sales uncollected, using the data from the accounts receivable aging method in requirement 2. (Round to one decimal place or to the nearest whole day.)
4. **ACCOUNTING CONNECTION** ► How do you explain that the two methods used in requirement 2 result in different amounts for Uncollectible Accounts Expense? What rationale underlies each method?

LO 2 **Accounts Receivable Aging Method**

✓ 4: Amount of uncollectible accounts expense: \$9,110

**P6.** Flossmoor Company uses the accounts receivable aging method to estimate uncollectible accounts. At the beginning of the year, the balance of the Accounts Receivable account was a debit of \$88,430, and the balance of Allowance for Uncollectible Accounts was a credit of \$7,200. During the year, the company had sales on account of \$473,000, sales returns and allowances of \$4,200, worthless accounts written off of \$7,900, and collections from customers of \$450,730. At the end of year (December 31, 2014), a junior accountant for Flossmoor was preparing an aging analysis of accounts receivable. At the top of page 6 of the report, the following totals appeared:

Customer Account	Total	Not Yet Due	1–30 Days Past Due	31–60 Days Past Due	61–90 Days Past Due	Over 90 Days Past Due
Balance Forward	\$89,640	\$49,030	\$24,110	\$9,210	\$3,990	\$3,300

To finish the analysis, the following accounts need to be classified:

Account	Amount	Due Date
B. Singh	\$ 930	Jan. 14 (next year)
L. Wells	620	Dec. 24
A. Rocky	1,955	Sept. 28
T. Cila	2,100	Aug. 16
M. Mix	375	Dec. 14
S. Prince	2,685	Jan. 23 (next year)
J. Wendt	295	Nov. 5
	<u>\$8,960</u>	

From past experience, the company has found that the following rates are realistic for estimating uncollectible accounts:

Time	Percentage Considered Uncollectible
Not yet due	2
1–30 days past due	5
31–60 days past due	15
61–90 days past due	25
Over 90 days past due	50

**REQUIRED**

- Complete the aging analysis of accounts receivable.
- Compute the end-of-year balances (before adjustments) of Accounts Receivable and Allowance for Uncollectible Accounts.
- Prepare an analysis computing the estimated uncollectible accounts. (Round to the nearest dollar.)
- Calculate Flossmoor's estimated uncollectible accounts expense for the year. (Round to the nearest whole dollar).
- ACCOUNTING CONNECTION** ► What role do estimates play in applying the aging analysis? What factors might affect these estimates?

LO 3 **Notes Receivable Calculations**

CASH FLOW

SPREADSHEET

✓ 2: Total accrued interest income as of August 31: \$6,025.64

**P7.** Vision Importing Company engaged in the following transactions involving promissory notes:

- |        |  |
|--------|--|
| July 2 | Sold engines to Morgan Company for \$180,000 in exchange for a 90-day, 12 percent promissory note. |
| 15     | Sold engines to Level Company for \$96,000 in exchange for a 60-day, 13 percent note.              |
| 30     | Sold engines to Level Company for \$90,000 in exchange for a 90-day, 11 percent note.              |

(Continued)

**REQUIRED**

1. For each of the notes, determine the (a) maturity date, (b) interest on the note, and (c) maturity value. (Round to the nearest cent.)
2. Assume that the fiscal year for Vision Importing ends on August 31. How much interest income should be recorded on that date? (Round to the nearest cent.)
3. **ACCOUNTING CONNECTION** ► What are the effects of the transactions in July on cash flows for the year ended August 31?

**LO 3 Notes Receivable Calculations**

✓ 5: Interest in 2015: \$3.92

**P8.** Assume that on November 3, 2014, Harris Company receives a 60-day, 6.5 percent, \$11,000 note, payable in full with interest at maturity, and that the company prepares monthly financial statements.

**REQUIRED**

1. What is the maturity date of the note?
2. How much interest will be earned on the note if it is paid when due? (Round to the nearest cent.)
3. What is the maturity value of the note?
4. If the company's fiscal year ends on December 31, calculate the amount of the adjusting entry that would be made.
5. How much interest will be earned on this note in 2015? (Round to the nearest cent.)
6. **ACCOUNTING CONNECTION** ► How much cash will be received for interest in 2014? Why does the amount of cash received for interest differ from the amount of interest earned?

**CASES****LO 1 Conceptual Understanding: Role of Credit Sales**

**C1. CONCEPT** ► **Mitsubishi Corp.**, a broadly diversified Japanese company, instituted a credit plan called Three Diamonds for customers who buy its major electronic products, such as large-screen televisions, from specified retail dealers.<sup>12</sup> Under the plan, approved customers who make purchases in July of one year do not have to make any payments until September of the next year. Nor do they have to pay interest during the intervening months. Mitsubishi pays the dealer the full amount less a small fee, sends the customer a Mitsubishi credit card, and collects from the customer at the specified time. What was Mitsubishi's motivation for establishing such generous credit terms? What costs are involved? What are the accounting implications?

**LO 1, 2 Conceptual Understanding: Role of Estimates in Accounting for Receivables**

**C2. CONCEPT** ► **CompuCredit** is a credit card issuer in Atlanta. It prides itself on making credit cards available to almost anyone in a matter of seconds over the Internet. The cost to the consumer is an interest rate of 28 percent, about double that of companies that provide cards only to customers with good credit. Despite its high interest rate, CompuCredit was successful for many years. To calculate its income, the company estimated that 10 percent of its \$1.3 billion in accounts receivable would not be paid; the industry average is 7 percent. Some analysts were critical of CompuCredit for being too optimistic in its projections of losses.<sup>13</sup> In fact, during the recent recession, CompuCredit losses from uncollectible accounts increased and exceeded its interest income and the company reported large operating losses.<sup>14</sup> Why are estimates necessary in accounting for receivables? If CompuCredit were to use the same estimate of losses as other companies in its industry, would it have been better or worse off? How would one determine if CompuCredit's estimate of losses is reasonable?



LO 4

CASH FLOW

**Conceptual Understanding: Receivables Financing**

**C3.** Gerard Appliances, Inc., is a small manufacturer of washing machines and dryers. It sells its products to large, established discount retailers that market the appliances under their own names. Gerard generally sells the appliances on trade credit terms of n/60, but if a customer wants a longer term, it will accept a note with a term of up to nine months. At present, the company is having cash flow troubles and needs \$10 million immediately. Its Cash balance is \$400,000, its Accounts Receivable balance is \$4.6 million, and its Notes Receivable balance is \$7.4 million. How might Gerard Appliances use its accounts receivable and notes receivable to raise the cash it needs? What are its prospects for raising the needed cash?

LO 1, 4

RATIO

**Interpreting Financial Reports: Accounting for Accounts Receivable**

**C4. BUSINESS APPLICATION** ▶ Robinson Products Co., a major consumer goods company, sells more than 3,000 products in 135 countries. Its report to the Securities and Exchange Commission in 2014 presented the following data:

	2014	2013	2012
Net sales	\$9,820,000	\$9,730,000	\$9,888,000
Accounts receivable	1,046,000	1,048,000	1,008,000
Allowance for uncollectible accounts	37,200	42,400	49,000
Uncollectible accounts expense	30,000	33,400	31,600
Uncollectible accounts written off	38,600	40,200	35,400
Recoveries of accounts previously written off	3,400	200	2,000

1. Compute the ratio of uncollectible accounts expense to net sales and to accounts receivable and the ratio of allowance for uncollectible accounts to accounts receivable for 2012, 2013, and 2014. (Round to two decimal places for net sales and one decimal place for accounts receivable.)
2. Compute the receivables turnover and days' sales uncollected for each year assuming that net accounts receivable in 2011 were \$930,000. (Round to one decimal place or to the nearest whole day.)
3. What is your interpretation of the ratios? Describe management's attitude toward the collectability of accounts receivable over the three-year period.

LO 1, 2, 4

**Annual Report Case: Cash and Receivables**

**C5.** Refer to the **CVS** annual report in the Supplement to Chapter 16 to answer the following questions:

1. Which customers represent the main source of CVS's accounts receivable, and how much is CVS's allowance for uncollectible accounts?
2. What do you think CVS's seasonal needs for cash are? Where in CVS's financial statements is the seasonality of sales discussed?

LO 1, 4

RATIO

**Comparison Analysis: Accounts Receivable Analysis**

**C6. BUSINESS APPLICATION** ▶ Refer to the **CVS** annual report in the Supplement to Chapter 16 and to the following data (in millions) for **Walgreens**: net sales, \$72,184 and \$67,420 for 2011 and 2010, respectively; accounts receivable, net, \$2,497 and \$2,450 for 2011 and 2010, respectively.<sup>15</sup>

1. Compute receivables turnover and days' sales uncollected for 2011 and 2010 for CVS and Walgreens. Accounts receivable in 2009 were \$5,457 million for CVS and \$2,496 million for Walgreens. (Round to one decimal place.)
2. Do you discern any differences in the two companies' credit policies? Explain your answer.



LO 1, 4 **Ethical Dilemma: Uncollectible Accounts**

**C7. BUSINESS APPLICATION** ► Mullin Interiors, a successful retailer of high-quality furniture, is located in an affluent suburb where a large insurance company has just announced that it will lay off 4,000 employees. Because most of Mullin Interiors' sales are made on credit, accounts receivable is one of its major assets. Although the company's annual losses from uncollectible accounts are not out of line, they represent a sizable amount. The company depends on bank loans for its financing. Sales and net income have declined in the past year, and some customers are falling behind in paying their accounts.

Veronica Mullin, the owner, knows that the bank's loan officer likes to see a steady performance. She has therefore instructed the company's controller to underestimate the uncollectible accounts this year to show a small growth in earnings. Mullin believes this action is justified because earnings in future years will average out the losses. Since the company has a history of success, she believes the adjustments are meaningless accounting measures anyway.

Are Mullin's actions ethical? Would any parties be harmed by her actions? How important is it to try to be accurate in estimating losses from uncollectible accounts?

**RATIO**

**Continuing Case: Annual Report Project**

**C8.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the balance sheet and accompanying notes of your company. Answer the following questions:

1. What percentage of total current assets is accounts receivable? Is this figure the total accounts receivable or net accounts receivable? Why or why not?
2. Find the disclosures about accounts receivable in the notes to the financial statements. What is the amount of the allowance account and what percentage of total accounts receivable is it?
3. Does the company have notes receivable on the balance sheet? If so, read the note to the financial statements on notes receivable. What do you learn from it about the business?
4. **BUSINESS APPLICATION** ► Compute receivables turnover and days' sales uncollected for the most recent year.

# CHAPTER 10

## Long-Term Assets

### BUSINESS INSIGHT

#### Neighborhood Carriers

An issue involved in accounting for long-term assets is how to allocate their costs over their expected useful lives. For instance, suppose that on January 2, 2014, Neighborhood Carriers pays \$29,000 for a small van that it will use in making deliveries to its customers. The company expects that the van will be driven a total of 150,000 miles over a 5-year period and that, at the end of that time, it will be worth \$2,000. Based on the mileage shown in the following table, Neighborhood Carriers can allocate the cost of the van over the 5 years. However, the company can choose other ways of allocating this cost.

Years	Miles
2014	30,000
2015	52,500
2016	45,000
2017	15,000
2018	7,500
Total	<u>150,000</u>

- 1. CONCEPT** ► *What is the classification of long-term assets, how are the assets valued, and what is the distinction in recognizing capital and revenue expenditures?*
- 2. ACCOUNTING APPLICATION** ► *In what ways are the costs of long-term assets, such as a delivery van, allocated to the periods they benefit?*
- 3. BUSINESS APPLICATION** ► *How does management decide to acquire, finance, and evaluate long-term assets?*

### LEARNING OBJECTIVES

- LO 1** Identify the classifications of long-term assets, and describe how they are valued by allocating their costs to the periods that they benefit.
- LO 2** Account for the acquisition costs of property, plant, and equipment.
- LO 3** Compute depreciation under the straight-line, production, and declining-balance methods.
- LO 4** Account for the disposal of depreciable assets.
- LO 5** Identify the issues related to accounting for natural resources, and compute depletion.
- LO 6** Identify the issues related to accounting for intangible assets, including research and development costs and goodwill.
- LO 7** Describe the disclosure of acquiring and financing long-term assets, and calculate free cash flow.

## SECTION 1

## CONCEPTS

## CONCEPTS

- Valuation
- Classification
- Accrual Accounting (matching rule)
- Disclosure
- Recognition

## RELEVANT LEARNING OBJECTIVE

**LO 1** Identify the classifications of long-term assets, and describe how they are valued by allocating their costs to the periods that they benefit.

## LO 1 Concepts Underlying Long-Term Assets

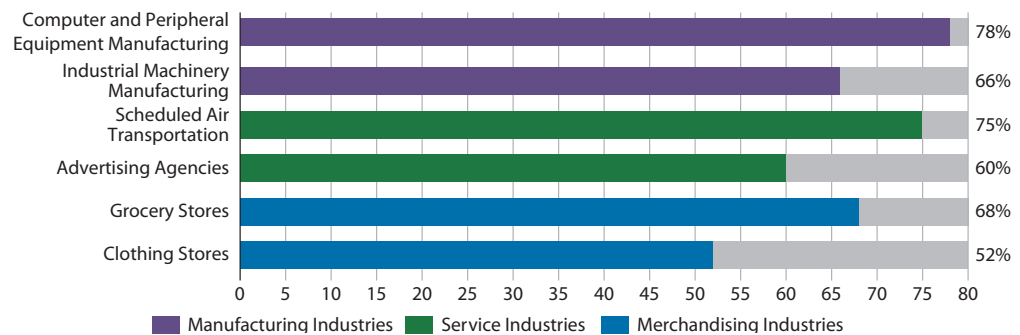
**Long-term assets** (or *fixed assets*) have the following characteristics:

- **They have a useful life of more than one year.** This distinguishes them from current assets, which a company expects to use up or convert to cash within 1 year or during its operating cycle, whichever is longer. The most common criterion for the useful life of a long-term asset is that it be capable of repeated use for more than a year.
- **They are used in the operation of a business.** For an asset to be *classified* as property, plant, and equipment, it must be “put in use,” which means it is available for its intended purpose. An emergency generator is “put in use” when it is available for emergencies, even if it is never used. Assets not used in the normal course of business, such as land held for speculative reasons or buildings no longer used in ordinary operations, should be *classified* as investments.
- **They are not intended for resale to customers.** An asset that a company intends to resell to customers should be *classified* as inventory, no matter how durable it is. For example, a computer that a company uses in an office is a long-term plant asset. An identical computer that a company sells to customers is inventory.

Exhibit 1 shows the relative importance of long-term assets in various industries.

### Exhibit 1

Long-Term Assets as a Percentage of Total Assets for Selected Industries



Based on Bizmin Industry Financial Report, December 2011.

## Classification, Accrual Accounting, and Disclosure of Long-Term Assets


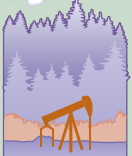

Long-term assets are *classified* as property, plant, and equipment; natural resources; and intangible assets. **Property, plant, and equipment** is land and other long-term assets that have physical substance. **Natural resources** are assets purchased for the economic value that can be extracted from them, such as oil and gas. **Intangible assets** are long-term assets that have no physical substance, such as copyrights and patents. Under *accrual accounting* the cost of these assets, with the exception of land and some intangible assets, is allocated to the periods they benefit, as follows.

- The periodic allocation of the costs of plant and equipment over their estimated useful lives is called **depreciation**. Although land is property, it is not depreciated because it has an unlimited life.
- The allocation of the costs of natural resources is called **depletion**.
- The allocation of the costs of most long-term intangible assets, which represent a legal right or advantage, is called **amortization**. Some intangible assets not subject to amortization.

The methods used to determine depreciation, depletion, and amortization are *disclosed* in the notes to the financial statements. Exhibit 2 shows how long-term assets are *classified* and defines the *accrual accounting* methods of allocating their cost of their use to the income statement.

**Exhibit 2**

**Classification of Long-Term Assets and Methods of Accounting for Them**

Balance Sheet Long-Term Assets	Income Statement Expenses				
 <p><b>Property, Plant, and Equipment:</b> long-term assets with physical substance used in business operations</p> <ul style="list-style-type: none"> <li>• Land</li> <li>• Plant Assets                             <ul style="list-style-type: none"> <li>– Plant</li> <li>– Buildings</li> <li>– Equipment</li> </ul> </li> </ul>	<p>Land is not expensed because it has an unlimited life.</p> <p><b>Depreciation:</b> periodic allocation of the cost of a tangible long-lived asset (other than land and natural resources) over its estimated useful life</p>				
 <p><b>Natural Resources:</b> long-term assets purchased for the economic value that can be taken from the land and used up, as with ore, lumber, oil, and gas or other resources contained in the land</p> <ul style="list-style-type: none"> <li>• Mines</li> <li>• Timberland</li> <li>• Oil and Gas Fields</li> </ul>	<p><b>Depletion:</b> exhaustion of a natural resource through mining, cutting, pumping, or other extraction and the way in which the cost is allocated</p>				
 <p><b>Intangible Assets:</b> long-term assets that have no physical substance but have a value based on rights or advantages accruing to the owner</p> <table border="0" style="width: 100%;"> <tr> <td style="width: 50%; text-align: center;"><i>Subject to Amortization and Impairment Test</i></td> <td style="width: 50%; text-align: center;"><i>Subject Only to Annual Impairment Test</i></td> </tr> <tr> <td style="vertical-align: top;"> <ul style="list-style-type: none"> <li>• Copyrights</li> <li>• Customer lists</li> <li>• Franchises</li> <li>• Licenses</li> <li>• Leaseholds</li> <li>• Noncompete covenants</li> <li>• Patents</li> <li>• Software</li> </ul> </td> <td style="vertical-align: top;"> <ul style="list-style-type: none"> <li>• Brand names</li> <li>• Goodwill</li> <li>• Trademarks</li> </ul> </td> </tr> </table>	<i>Subject to Amortization and Impairment Test</i>	<i>Subject Only to Annual Impairment Test</i>	<ul style="list-style-type: none"> <li>• Copyrights</li> <li>• Customer lists</li> <li>• Franchises</li> <li>• Licenses</li> <li>• Leaseholds</li> <li>• Noncompete covenants</li> <li>• Patents</li> <li>• Software</li> </ul>	<ul style="list-style-type: none"> <li>• Brand names</li> <li>• Goodwill</li> <li>• Trademarks</li> </ul>	<p><b>Amortization:</b> periodic allocation of the cost of an intangible asset to the periods it benefits</p> <p><b>Impairment:</b> occurs when the fair value of the asset falls below the carrying value; all long-term assets are subject to an annual test for impairment</p>
<i>Subject to Amortization and Impairment Test</i>	<i>Subject Only to Annual Impairment Test</i>				
<ul style="list-style-type: none"> <li>• Copyrights</li> <li>• Customer lists</li> <li>• Franchises</li> <li>• Licenses</li> <li>• Leaseholds</li> <li>• Noncompete covenants</li> <li>• Patents</li> <li>• Software</li> </ul>	<ul style="list-style-type: none"> <li>• Brand names</li> <li>• Goodwill</li> <li>• Trademarks</li> </ul>				

© Cengage Learning 2014

## Valuation and Disclosure of Long-Term Assets

Long-term assets are generally reported and *valued* at carrying value. **Carrying value** (or *book value*) is the unexpired part of an asset’s cost, computed as shown in Exhibit 3. If a long-term asset loses some or all of its potential to generate revenue before the end of its useful life, it is *impaired*, and its carrying value is reduced.

**Asset impairment** occurs when the carrying value of a long-term asset exceeds its fair value.<sup>1</sup> *Fair value* is the amount for which the asset could be bought or sold in a current transaction. For example, if the sum of the expected cash flows from an asset is less than its carrying value, the asset would be impaired, and a loss would be recorded. When the market prices used to establish fair value are not available, the amount of an impairment must be estimated from the best available information.

**Exhibit 3**

**Carrying Value of Long-Term Assets on the Balance Sheet**

<table border="0" style="width: 100%;"> <tr> <td style="padding: 2px;">Building</td> <td style="text-align: right; padding: 2px;">\$200,000</td> </tr> <tr> <td style="padding: 2px;">Less Accumulated Depreciation</td> <td style="text-align: right; padding: 2px;"><u>30,000</u></td> </tr> <tr> <td style="padding: 2px;">Total Plant Assets</td> <td style="text-align: right; padding: 2px;"><u>\$170,000</u></td> </tr> </table>	Building	\$200,000	Less Accumulated Depreciation	<u>30,000</u>	Total Plant Assets	<u>\$170,000</u>	<table border="0" style="width: 100%;"> <tr> <td style="padding: 2px;">Mines</td> <td style="text-align: right; padding: 2px;">\$100,000</td> </tr> <tr> <td style="padding: 2px;">Less Accumulated Depletion</td> <td style="text-align: right; padding: 2px;"><u>40,000</u></td> </tr> <tr> <td style="padding: 2px;">Total Natural Resources</td> <td style="text-align: right; padding: 2px;"><u>\$ 60,000</u></td> </tr> </table>	Mines	\$100,000	Less Accumulated Depletion	<u>40,000</u>	Total Natural Resources	<u>\$ 60,000</u>	<table border="0" style="width: 100%;"> <tr> <td style="padding: 2px;">Patents</td> <td style="text-align: right; padding: 2px;">\$20,000</td> </tr> <tr> <td style="padding: 2px;">Less Accumulated Amortization</td> <td style="text-align: right; padding: 2px;"><u>5,000</u></td> </tr> <tr> <td style="padding: 2px;">Total Intangible Assets</td> <td style="text-align: right; padding: 2px;"><u>\$15,000</u></td> </tr> </table>	Patents	\$20,000	Less Accumulated Amortization	<u>5,000</u>	Total Intangible Assets	<u>\$15,000</u>
Building	\$200,000																			
Less Accumulated Depreciation	<u>30,000</u>																			
Total Plant Assets	<u>\$170,000</u>																			
Mines	\$100,000																			
Less Accumulated Depletion	<u>40,000</u>																			
Total Natural Resources	<u>\$ 60,000</u>																			
Patents	\$20,000																			
Less Accumulated Amortization	<u>5,000</u>																			
Total Intangible Assets	<u>\$15,000</u>																			

© Cengage Learning 2014



## Business Perspective

© Allija / iStockphoto.com

Impairments reflect valuations at a point in time. For example, in 2004, **Apple Computer** recognized losses of \$5.5 million in asset impairments. With the huge success of the iPhone and iPad in subsequent years, the company had no occasion to recognize impairments in subsequent years. Taking a large write-down in a bad year is often called “taking a big bath” because it “cleans” future years of the bad year’s costs and thus can help a company return to a profitable status. In other words, by taking the largest possible loss in a bad year, companies hope to reduce the costs of depreciation or amortization on the asset in subsequent years.<sup>2</sup>

### Recognition of the Acquisition Cost of Long-Term Assets

An **expenditure** is a payment or an obligation to make a future payment for an asset or a service. Expenditures are *classified* as capital expenditures or revenue expenditures.

- A **capital expenditure** is for the purchase or expansion of a long-term asset. Capital expenditures are recorded in asset accounts because they benefit more than the current period.
- A **revenue expenditure** is for the ordinary repairs and maintenance needed to keep a long-term asset in good operating condition. For example, trucks, machines, and other equipment require periodic tune-ups and routine repairs. Expenditures of this type are recorded in expense accounts because their benefits are realized in the current period.

Capital expenditures include outlays for plant assets, natural resources, and intangible assets. They also include the following:

- **Additions** are enlargements to the physical layout of a plant asset. For example, if a new wing is added to a building, the benefits from the expenditure will be received over several years, and the amount paid should be debited to an asset account.
- **Betterments** are improvements to a plant asset but not an addition to the plant’s physical layout. Installation of an air-conditioning system is an example. Because betterments provide benefits over a period of years, their costs should be debited to an asset account.
- **Extraordinary repairs** are repairs that significantly enhance a plant asset’s estimated useful life or residual value. For example, the overhaul of a building’s heating and cooling system may extend the system’s useful life by five years. Extraordinary repairs are typically recorded by reducing the Accumulated Depreciation account. The effect is to increase the asset’s carrying value by the cost of the extraordinary repair. The new carrying value should be depreciated over the asset’s new estimated useful life.



## International Perspective

IFRS

### Asset Impairment Under IFRS

© loops7 / iStockphoto.com

The IFRS method of evaluating asset impairment does not consider the sum of the expected cash flows as is done under U. S. GAAP. Instead, it compares the carrying value with the recoverable amount. The recoverable amount is the greater of either the *net selling price* (the market value of the asset less disposal costs) or the *value in use*, which is based on the cash generating ability of the asset adjusted for interest rates. This is called *present value*, which will be explained in a later chapter.

Because the recoverable value is usually less than the sum of the expected cash flows, the IFRS method is much more likely than the GAAP method to result in write-offs due to impairment. The IFRS method also allows reversals of impairment write-offs if the value later increases because of revaluation, whereas the GAAP method prohibits future impairment reversals. One exception under IFRS is that goodwill impairments cannot be reversed.

© Cengage Learning 2014

The distinction between capital and revenue expenditures is important in applying *accrual accounting*, as illustrated in the examples that follow.

	Asset Incorrectly Recorded as Revenue Expenditure	Revenue Expenditure Incorrectly Recorded as Asset
<b>Example</b>	The purchase of a machine that will benefit a company for several years is mistakenly recorded as a revenue expenditure.	A revenue expenditure, such as the routine overhaul of a piece of machinery, is charged to an asset account.
<b>Result</b>	<p>The total cost of the machine becomes an expense on the income statement in the current period.</p> <p>▼ Current net income will be reported at a lower amount (<i>understated</i>).</p> <p>▲ In future periods, net income will be reported at a higher amount (<i>overstated</i>).</p>	<p>▼ The expense of the current period will be <i>understated</i>.</p> <p>▲ Current net income will be <i>overstated</i> by the same amount.</p> <p>▼ The net income of future periods will be <i>understated</i>.</p>

## APPLY IT!

Match each term that follows with the corresponding action.

- |                         |  |
|-------------------------|--|
| 1. Addition             | a. Repainting of an existing building.   |
| 2. Betterment           | b. Installation of a new roof that extends an existing building's useful life. |
| 3. Extraordinary repair | c. Erection of a new storage facility at the back of an existing building.     |
| 4. Revenue expenditure  | d. Decrease in value of intangible asset below carrying value.                 |
| 5. Impairment           | e. Installation of a new heating system in an existing building.               |

### SOLUTION

1. c; 2. e; 3. b; 4. a; 5. d

### TRY IT! E1A, E1B



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Computing acquisition cost
- Computing depreciation
  - Straight-line method
  - Production method
  - Declining-balance method
- Accounting for the disposition of depreciable assets
- Accounting for natural resources
- Accounting for intangible assets

## RELEVANT LEARNING OBJECTIVES

**LO 2** Account for the acquisition costs of property, plant, and equipment.

**LO 3** Compute depreciation under the straight-line, production, and declining-balance methods.

**LO 4** Account for the disposal of depreciable assets.

**LO 5** Identify the issues related to accounting for natural resources, and compute depletion.

**LO 6** Identify the issues related to accounting for intangible assets, including research and development costs and goodwill.

## LO 2 Acquisition Cost of Property, Plant, and Equipment

The acquisition cost of property, plant, and equipment includes all expenditures reasonable and necessary to get an asset in place and ready for use. For example, the cost of installing and testing a machine is a legitimate cost of acquiring the machine. However, if the machine is damaged during installation, the cost of repairs is an operating expense.

The cost of an asset is equal to its purchase price plus other costs:

$$\text{Cost of Asset} = \text{Purchase Price} + \text{Additional Expenditures (freight, installation, etc.)}$$

Thus, expenditures for freight, insurance while in transit, and installation are included in the cost of the asset because they are necessary for the asset to function. In accordance with *accrual accounting*, these expenditures are allocated over the asset's useful life.

Any interest charges incurred in purchasing an asset are not a cost of the asset. They are a cost of borrowing the money to buy the asset and are, therefore, an operating expense. An exception to this rule is that interest costs incurred during the construction of an asset are properly included as a cost of the asset.<sup>3</sup>

Many companies establish policies that define when an expenditure should be recorded as an expense or as an asset. For example, small expenditures for items that qualify as long-term assets may be treated as expenses because the amounts involved are not *material*. Thus, although a wastebasket may last for years, it would be recorded as an expense rather than as a depreciable asset.

### Specific Applications of Determining the Acquisition Cost of Property, Plant, and Equipment

The sections that follow discuss some of the problems of determining the cost of long-term plant assets.

**Land** The purchase price of land should be debited to the Land account. Other expenditures that should be debited to Land include:

- Commissions to real estate agents
- Lawyers' fees
- Accrued taxes paid by the purchaser
- Costs of preparing the land to build on, such as the costs of tearing down old buildings and grading the land
- Assessments for local improvements, such as putting in streets and sewage systems
- Landscaping

Land is not depreciated because it has an unlimited useful life.

Assume that a company pays \$340,000 for land, \$16,000 in brokerage and legal fees, \$20,000 to have an old building on the site torn down, and \$2,000 to have the site graded. It receives \$8,000 in salvage from the old building. The cost of the land is \$370,000, calculated as follows.

Net purchase price		\$340,000
Brokerage and legal fees		16,000
Tearing down old building	\$20,000	
Less salvage	<u>8,000</u>	12,000
Grading		<u>2,000</u>
Total cost		<u>\$370,000</u>





REUTERS/Str Oid

Like other costs involved in preparing land for use, the cost of implosion is debited to Land. Other expenditures debited to Land include the purchase price of the land, brokerage and legal fees involved in the purchase, taxes paid by the purchaser, and landscaping.

**Land Improvements** Some improvements to real estate, such as driveways, parking lots, and fences, have a limited life and, thus, are subject to depreciation. They should be recorded in an account called Land Improvements.

**Buildings** When a company buys a building, the cost includes the purchase price and all expenditures required to put the building in usable condition. When a company uses a contractor to construct a building, the cost includes the net contract price plus other expenditures necessary to put the building in usable condition. When a company constructs its own building, the cost includes:

- Costs of materials, labor, overhead and other indirect costs
- Architects' fees and lawyers' fees
- Insurance during construction
- Interest on construction loans during the period of construction
- Building permits

Because buildings have a limited useful life, they are subject to depreciation.

**Leasehold Improvements** Improvements to leased property on the books of the lessee that become the property of the lessor (the owner of the property) at the end of the lease are called **leasehold improvements**. For example, a tenant's installation of light fixtures, carpets, or walls would be considered a leasehold improvement. These improvements are usually classified in the property, plant, and equipment section of the balance sheet.<sup>4</sup> The cost of a leasehold improvement is depreciated over the remaining term of the lease or the useful life of the improvement, whichever is shorter.

A study of large companies showed that 26 percent report leasehold improvements. The percentage is likely to be much higher for small businesses because they generally operate in leased premises.<sup>5</sup>

**Equipment** The cost of equipment includes all expenditures connected with purchasing the equipment and preparing it for use. These expenditures include:

- Invoice price less cash discounts
- Freight, including insurance
- Excise taxes and tariffs
- Buying expenses
- Installation costs
- Test runs to ready the equipment for operation

Equipment is subject to depreciation.

**Group Purchases** Companies sometimes purchase land and other assets for a lump sum. The lump-sum purchase price must be apportioned between the land and the other assets. For example, suppose that a company buys a building and land for \$170,000. The company can determine what it would have paid for the building and for the land if it had purchased them separately and apply the appropriate percentages to the lump-sum price. If appraisals yield estimates of \$20,000 for the land and \$180,000 for the building, the lump-sum price would be allocated as follows.

	Appraisal	Percentage	Apportionment
Land	\$ 20,000	10% (\$ 20,000 ÷ \$200,000)	\$ 17,000 (\$170,000 × 10%)
Building	180,000	90% (\$180,000 ÷ \$200,000)	153,000 (\$170,000 × 90%)
Totals	<u>\$200,000</u>	<u>100%</u>	<u>\$170,000</u>

**STUDY NOTE:** The wiring and plumbing of a dental chair are included in the cost of the asset because they are a necessary cost of preparing the asset for use.

## APPLY IT!

Match each term that follows with the corresponding action.

- |                          |  |
|--------------------------|--|
| 1. Land                  | a. Purchase of a computer.   |
| 2. Land improvement      | b. Purchase of a lighting system for a parking lot.                    |
| 3. Leasehold improvement | c. Construction of a foundation for a new building.                    |
| 4. Buildings             | d. Installation of partitions and shelves in a leased space.           |
| 5. Equipment             | e. Clearing of land in preparation for construction of a new building. |

### SOLUTION

1. e; 2. b; 3. d; 4. c; 5. a

**TRY IT! SE1, SE2, E2A, E3A, E4A, E2B, E3B, E4B**

**STUDY NOTE:** Depreciation is the allocation of the acquisition cost of a plant asset. Any similarity between carrying value and current market value is pure coincidence.

**STUDY NOTE:** A computer may function just as well as it did when purchased four years ago, but because much faster and more efficient computers are now available, it is obsolete.

## LO 3 Depreciation

As noted earlier, depreciation is the periodic allocation of the cost of property, plant, and equipment (other than land) over the asset's estimated useful life. In accounting for depreciation, it is important to keep the following points in mind:

- All plant assets, except land, have a limited useful life, and the costs of these assets must be distributed as expenses over the years they benefit.
- Depreciation refers to the allocation of the cost of a plant asset to the periods it benefits, not to the asset's physical deterioration or its decrease in market value. The term *depreciation* describes the gradual conversion of the cost of the asset into an expense.
- Depreciation is not a process of *valuation*. Accounting records are not indicators of changing price levels. They are kept in accordance with the *cost principle*. Because of an advantageous purchase price and market conditions, the value of a building may increase. Nevertheless, because depreciation is a process of allocation, not valuation, depreciation on the building must continue to be recorded.

Physical deterioration and obsolescence are the major factors in limiting a depreciable asset's useful life.

- **Physical deterioration:** The result of use or exposure to the elements, such as wind and sun. Periodic repairs and a sound maintenance policy may keep buildings and equipment in good operating order, but every machine or building must, at some point, be discarded.
- **Obsolescence:** The process of going out of date. Because of fast-changing technology and demands, machinery and even buildings often become obsolete before they wear out.

Accountants do not distinguish between physical deterioration and obsolescence because they are interested in the length of an asset's useful life, not in what limits its useful life.



## Business Perspective

### How Long Is the Useful Life of an Airplane?

Most airlines depreciate their planes over an estimated useful life of 10 to 20 years. But how long will a properly maintained plane really last? **Western Airlines** paid \$3.3 million for a new Boeing 737 in July 1968. More than 78,000 flights and 30 years later, this aircraft was still flying for **Vanguard Airlines**, a no-frills airline. Among the other airlines that have owned this plane are **Piedmont, Delta**, and **US Airways**. Virtually every part of the plane has been replaced over the years. **Boeing** believes the plane could theoretically make double the number of flights before it is retired.

The useful lives of many types of assets can be extended indefinitely if the assets are correctly maintained. However, each airline that owned the plane would have depreciated it over a "reasonable" useful life.

## Factors in Computing Depreciation

Four factors affect the computation of depreciation:

- **Cost** is the net purchase price of an asset plus all reasonable and necessary expenditures to get it in place and ready for use.
- **Residual value** (or *salvage value*, *disposal value*, and *trade-in value*) is the portion of an asset's acquisition cost that a company expects to recover when it disposes of the asset.
- **Depreciable cost** is an asset's cost less its residual value. For example, a truck that cost \$24,000 and that has a residual value of \$6,000 would have a depreciable cost of \$18,000. Depreciable cost must be allocated over the estimated useful life of the asset.
- **Estimated useful life** is the total number of service units expected from a long-term asset. Service units may be measured in terms of the years an asset is expected to be used, the units it is expected to produce, the miles it is expected to be driven, or similar measures. In computing an asset's estimated useful life, an accountant should consider all relevant information, including past experience with similar assets, the asset's present condition, the company's repair and maintenance policy, and current technological and industry trends.

At the end of a period, depreciation is recorded with an adjusting entry that takes the following form:

$$\begin{array}{r} \text{A} \\ - \text{XXX} \end{array} = \begin{array}{r} \text{L} \\ + \text{OE} \\ - \text{XXX} \end{array}$$

Depreciation Expense—Asset Name	XXX	
Accumulated Depreciation—Asset Name		XXX
To record depreciation for the period		

**STUDY NOTE:** Depreciable cost, not acquisition cost, is allocated over a plant asset's useful life.

## Methods of Computing Depreciation

Many methods are used to allocate the cost of plant assets to accounting periods. The most common methods are the straight-line method, the production method, and the declining-balance method (an accelerated method).

### Straight-Line Method

**Method** When the **straight-line method** is used, the asset's depreciable cost is spread evenly over the estimated useful life of the asset. The straight-line method is based on the assumption that depreciation depends only on the passage of time.

**Formula** The depreciation expense for each period is computed by dividing the depreciable cost (cost less estimated residual value) by the number of accounting periods in the asset's estimated useful life:

$$\text{Depreciation Expense} = (\text{Cost} - \text{Residual Value}) \div \text{Estimated Useful Life}$$

**STUDY NOTE:** Estimates of residual value and useful life are, at best, educated guesses.



## International Perspective

### IFRS Depreciation of Buildings Under IFRS

Under GAAP, the costs of a building and its components, such as a heating and air conditioning system, are usually lumped together as one asset and are depreciated over the life of the building. Under IFRS, however, a building and its components are depreciated on an individual basis. In other words, each component of a building—each property, plant, and equipment asset—is considered to have its own useful life and fair value and is depreciated on that basis. Because many of a building's assets often have shorter useful lives than the building itself, IFRS tend to increase depreciation expense. These standards also require more precise record keeping.

**Example** A delivery truck cost \$20,000 and has an estimated residual value of \$2,000 at the end of its estimated useful life of five years. Under the straight-line method, the annual depreciation would be \$3,600, calculated as follows.

$$\text{Depreciation Expense} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Useful Life}} = \frac{\$20,000 - \$2,000}{5 \text{ Years}} = \$3,600 \text{ per Year}$$

Exhibit 4 shows the depreciation schedule for the five years. Note that in addition to annual depreciation being the same each year, the accumulated depreciation increases uniformly and the carrying value decreases uniformly until it reaches the estimated residual value.

**Exhibit 4**  
Depreciation Schedule,  
Straight-Line Method

	Cost	Annual Depreciation	Accumulated Depreciation	Carrying Value
Date of purchase	\$20,000	—	—	\$20,000
End of first year	20,000	\$3,600	\$ 3,600	16,400
End of second year	20,000	3,600	7,200	12,800
End of third year	20,000	3,600	10,800	9,200
End of fourth year	20,000	3,600	14,400	5,600
End of fifth year	20,000	3,600	18,000	2,000

© Cengage Learning 2014

### Production Method

**Method** The **production method** (or *units of production method*) is based on the assumption that depreciation is solely the result of use and that the passage of time plays no role in the process. The production method is appropriate when a company has widely fluctuating rates of production. For example, carpet mills often close during the first two weeks in July but may run double shifts in September. With the production method, depreciation would be in direct relation to a mill's units of output.

**Formula** Under the production method, depreciation is calculated as follows.

$$\text{Depreciation Expense} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Units of Useful Life}}$$

**Example** Assume that the delivery truck in the previous example has an estimated useful life of 90,000 miles. The depreciation cost per mile would be determined as follows.

$$\text{Depreciation Expense} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Units of Useful Life}} = \frac{\$20,000 - \$2,000}{90,000} = \$0.20 \text{ per Mile}$$

If the truck were driven 20,000 miles in the first year, 30,000 miles in the second, 10,000 miles in the third, 20,000 miles in the fourth, and 10,000 miles in the fifth, the depreciation schedule for the truck would be as shown in Exhibit 5. As you can see, the amount of depreciation each year is directly related to the units of use. The carrying value decreases each year until it reaches the estimated residual value.

**Exhibit 5**  
Depreciation Schedule,  
Production Method

	Cost	Miles	Annual Depreciation	Accumulated Depreciation	Carrying Value
Date of purchase	\$20,000	—	—	—	\$20,000
End of first year	20,000	20,000	\$4,000	\$ 4,000	16,000
End of second year	20,000	30,000	6,000	10,000	10,000
End of third year	20,000	10,000	2,000	12,000	8,000
End of fourth year	20,000	20,000	4,000	16,000	4,000
End of fifth year	20,000	10,000	2,000	18,000	2,000

© Cengage Learning 2014

In considering whether to use the production method, it is important to keep the following points in mind:

- It must be possible to estimate with reasonable accuracy the output of an asset over its useful life.
- The unit used to measure the estimated useful life of an asset must be appropriate for the asset.

**Declining-Balance Method** An **accelerated method** of depreciation results in relatively large amounts of depreciation in the early years of an asset’s life and smaller amounts in later years. This type of method is based on the assumption that many plant assets are most efficient when new and so provide the greatest benefits in their first years.

Under an accelerated method, depreciation charges will be highest in years when revenue generation from the asset is highest. Fast-changing technologies often cause equipment to become obsolete and lose service value rapidly. In addition, repair expense is likely to increase as an asset ages. In such cases, using an accelerated method is appropriate. Thus, the total of repair plus depreciation expense will remain fairly constant over the years.

**Declining-Balance Method**

**Method** The **declining-balance method** is the most common accelerated method of depreciation. With this method, depreciation is computed by applying a fixed rate to the declining carrying value of a long-term asset. It therefore results in higher depreciation charges in the early years of the asset’s life. Though any fixed rate can be used, the most common rate is a percentage equal to twice the straight-line depreciation percentage. When this rate is used, the method is usually called the **double-declining-balance method**.

**Example** In our example of the straight-line method, the delivery truck had an estimated useful life of five years, and the annual depreciation rate for the truck was therefore 20 percent:

$$\begin{aligned} \text{Annual Depreciation Rate} &= \frac{\text{Percent of Useful Life}}{\text{Estimated Useful Life}} \\ &= \frac{100\%}{5 \text{ Years}} \\ &= 20\% \end{aligned}$$

$$\text{Declining-Balance Depreciation Rate} = 2 \times 20\% = 40\%$$

Under the double-declining-balance method, the fixed rate would be 40 percent, or “double” the straight-line rate.

This rate is applied to the carrying value at the end of the previous year. With this method, the depreciation schedule would be as shown in Exhibit 6.

**STUDY NOTE:** The double-declining-balance method is the only method presented here in which the residual value is not deducted before calculating depreciation.

**Exhibit 6**  
Depreciation Schedule, Double-Declining-Balance Method

	Cost	Annual Depreciation	Accumulated Depreciation	Carrying Value
Date of purchase	\$20,000	—	—	\$20,000
End of first year	20,000	(40% × \$20,000) = \$8,000	\$ 8,000	12,000
End of second year	20,000	(40% × \$12,000) = 4,800	12,800	7,200
End of third year	20,000	(40% × \$ 7,200) = 2,880	15,680	4,320
End of fourth year	20,000	(40% × \$ 4,320) = 1,728	17,408	2,592
End of fifth year	20,000	592*	18,000	2,000

\*Depreciation is limited to the amount necessary to reduce carrying value to residual value: \$2,592 (previous carrying value) – \$2,000 (residual value) = \$592.

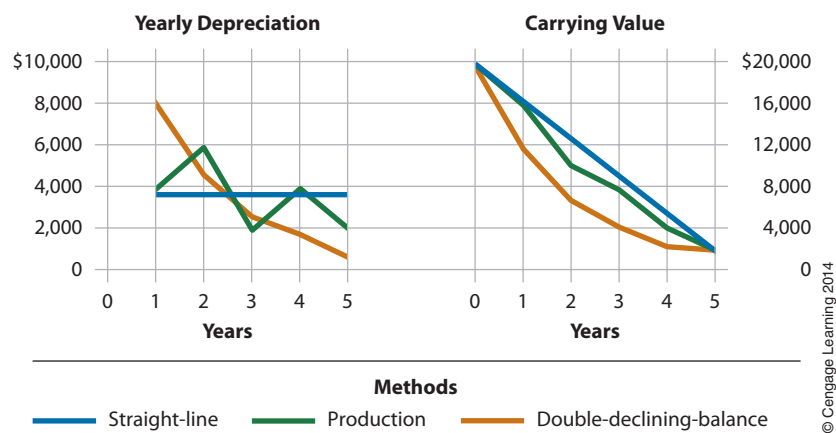
© Cengage Learning 2014

**Comparison of the Three Methods** Exhibit 7 compares yearly depreciation and carrying value under the three methods. The graph on the left shows yearly depreciation.

- Straight-line depreciation is uniform at \$3,600 per year over the 5-year period.
- The double-declining-balance method begins at \$8,000 and decreases each year to amounts that are less than straight-line (ultimately, \$592).
- The production method does not generate a regular pattern because of the random fluctuation of the depreciation from year to year.

The graph on the right side of Exhibit 7 shows the carrying value under the three methods. Each method starts in the same place (cost of \$20,000) and ends at the same place (residual value of \$2,000). However, the patterns of carrying value during the asset's useful life differ. For instance, the carrying value under the straight-line method is always greater than under the double-declining-balance method, except at the beginning and end of the asset's useful life.

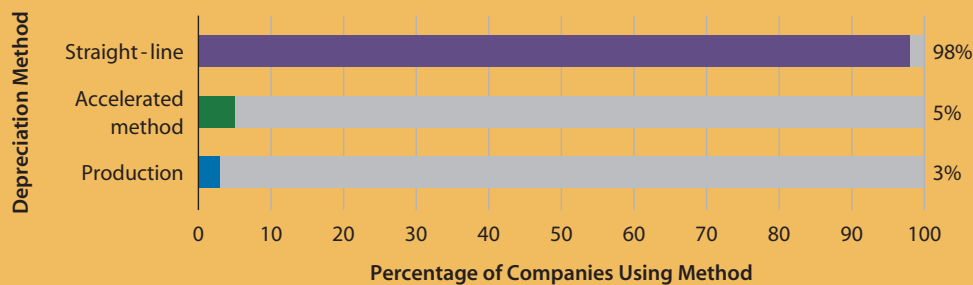
**Exhibit 7**  
Graphic Comparison of Three Methods of Determining Depreciation



## Business Perspective

### Accelerated Methods Save Money!

As shown in the graph below, an AICPA study of 500 large companies found that the overwhelming majority used the straight-line method of depreciation for financial reporting. Only about 5 percent used some type of accelerated method, and 3 percent used the production method. However, these figures tend to be misleading about the importance of accelerated depreciation methods. Federal income tax laws allow either the straight-line method or an accelerated method, and, for tax purposes, about 75 percent of the 500 companies studied preferred an accelerated method. The straight-line method can be advantageous for financial reporting because it can produce the highest net income, and an accelerated method can be beneficial for tax purposes because it can result in lower income taxes.



Note: Calculation more than 100% due to companies using more than one method.

Source: "Depreciation Methods Used by 600 Large Companies for Financial Reporting." Copyright © 2011 by AICPA. Reproduced with permission.



## Special Issues in Determining Depreciation

Other issues in depreciating assets include group depreciation, depreciation for partial years, revision of depreciation rates, and accelerated cost recovery for tax purposes.

**Group Depreciation** The estimated useful life of an asset is the average length of time assets of the same type are expected to last. For example, the average useful life of a particular type of machine may be six years. However, some machines in this category may last only two or three years, while others may last eight or nine years or longer. For this reason, and for convenience, large companies group similar assets, such as machines, to calculate depreciation. A survey of large businesses indicated that 67 percent used this method, called **group depreciation**, for all or part of their plant assets.<sup>6</sup>

**Depreciation for Partial Years** To simplify our examples of depreciation, we have assumed that plant assets were purchased at the beginning or end of a period. However, the time of year is normally not a factor in the decision to buy or sell assets. Thus, it is often necessary to calculate depreciation for partial years. Some companies compute depreciation to the nearest month. Others use the half-year convention, in which one-half year of depreciation is taken in the year the asset is purchased and one-half year is taken in the last year of the asset’s life.

**Revision of Depreciation Rates** The periodic depreciation charge is seldom precise. Sometimes, the estimate of useful life is revised, so that the periodic depreciation expense increases or decreases over the asset’s remaining useful life. For example, suppose a delivery truck cost \$14,000 and has a residual value of \$2,000. The truck was expected to last six years, and it was depreciated on the straight-line basis. However, after two years of intensive use, it is determined that the truck will last only two more years, but its residual value at the end of the two years will still be \$2,000. At the end of the second year, the asset account and its related accumulated depreciation account would be as follows.

Delivery Truck		Accumulated Depreciation— Delivery Truck	
Dr.	Cr.	Dr.	Cr.
Cost	14,000		Depreciation, Year 1      2,000
			Depreciation, Year 2      2,000

The remaining depreciable cost is computed as follows.

$$\text{Cost} - \text{Depreciation Already Taken} - \text{Residual Value} = \text{Depreciable Cost}$$

$$\$14,000 - \$4,000 - \$2,000 = \$8,000$$

The new annual periodic depreciation charge is computed by dividing the remaining depreciable cost of \$8,000 by the remaining useful life of two years. Therefore, the new periodic depreciation charge is \$4,000.<sup>7</sup>

**Special Rules for Tax Purposes** Over the years, Congress has revised the federal income tax law to encourage businesses to invest in new plant and equipment. For instance, the tax law allows rapid write-offs of plant assets, which differs considerably from the depreciation methods most companies use for financial reporting. Tax methods of depreciation are usually not acceptable for financial reporting because the periods over which deductions may be taken are often shorter than the assets’ estimated useful lives. A change in the federal income tax law—the result of the **Economic Stimulus Act of 2008**—allows a small company to expense the first \$250,000 of equipment expenditures rather than record them as assets and depreciate them over their useful lives. Also, for assets that are subject to depreciation, there is a bonus first-year deduction.



## APPLY IT!

On January 13, 2014, Miko Company purchased a company car for \$47,500. Miko expects the car to last five years or 120,000 miles, with an estimated residual value of \$7,500. During 2015, the car is driven 27,000 miles. Miko's year-end is December 31. Compute the depreciation for 2015 under each of the following methods: (1) straight-line, (2) production, and (3) double-declining-balance. Using the amount computed in (3), prepare the journal entry to record depreciation expense for the second year and compute carrying value of the company car as it would appear on the balance sheet.

### SOLUTION

Depreciation computed:

1. Straight-line method:  $(\$47,500 - \$7,500) \div 5 \text{ years} = \$8,000$
2. Production method:  $(\$47,500 - \$7,500) \div 120,000 \text{ miles} = \$0.3333 \text{ per mile}$   
 $27,000 \text{ miles} \times \$0.3333 = \$9,000^*$
3. Double-declining-balance method:  $(1 \div 5) \times 2 = 0.40$   
 2014:  $\$47,500 \times 0.40 = \$19,000$   
 2015:  $(\$47,500 - \$19,000) \times 0.40 = \$11,400$   
 \* Rounded

### Journal entry:

Depreciation Expense	11,400	
Accumulated Depreciation		11,400
<i>To record depreciation of car: <math>(\\$47,500 - \\$19,000) \times 0.40</math></i>		

Balance sheet carrying value:

Company car	\$47,500	
Less accumulated depreciation	<u>30,400</u>	\$17,100

**TRY IT! SE3, SE4, SE5, E4A, E5A, E6A, E7A, E4B, E5B, E6B, E7B**

## LO 4 Disposal of Depreciable Assets

When plant assets, like buildings and equipment, are no longer useful because they have physically deteriorated or become obsolete, a company can:

- Discard them
- Sell them
- Trade them in on the purchase of a new asset

Regardless of how a company disposes of a plant asset, it must record depreciation expense for the partial year up to the date of disposal. This step is required because the company used the asset until that date and, under accrual accounting, the accounting period should receive the proper allocation of depreciation expense.

To illustrate how a company records each type of disposal, we will use BTL Company.

### Discarded Plant Assets

If an asset remains in use beyond the end of its estimated life, its cost and accumulated depreciation remain in the ledger accounts. Thus, proper records will be available for maintaining control over plant assets. If the residual value is zero, the carrying value of a fully depreciated asset is zero. When the asset is discarded, no gain or loss results. For assets with a carrying value, however, a loss equal to the carrying value should be recorded.

#### Discarding Assets with a Carrying Value

**Transaction** BTL purchases a machine on January 2, 2014, for \$13,000 and plans to depreciate it on a straight-line basis over an estimated useful life of eight years. The machine's residual value at the end of eight years is estimated to be \$600. On December 31, 2019, the balances of the relevant accounts are as shown below. On January 2, 2020, management disposes of the asset.

**STUDY NOTE:** When a company disposes of an asset, it must bring the depreciation up to date and remove all evidence of ownership of the asset, including the contra account Accumulated Depreciation.

Machinery		Accumulated Depreciation—Machinery	
Dr.	Cr.	Dr.	Cr.
13,000			9,300

The discarded equipment has a carrying value of \$3,700 at the time of its disposal (\$13,000 less accumulated depreciation of \$9,300).

**Analysis** A loss equal to the carrying value should be recorded. This journal entry

- ▼ decreases the asset *Machinery* with a credit
- ▼ decreases Machinery’s related *Accumulated Depreciation* with a debit
- ▲ increases the *Loss on Disposal of Machinery* account with a debit

**Application of Accrual Accounting**

Assets		=	Liabilities	+	Owner’s Equity	
<b>Machinery</b>					<b>Loss on Disposal of Machinery</b>	
Dr.	Cr.				Dr.	Cr.
	Jan. 2 13,000				Jan. 2 3,700	
<b>Accumulated Depreciation—Machinery</b>						
Dr.	Cr.					
Jan. 2 9,300						

**Journal Entry**

	Dr.	Cr.
Jan. 2 Accumulated Depreciation—Machinery	9,300	
Loss on Disposal of Machinery	3,700	
Machinery		13,000
Disposal of machine no longer in use		

$$\begin{array}{r}
 \mathbf{A} \\
 -13,000 \\
 + 9,300
 \end{array}
 =
 \begin{array}{r}
 \mathbf{L} \\
 -3,700
 \end{array}
 +
 \begin{array}{r}
 \mathbf{OE} \\
 -3,700
 \end{array}$$

**Comment** *Recognized* gains and losses on disposals of plant assets are *classified* as other revenues and expenses on the income statement.

**Plant Assets Sold for Cash**

The entry to record a plant asset sold for cash is similar to the one just illustrated, except that the receipt of cash should also be recorded. The following entries show how to record the sale of a machine at three different selling prices.

**Cash Received Equal to Carrying Value**

**Transaction** \$3,700 cash is received and is exactly equal to the \$3,700 carrying value of the machine.

**Analysis** The journal entry to record the sale of an asset at carrying value

- ▼ decreases the *Machinery* account and the *Accumulated Depreciation* account
- ▲ increases the *Cash* account

**STUDY NOTE:** When an asset is discarded or sold for cash, the gain or loss equals cash received minus the carrying value.

**Application of Double Entry**

Assets		=	Liabilities	+	Owner's Equity
<b>Cash</b>					
<i>Dr.</i>	<i>Cr.</i>				
Jan. 2	3,700				
<b>Accumulated Depreciation—Machinery</b>					
<i>Dr.</i>	<i>Cr.</i>				
Jan. 2	9,300				
<b>Machinery</b>					
<i>Dr.</i>	<i>Cr.</i>				
	Jan. 2	13,000			

**Journal Entry**

**A = L + OE**  
 + 3,700  
 + 9,300  
 -13,000

2020		<i>Dr.</i>	<i>Cr.</i>
Jan. 2	Cash	3,700	
	Accumulated Depreciation—Machinery	9,300	
	Machinery		13,000
	Sale of machine for carrying value; no gain or loss		

**Comment** No gain or loss is *recognized* because the amount of cash is exactly equal to the carrying value of the machinery being sold.

**Cash Received Less Than Carrying Value**

**Transaction** \$2,000 cash is received, which is less than the carrying value of \$3,700, resulting in a loss of \$1,700.

**Analysis** The journal entry to record the sale of an asset at less than carrying amount

- ▼ *decreases* the *Machinery* account and the *Accumulated Depreciation* account
- ▲ *increases* the *Cash* account
- ▲ *increases* the *Loss on Sale of Machinery* account for the difference

**Application of Double Entry**

Assets		=	Liabilities	+	Owner's Equity
<b>Cash</b>					<b>Loss on Sale of Machinery</b>
<i>Dr.</i>	<i>Cr.</i>			<i>Dr.</i>	<i>Cr.</i>
Jan. 2	2,000			Jan. 2	1,700
<b>Accumulated Depreciation—Machinery</b>					
<i>Dr.</i>	<i>Cr.</i>				
Jan. 2	9,300				
<b>Machinery</b>					
<i>Dr.</i>	<i>Cr.</i>				
	Jan. 2	13,000			

**Journal Entry**

**A = L + OE**  
 + 2,000  
 + 9,300  
 -13,000

2020		<i>Dr.</i>	<i>Cr.</i>
Jan. 2	Cash	2,000	
	Accumulated Depreciation—Machinery	9,300	
	Loss on Sale of Machinery	1,700	
	Machinery		13,000
	Sale of machine at less than carrying value; loss of \$1,700 (\$3,700 - \$2,000) recorded		

**Comment** A loss is *recognized* because the amount of cash is less than the carrying value of the machinery being sold.

**Cash Received More Than Carrying Value**

**Transaction** \$4,000 cash is received, which exceeds the carrying value of \$3,700, resulting in a gain of \$300.

- Analysis** The journal entry to record the sale of an asset at less than carrying amount
- ▼ *decreases* the *Machinery* account and the *Accumulated Depreciation* account
  - ▲ *increases* the *Cash* account
  - ▲ *increases* the *Gain on Sale of Machinery* account for the difference

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity		
<b>Cash</b>						<b>Gain on Sale of Machinery</b>		
Dr.	Cr.				Dr.	Cr.		
Jan. 2	4,000						Jan. 2	300
<b>Accumulated Depreciation—Machinery</b>								
Dr.	Cr.							
Jan. 2	9,300							
<b>Machinery</b>								
Dr.	Cr.							
							Jan. 2	13,000

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+ 4,000				+300
+ 9,300				
-13,000				

2020	Dr.	Cr.
Jan. 2	4,000	
	9,300	
		13,000
		300
Sale of machine at more than the carrying value; gain of \$300 (\$4,000 – \$3,700) recorded		

**Comment** A gain is *recognized* because the amount of cash is more than the carrying value of the machinery being sold.

**Exchanges of Plant Assets**

Exchanges may involve similar assets, such as an old machine traded in on a newer model, or dissimilar assets, such as a cement mixer traded in on a truck. In either case, the purchase price is reduced by the amount of the trade-in allowance.

Basically, accounting for exchanges of plant assets is similar to accounting for sales of plant assets.

- ▲ If the trade-in allowance is greater than the asset's carrying value, the company realizes a gain.
- ▼ If the allowance is less, it suffers a loss.<sup>8</sup>

## APPLY IT!

On January 2, the first day of business of the current year, Kamila Company sold a car that cost \$47,500 and on which \$30,400 of accumulated depreciation had been recorded. For each of the following assumptions, prepare the journal entry (without explanation) for the disposal: (1) The car was sold for \$17,100 cash. (2) The car was sold for \$15,000 cash. (3) The car was sold for \$20,000 cash.

### SOLUTION

	Dr.	Cr.
1. Cash	17,100	
Accumulated Depreciation—Automobile	30,400	
Automobile		47,500
2. Cash	15,000	
Accumulated Depreciation—Automobile	30,400	
Loss on Sale of Automobile	2,100	
Automobile		47,500
3. Cash	20,000	
Accumulated Depreciation—Automobile	30,400	
Automobile		47,500
Gain on Sale of Automobile		2,900

**TRY IT! SE6, E8A, E9A, E8B, E9B**

## LO 5 Natural Resources

Natural resources are long-term assets that appear on a balance sheet with descriptive titles like “Timberlands,” “Oil and gas reserves,” and “Mineral deposits.” These assets are converted to inventory by cutting, pumping, mining, or other extraction methods.

Natural resources are recorded at acquisition cost, which may include some costs of development. As these resources are converted to inventory, their asset accounts must be proportionally reduced. For example, the carrying value of oil reserves on the balance sheet is reduced by the proportional cost of the barrels pumped during the period. The original cost of the oil reserves is thus gradually reduced, and depletion is recognized.

### Depletion

Depletion refers not only to the exhaustion of a natural resource but also to the proportional allocation of the cost of a natural resource to the units extracted. The way in which the cost of a natural resource is allocated closely resembles the production method of calculating depreciation. When a natural resource is purchased or developed, the total units that will be available, such as tons of coal, must be estimated. The depletion cost per unit is computed as follows.

$$\text{Depletion Cost per Unit} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Number of Units}}$$

#### Depletion of a Natural Resource

**Transaction** A mine was purchased for \$3,600,000. It has an estimated residual value of \$600,000, and it contains an estimated 3,000,000 tons of coal. The depletion charge per ton of coal is \$1, calculated as follows.

$$\text{Depletion Cost per Unit} = \frac{\text{Cost} - \text{Residual Value}}{\text{Estimated Number of Units}}$$

$$\frac{\$3,600,000 - \$600,000}{3,000,000 \text{ Tons}} = \$1 \text{ per Ton}$$

The amount of the depletion cost for each accounting period is then computed by multiplying the depletion cost per unit by the number of units extracted and sold. Thus, if 230,000 tons of coal are mined and sold during the first year, the depletion charge for the year is \$230,000.

**Analysis** The journal entry to record the depletion of a natural resource

- ▲ increases the *Depletion Expense* account
- ▲ increases the *Accumulated Depletion* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
<b>Accumulated Depletion— Coal Deposits</b>						<b>Depletion Expense— Coal Deposits</b>	
<i>Dr.</i>	<i>Cr.</i>					<i>Dr.</i>	<i>Cr.</i>
	Dec. 31 230,000					Dec. 31 230,000	

**Journal Entry**

	<b>A</b>	=	<b>L</b>	+	<b>OE</b>	
	-230,000				-230,000	

Dec. 31	Depletion Expense—Coal Deposits	230,000	←	230,000	←	230,000			
	Accumulated Depletion—Coal Deposits								
	To record depletion of coal mine: \$1 per ton for 230,000 tons mined and sold								

On the balance sheet, data for the mine would be presented as follows.

Coal deposits	\$3,600,000	
Less accumulated depletion	230,000	\$3,370,000

**Comment** If a natural resource is not sold in the year it is extracted, it is reported as inventory. It would be *recorded* as a depletion *expense* in the year it is *sold*.

## Depreciation of Plant Assets Related to Natural Resources

**STUDY NOTE:** A company may abandon equipment that is still in good working condition because of the expense involved in dismantling the equipment and moving it to another site.

The extraction of natural resources generally requires special on-site buildings and equipment (e.g., conveyors, drills, and pumps). The useful life of these plant assets may be longer than the estimated time it will take to deplete the resources. However, a company may plan to abandon these assets after all the resources have been extracted because they no longer serve a useful purpose. In this case, they should be depreciated on the same basis as the depletion.

For example, suppose machinery with a useful life of ten years is installed on an oil field that is expected to be depleted in eight years. The machinery should be depreciated over the eight-year period, using the production method. That way, each year's depreciation will be proportional to the year's depletion.<sup>9</sup>

## Development and Exploration Costs in the Oil and Gas Industry

The costs of exploring and developing oil and gas resources can be accounted for under one of two methods: successful efforts or full costing. The Financial Accounting Standards Board permits the use of either method.<sup>10</sup>

**Successful Efforts Accounting** Under **successful efforts accounting**, the cost of successful exploration—for example, an exploration that produces an oil well—is a cost of the resource. It should be recorded as an asset and depleted over the resource's estimated life. The cost of an unsuccessful exploration—such as one that produces a dry well—is written off immediately as a loss. Because of these immediate write-offs, successful efforts accounting is considered the more conservative method and is used by most large oil companies.



## Business Perspective

### How Do You Measure What's Underground? With a Good Guess.

© Allija / Stockphoto.com

Accounting standards require publicly traded energy companies to *disclose* in their annual reports their production activities, estimates of their proven oil and gas reserves, and estimates of the future cash flows those reserves are expected to generate. Since the reserves are often miles underground or beneath deep water, these figures are considered “supplementary” and not reliable enough to be audited independently. As a result, some companies have overestimated their reserves and, thus, overestimated their future prospects. Apparently, some managers at **Royal Dutch/Shell Group** were receiving bonuses based on the amount of new reserves added to the annual report. When the company announced that it was reducing its reported reserves by 20 percent, the price of its stock dropped.<sup>11</sup>

**Full-Costing Method** Small, independent oil companies argue that the cost of dry wells is part of the overall cost of the systematic development of an oil field and is, thus, a part of the cost of producing wells. Under the **full-costing method**, all costs, including the cost of dry wells, are recorded as assets and depleted over the estimated life of the resources. This method tends to improve a company’s earnings performance in its early years.

## APPLY IT!

Sharp Mining Company paid \$8,800,000 for land containing an estimated 40 million tons of ore. The land without the ore is estimated to be worth \$2,000,000. The company spent \$1,380,000 to erect buildings on the site and \$2,400,000 on equipment installed on site. The buildings have an estimated useful life of 30 years, and the equipment has an estimated useful life of 10 years. Neither the buildings nor the equipment has a residual value. The company expects to mine all the usable ore in 10 years. During its first year of operation, it mined and sold 2,800,000 tons of ore.

1. Compute the depletion charge per ton.
2. Compute the depletion expense that Sharp Mining should record for its first year of operation.
3. Determine the depreciation expense for the year for the buildings, making it proportional to the depletion.
4. Determine the depreciation expense for the year for the equipment, using two alternatives:
  - (a) making the expense proportional to the depletion, and
  - (b) using the straight-line method.

### SOLUTION

1.  $\frac{\$8,800,000 - \$2,000,000}{40,000,000 \text{ tons}} = \$0.17 \text{ per ton}$
2.  $2,800,000 \text{ tons} \times \$0.17 \text{ per ton} = \$476,000$
3.  $\frac{2,800,000 \text{ tons}}{40,000,000 \text{ tons}} \times \$1,380,000 = \$96,600$
4. a.  $\frac{2,800,000 \text{ tons}}{40,000,000 \text{ tons}} \times \$2,400,000 = \$168,000$   
 b.  $\frac{\$2,400,000}{10 \text{ years}} \times 1 \text{ year} = \$240,000$

**TRY IT! SE7, E10A, E10B**

## LO 6 Intangible Assets

An intangible asset is both long-term and nonphysical. Its value comes from the long-term rights it affords its owner. Exhibit 8 describes the following most common types of intangible assets and their accounting treatment. Like intangible assets, some current assets—for example, accounts receivable and certain prepaid expenses—have no physical substance; but because they are short-term, they are not classified as intangible assets.

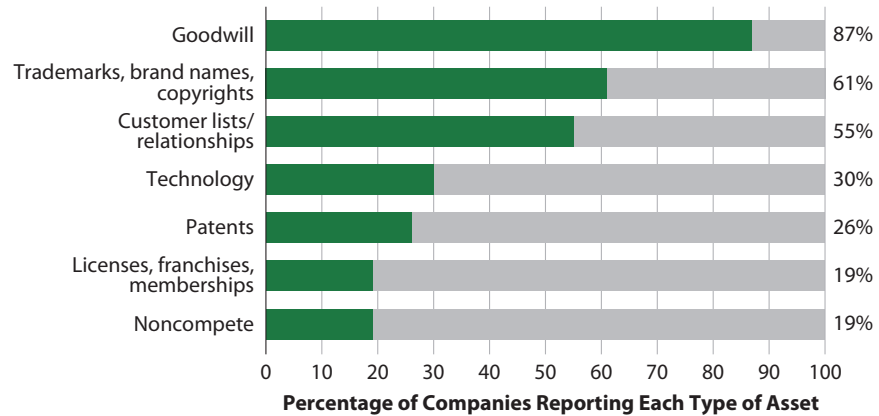


**Exhibit 8**  
 Accounting for Intangible Assets

Type	Description	Usual Accounting Treatment
<b>Subject to Amortization and Annual Impairment Test</b>		
<b>Copyright</b>	An exclusive right granted by the federal government to reproduce and sell literary, musical, and other artistic materials and computer programs for a period of the author's life plus 70 years.	Record at acquisition cost, and amortize over the asset's useful life, which is often much shorter than its legal life. For example, the cost of paperback rights to a popular novel would typically be amortized over a useful life of 2 to 4 years.
<b>Patent</b>	An exclusive right granted by the federal government for a period of 20 years to make a particular product or use a specific process. A design may be granted a patent for 14 years.	The cost of successfully defending a patent in a patent infringement suit is added to the acquisition cost of the patent. Amortize over the asset's useful life, which may be less than its legal life.
<b>Leasehold</b>	A right to occupy land or buildings under a long-term rental contract. For example, if Company A sells or subleases its right to use a retail location to Company B for 10 years in return for one or more rental payments, Company B has purchased a leasehold.	The lessor (Company A) debits Leasehold for the amount of the rental payment and amortizes it over the remaining life of the lease. The lessee (Company B) debits payments to Lease Expense.
<b>Software</b>	Capitalized costs of computer programs developed for sale, lease, or internal use.	Record the amount of capitalizable production costs, and amortize over the estimated economic life of the product.
<b>Noncompete covenant</b>	A contract limiting the rights of others to compete in a specific industry or line of business for a specified period.	Record at acquisition cost, and amortize over the contract period.
<b>Franchise, License</b>	A right to an exclusive territory or market or the right to use a formula, technique, process, or design.	Debit Franchise or License for the acquisition cost, and amortize it over a reasonable life.
<b>Customer list</b>	A list of customers or subscribers.	Debit Customer List for amount paid, and amortize over the asset's expected life.
<b>Subject to Annual Impairment Test Only</b>		
<b>Goodwill</b>	The excess of the amount paid for a business over the fair market value of the business's net assets.	Debit Goodwill for the acquisition cost, and review impairment annually.
<b>Trademark, Brand name</b>	A registered symbol or name that can be used only by its owner to identify a product or service.	Debit Trademark or Brand Name for the acquisition cost, and review impairment annually.

Exhibit 9 shows the percentage of companies (out of those surveyed) that report various intangible assets. For some companies, intangible assets make up a substantial portion of total assets. For example, **Apple's** goodwill and other acquired intangible assets amounted to \$4.4 billion in 2011. How these assets are accounted for has a major effect on Apple's performance. For example, acquired intangible assets are amortized over six years, and amortization expenses for these costs amounted to \$192 million in 2011.

**Exhibit 9**  
Assets Reported by  
Large Companies



Source: Data from American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).

The purchase of an intangible asset is a special kind of capital expenditure. Such assets are accounted for at the amount that a company paid for them. Some intangible assets, such as goodwill and trademarks, may be acquired at little or no cost. Even though these assets may have great value and may be needed for profitable operations, a company should include them on its balance sheet only if it purchased them from another party at a price established in the marketplace. When a company develops its own intangible assets, it should record the costs of development as expenses. An exception is the cost of internally developed computer software after a working prototype of the software has been developed.

Purchased intangible assets are recorded at cost or at fair value when purchased as part of a group of assets. The useful life of an intangible asset is the period over which the asset is expected to contribute to the company's future cash flows. The useful life may be definite or indefinite.<sup>12</sup>

- **Definite useful life:** A definite useful life is subject to a legal limit or can be reasonably estimated. Examples include patents, copyrights, and leaseholds. The estimated useful lives of these assets are often less than their legal limits. The cost of an intangible asset with a definite useful life should be allocated to expense through periodic amortization.
- **Indefinite useful life:** An indefinite useful life is not limited by legal, regulatory, contractual, competitive, economic, or other factors. This definition does not imply that these assets last forever. Examples can include trademarks and brands, which can last for as short or as long as the company is successful in using them. The

costs of intangible assets with an indefinite life are not amortized as long as circumstances continue to support an indefinite life.

All intangible assets, whether definite or indefinite, are subject to an annual impairment test to determine if the assets justify their value on the balance sheet. If they have lost some or all of their value in producing future cash flows, they should be written down to their fair value or to zero if they have no fair value. The amount of the write-down is



## Business Perspective

### Who's Number One in Brands?

Brands are intangible assets that often do not appear on a company's balance sheet because, rather than purchasing them, the company has developed them over time. According to one report, the 10 most valuable brands were:<sup>13</sup>

<b>Apple</b>	<b>Coca-Cola</b>
<b>Google</b>	<b>AT&amp;T</b>
<b>IBM</b>	<b>Marlboro</b>
<b>McDonald's</b>	<b>China Mobile</b>
<b>Microsoft</b>	<b>GE</b>

Apple's brand was valued at almost \$153 billion, whereas GE's brand was valued at \$50 billion.

shown on the income statement as an impairment charge (deduction) in determining income from operations.

To illustrate accounting for intangible assets with limited useful lives, suppose Soda Bottling Company purchases a patent on a unique bottle cap for \$36,000. The purchase would be recorded with an entry of \$36,000 in the asset Patents.<sup>14</sup> Although the patent for the bottle cap will last for 20 years, Soda determines that it will sell the product that uses the cap for only six years. Thus, the annual amortization expense is \$6,000 ( $\$36,000 \div 6$  years). When the expense is recorded, the Patents account is reduced directly by the amount of the amortization expense (in contrast to the treatment of other long-term assets, for which depreciation or depletion is accumulated in separate contra accounts). The journal entry would be as follows.

$$\begin{array}{r} \mathbf{A} \\ -6,000 \end{array} = \begin{array}{r} \mathbf{L} \\ -6,000 \end{array} + \begin{array}{r} \mathbf{OE} \\ -6,000 \end{array}$$

Dec. 31	Amortization Expense—Patents	6,000	
	Patents		6,000
	To record amortization of patient		

## Research and Development Costs

Most successful companies carry out research and development (R&D) activities, often within a separate department. Among these activities are development of new products, testing of existing and proposed products, and pure research. The costs of these activities are substantial for many companies. In a recent year, **General Motors** spent \$8.1 billion, or about 5.4 percent of its revenues, on R&D.<sup>15</sup> R&D costs can be even greater in high-tech fields like pharmaceuticals. For example, **Abbott Laboratories** recently spent \$4.1 billion, or 10.6 percent of its revenues, on R&D.<sup>16</sup>

The Financial Accounting Standards Board requires that all R&D costs be charged to expense in the period in which they are incurred.<sup>17</sup> The reasoning is that it is too hard to trace specific costs to specific profitable developments. Also, the costs of research and development are continuous and necessary for the success of a business and so should be treated as current expenses.

## Computer Software Costs

The costs that companies incur in developing computer software for sale or lease or for their own internal use are considered research and development costs until the product has proved feasible. Thus, costs incurred before that point should be charged to expense as they are incurred. A product is deemed feasible when a detailed working

program has been designed. Once that occurs, all software production costs are recorded as assets and are amortized over the software's estimated economic life, using the straight-line method. If at any time a company cannot expect to realize the amount of the unamortized software costs, the asset should be written down to the amount expected to be realized.<sup>18</sup>



## International Perspective

### IFRS R&D Costs Under IFRS

In contrast to GAAP, under which all research and development costs are expensed, IFRS require that research costs be expensed and that development costs be capitalized and amortized. This requires a judgment about what constitutes research and what constitutes development. These differences in accounting treatments—immediate expensing versus amortization over time—can have considerable impact on reported income over many years.

## Goodwill

Goodwill generally refers to a company's good reputation. From an accounting standpoint, goodwill exists when a purchaser pays more for a business than the fair market value of the business's net assets. In other words, the purchaser would pay less if it bought the assets separately. Most businesses are worth more as going concerns than as collections of assets.

Goodwill reflects all the factors that allow a company to earn a higher-than-market rate of return on its assets, including:

- Customer satisfaction
- Good management
- Manufacturing efficiency
- The advantages of having a monopoly
- Good locations
- Good employee relations

The FASB requires that purchased goodwill be reported as a separate line item on the balance sheet and that it be reviewed annually for impairment. If the fair value of goodwill is less than its carrying value, it is considered impaired. In that case, it is reduced to its fair value, and the impairment charge is reported on the income statement.<sup>19</sup>

A company should record goodwill only when it acquires a controlling interest in another business. The amount to be recorded as goodwill can be determined by writing the identifiable net assets up to their fair market values at the time of purchase and subtracting the total from the purchase price. For example, suppose a company pays \$11,400,000 to purchase another business.

- If the net assets of the business (total assets – total liabilities) are *fairly valued* at \$10,000,000, the amount of the goodwill is \$1,400,000 (\$11,400,000 – \$10,000,000).
- If the fair market value of the net assets is more or less than \$10,000,000, an entry is made in the accounting records to adjust the assets to the fair market value. The goodwill would then represent the difference between the adjusted net assets and the purchase price of \$11,400,000.

## Long-Term Assets and the Financial Statements

Exhibit 10 shows that purchase, use, and disposal of long-term assets affect all financial statements. As you can see, the acquisition cost of long-term assets increases by the amount of capital expenditures and accumulated depreciation increases by the amount of depreciation expense.



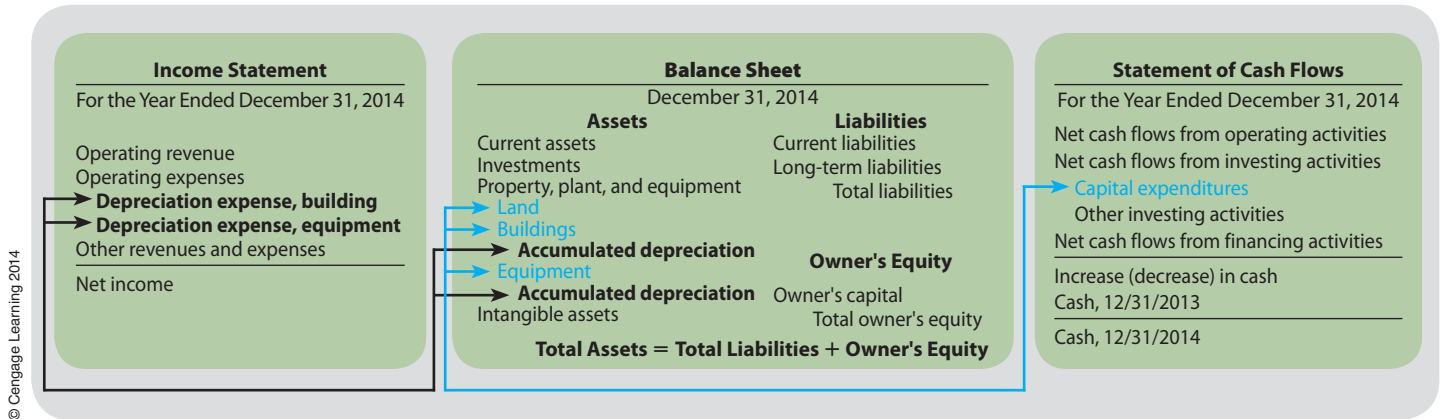
### Business Perspective

#### Wake up! Goodwill Is Growing!

Eighty-nine percent of 500 large companies separately report goodwill as an asset.<sup>20</sup> Because much of the growth of these companies has come through purchasing other companies, goodwill as a percentage of total assets has also grown. As shown right, the amount of goodwill can be material.<sup>21</sup>

	Goodwill (in billions)	Percentage of Total Assets
General Mills	\$ 8,205	38%
Heinz	\$ 3,298	32%
Cisco Systems	\$16,823	19%

**Exhibit 10**  
**Relationship of Long-Term Assets**  
**to the Financial Statements**



© Cengage Learning 2014

**APPLY IT!**

For each of the following intangible assets, indicate (a) if the asset is to be amortized over its useful life or (b) if the asset is not amortized but only subject to annual impairment test:

- |               |              |
|---------------|--------------|
| 1. Goodwill   | 4. Patent    |
| 2. Copyright  | 5. Trademark |
| 3. Brand name |              |

**SOLUTION**

1. b; 2. a; 3. b; 4. a; 5. b

**TRY IT! SE8, E11A, E12A, E11B, E12B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Acquiring and Financing Long-Term Assets
- Free Cash Flow
- Ethics

## RELEVANT LEARNING OBJECTIVE

**LO 7** Describe the disclosure of acquiring and financing long-term assets, and calculate free cash flow.

## LO 7 Management Decisions Relating to Long-Term Assets

The decision to acquire and finance a long-term asset is a complex process. Although some companies are profitable enough to pay for long-term assets out of cash flows from operations, for major long-term acquisitions of long-term assets, a company may need to finance them with the issue of stock, long-term notes, or bonds.



### Acquiring and Financing Long-Term Assets

A good place to study a company's investing and financing activities is its statement of cash flows and in the *disclosures* in the notes to the financial statements. For example, **Apple's** decision to establish retail stores required very careful analysis. Evaluating data to make sound decisions about acquiring long-term assets is part of the capital budgeting process, a topic covered in detail in managerial accounting texts. However, information about acquisitions of long-term assets appears in the investing activities section of the statement of cash flows. The investing section of Apple's statement of cash flows in its 2011 annual report shows acquisition of property, plant, and equipment to be \$4.3 billion in 2011. Apple's management reveals the portion of this amount spent on retail stores in 2011 and its plans for 2012 in the notes, as follows.

*The Company's actual cash payments for capital expenditures during 2011 were \$4.3 billion, of which \$612 million relates to retail store facilities. . . . The Company anticipates utilizing approximately \$8.0 billion for capital expenditures during 2012, including approximately \$900 million for retail store facilities and approximately \$7.1 billion for product tooling and manufacturing process equipment, and corporate facilities and infrastructure, including information systems hardware, software and enhancements.*

The financing section of Apple's statement of cash flows reveals that the company raised \$813 million through the issuance of common stock in 2011. Since this is much less than the \$4.3 billion in acquisitions, the company must have used funds it already had from its operations. A measure of the company's success in funding these acquisitions is free cash flow, discussed in the next section.

**Free Cash Flow** Although not a financial ratio, **free cash flow** is an important measure of a company's ability to finance long-term assets. It is the amount of cash that remains after deducting the funds a company must commit to continue operating at its planned level. These commitments include:

- Current or continuing operations
- Interest
- Income taxes
- Dividends
- Net capital expenditures (purchases of plant assets minus sales of plant assets)

If a company fails to pay for current or continuing operations, interest, and income taxes, its creditors or the government can take legal action. Although the payment of dividends is not required, dividends represent a commitment to stockholders. If they are reduced or eliminated, stockholders may be unhappy, which will cause the price of the company's stock to fall.

A positive free cash flow means that a company has met all its cash commitments and has cash available to reduce debt or to expand operations. A negative free cash flow

means that it will have to sell investments, borrow money, or issue stock to continue at its planned level. If its free cash flow remains negative for several years, a company may not be able to raise cash by issuing stock or bonds.

Using data from **Apple's** statement of cash flows in its 2011 annual report, we can compute the company's free cash flow as follows (in millions).

$$\begin{aligned} \text{Free Cash Flow} &= \text{Net Cash Flows from Operating Activities} - \text{Dividends} \\ &\quad - \text{Purchases of Plant Assets} + \text{Sales of Plant Assets} \\ &= \$37,529 - \$0 - \$4,260 + \$0 \\ &= \$33,269 \end{aligned}$$

This analysis confirms Apple's strong financial position. Its cash flow from operating activities far exceeded its net capital expenditures of \$4,260 million. A factor in its positive free cash flow of \$33,269 million is that the company pays no dividends. In addition, the financing activities section of Apple's statement of cash flows indicates that the company, rather than incurring debt for expansion, actually made net investments of \$32,464 million.

### Ethics in Acquiring and Financing Long-Term Assets

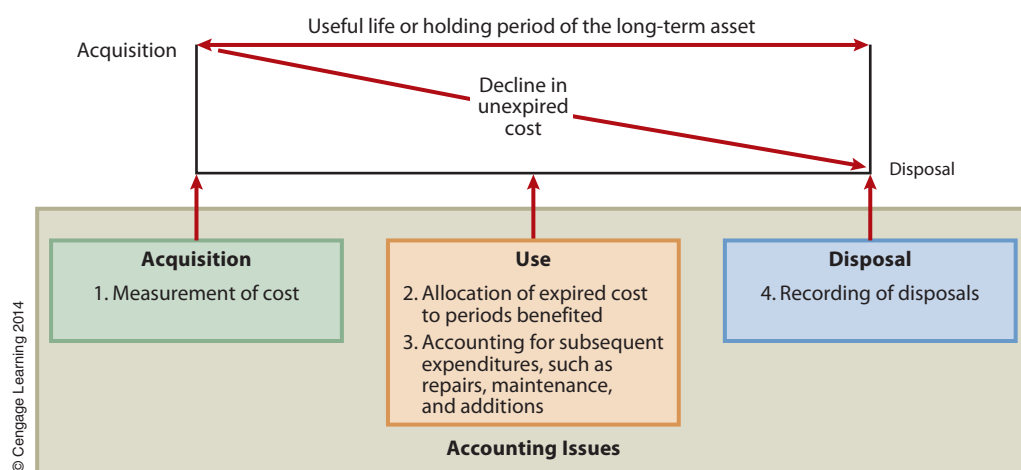
When a company records a long-term asset, it defers some of the asset's cost to later periods. Thus, the current period's profitability looks better than it would have if the asset's total cost had been expensed immediately. Management has considerable latitude in making the judgments and estimates necessary to account for long-term assets, and this latitude has sometimes been used unethically. For example, in the **WorldCom** accounting fraud, management ordered that expenditures that should have been recorded as operating expenses be recorded as long-term assets and written off over several years. The result was an overstatement of income by about \$10 billion, which ultimately led to one of the largest bankruptcies in the history of U.S. business.

To avoid fraudulent reporting of long-term assets, a company's management must apply accrual accounting in resolving properly two important issues:

- The amount of the total cost of a long-term asset to allocate to expense in the current period.
- The amount to retain on the balance sheet as an asset.

To resolve these issues, management must answer four important questions about the acquisition, use, and disposal of each long-term asset. These questions are illustrated in Exhibit 11.

**Exhibit 11**  
Issues in Accounting for Long-Term Assets





1. How is the cost of the long-term asset determined?
2. How should the expired portion of the cost of the long-term asset be allocated against revenues over time?
3. How should subsequent expenditures, such as repairs and additions, be treated?
4. How should disposal of the long-term asset be recorded?

Management's answers to these questions can be found in the company's annual report under management's discussion and analysis and in the notes to the financial statements.

## APPLY IT!

In the past year, Bivak Company had net cash flows of \$133,000 from operating activities. It expended \$61,000 for property, plant, and equipment; sold property, plant, and equipment for \$14,000; and paid dividends of \$20,000. Calculate the company's free cash flow. What does the result tell you about the company?

### SOLUTION

Net cash flows from operating activities	\$133,000
Purchases of property, plant, and equipment	(61,000)
Sales of property, plant, and equipment	14,000
Dividends	(20,000)
Free cash flow	<u>\$ 66,000</u>

Bivak's operations provide sufficient cash flows to fund its current expansion and its payment of dividends without raising additional capital.

**TRY IT! SE9, SE10, E13A, E14A, E13B, E14B**

## TriLevel Problem



Monkey Business Images/Dreamstime.com

### Neighborhood Carriers

The beginning of this chapter focused on Neighborhood Carriers, a company that had a choice to make about which depreciation method it would use in allocating the cost of its delivery van over a 5-year period. In addition to its delivery van, Neighborhood Carriers' plant assets might include land, buildings, and equipment, as well as leasehold improvements if it operates out of a rented space. All these assets would be depreciated. Neighborhood Carriers might also have intangible assets, such as a trademark, which would be amortized. In accounting for its delivery van, Neighborhood Carriers would have to determine the purchase price, useful life, residual value, and costs of repairs, maintenance, and other expenses. The company could use any one of the three common methods of calculating depreciation. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*What is the classification of long-term assets, how are the assets valued, and what is the distinction in recognizing capital and revenue expenditures?*

#### Section 2: Accounting Applications

*In what ways are the costs of long-term assets, such as a delivery van, allocated to the periods they benefit? Complete the following to answer this question:*

1. Compute the depreciation expense and carrying value of the delivery van for 2014 to 2018 using the following methods: (a) straight-line, (b) production, and (c) double-declining-balance. The cost of the delivery van was \$29,000, and its expected salvage value is \$2,000. The expected production over the life of the delivery van is 150,000 units (30,000 in 2014; 52,500 in 2015; 45,000 in 2016; 15,000 in 2017; and 7,500 in 2018).
2. Assuming the straight-line method is used and that the delivery van is sold for \$5,000 on December 31, 2018, show the entry to record the sale.
3. What conclusions can you draw from the patterns of yearly depreciation?

#### Section 3: Business Applications

*How does management decide to acquire, finance, and evaluate long-term assets?*



2.	Dec. 31	Cash	5,000	
		Accumulated Depreciation—Delivery Van	27,000	
		Delivery Van		29,000
		Gain on Sale of Delivery Van		3,000
		To record the sale of delivery van		

3. In the earlier years, the amount of depreciation under the double-declining-balance method is significantly greater than the amount under the straight-line method. In the later years, the opposite is true. The carrying value under the straight-line method is greater than under the double-declining-balance method at the end of all years except the fifth year. Depreciation under the production method differs from depreciation under the other methods in that it follows no regular pattern. It varies with the amount of use. Consequently, depreciation is greatest in 2015 and 2016, which are the years of greatest use.

### Section 3: Business Applications

The decision to acquire a long-term asset involves determining if the company has sufficient funds to make the purchase and, if not, to obtain appropriate financing. A company can finance a long-term asset purchase with cash or by issuing stocks, long-term notes, or bonds. Management needs to analyze the company's statement of cash flows and calculate free cash flow as follows.

$$\text{Free Cash Flow} = \text{Net Cash Flows from Operating Activities} - \text{Dividends} - \text{Purchases of Plant Assets} + \text{Sales of Plant Assets}$$

Finally, when acquiring and recording long-term assets, the company needs to apply accrual accounting in deciding how to allocate the total cost of the asset to expense in the current period and over time (whether the purchase is a capital or revenue expenditure and choosing a depreciation method), how to treat subsequent expenditures (repair and maintenance, betterments, etc.), and how to record the disposal of the asset. These decisions will impact the long-term asset's value presented on the balance sheet as well as the net income amount in current and future periods.

## Chapter Review

Identify the classifications of long-term assets, and describe how they are valued by allocating their costs to the periods that they benefit. **LO 1**

Long-term assets have a useful life of more than one year, are used in the operation of a business, and are not intended for resale. They are classified as property, plant, and equipment; natural resources; or intangible assets. In the latter category are patents, trademarks, franchises, and other rights, as well as goodwill. Accrual accounting and valuation of long-term asset are applied through depreciation, depletion, amortization, or impairment tests, depending on the classification of the asset.

Capital expenditures are classified as assets, whereas revenue expenditures are classified as expenses of the current period. Capital expenditures include not only outlays for plant assets, natural resources, and intangible assets, but also expenditures for additions, betterments, and extraordinary repairs that increase an asset's residual value or extend its useful life. Revenue expenditures are made for ordinary repairs and maintenance. The error of classifying a capital expenditure as a revenue expenditure, or vice versa, has an important effect on net income.

**Account for the acquisition costs of property, plant, and equipment.** **LO 2**

The acquisition cost of property, plant, and equipment includes all expenditures reasonable and necessary to get the asset in place and ready for use. Among these expenditures are the purchase price, installation cost, freight charges, and insurance during transit. The acquisition cost of a plant asset is allocated over the asset's useful life.

**Compute depreciation under the straight-line, production, and declining-balance methods.** **LO 3**

Depreciation—the periodic allocation of the cost of a plant asset over its estimated useful life—is commonly computed by using the straight-line method, the production method, or an accelerated method. The straight-line method is related directly to the passage of time, whereas the production method is related directly to use or output. An accelerated method, which results in relatively large amounts of depreciation in earlier years and reduced amounts in later years, is based on the assumption that plant assets provide greater economic benefits in their earlier years than in later ones. The most common accelerated method is the declining-balance method.

**Account for the disposal of depreciable assets.** **LO 4**

A company can dispose of a long-term plant asset by discarding or selling it or exchanging it for another asset. An asset being disposed of must have depreciation recorded up to the date of disposal. To record the disposal, the carrying value must be removed from the asset account and the depreciation to date must be removed from the accumulated depreciation account. When a company sells a depreciable long-term asset at a price that differs from its carrying value, it should report the gain or loss on its income statement. In recording exchanges of similar plant assets, a gain or loss may arise.

**Identify the issues related to accounting for natural resources, and compute depletion.** **LO 5**

Natural resources are depletable assets that are converted to inventory by cutting, pumping, mining, or other forms of extraction. They are recorded at cost as long-term assets. As natural resources are sold, their costs are allocated as expenses through depletion charges. The depletion charge is based on the ratio of the resource extracted to the total estimated resource. A major issue related to this subject is accounting for oil and gas reserves.

**Identify the issues related to accounting for intangible assets, including research and development costs and goodwill.** **LO 6**

The purchase of an intangible asset should be treated as a capital expenditure and recorded at acquisition cost. All intangible assets are subject to annual tests for impairment of value. Intangible assets with a definite life are also amortized annually. The FASB requires that research and development costs be expensed. Software costs are treated as research and development costs and expensed until a feasible working program is developed, after which time the costs may be capitalized and amortized over a reasonable estimated life. Goodwill is the excess of the amount paid for a business over the fair market value of the net assets and is usually related to the business's superior earning potential. It should be recorded only when a company purchases an entire business, and it should be reviewed annually for possible impairment.

**Describe the disclosure of acquiring and financing long-term assets, and calculate free cash flow.** **LO 7**

Information about the acquisition and financing of long-term assets is found in the statement of cash flows and in the disclosures in the notes to the financial statements. Free cash flow is the amount of cash that remains after deducting the funds a company must commit to continue operating at its planned level.

## Key Terms

**accelerated method** 377 (LO3)  
**additions** 370 (LO1)  
**amortization** 368 (LO1)  
**asset impairment** 369 (LO1)  
**betterments** 370 (LO1)

**brand name** 387 (LO6)  
**capital expenditure** 370 (LO1)  
**carrying value** 369 (LO1)  
**copyright** 387 (LO6)  
**cost** 375 (LO3)

**customer list** 387 (LO6)  
**declining-balance method** 377 (LO3)  
**depletion** 368 (LO1)  
**depreciable cost** 375 (LO3)  
**depreciation** 368 (LO1)

**double-declining-balance method** 377 (LO3)

**Economic Stimulus Act of 2008** 379 (LO3)

**estimated useful life** 375 (LO3)

**expenditure** 370 (LO1)

**extraordinary repairs** 370 (LO1)

**franchise** 387 (LO6)

**free cash flow** 392 (LO7)

**full-costing method** 386 (LO5)

**goodwill** 387 (LO6)

**group depreciation** 379 (LO3)

**intangible assets** 368 (LO1)

**leasehold** 387 (LO6)

**leasehold improvements** 373 (LO2)

**license** 387 (LO6)

**long-term assets** 368 (LO1)

**natural resources** 368 (LO1)

**noncompete covenant** 387 (LO6)

**obsolescence** 374 (LO3)

**patent** 387 (LO6)

**physical deterioration** 374 (LO3)

**production method** 376 (LO3)

**property, plant, and**

**equipment** 368 (LO1)

**residual value** 375 (LO3)

**revenue expenditure** 370 (LO1)

**software** 387 (LO6)

**straight-line method** 375 (LO3)

**successful efforts**

**accounting** 385 (LO5)

**trademark** 387 (LO6)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ► Is carrying value ever the same as market value?
- LO 2 **DQ2.** What incentive does a company have to allocate more of a group purchase price to land than to building?
- LO 3 **DQ3.** Which depreciation method would best reflect the risk of obsolescence from rapid technological changes?
- LO 4 **DQ4.** When would the disposal of a long-term asset result in no gain or loss?
- LO 5 **DQ5.** When would annual depletion not equal depletion expense?
- LO 6 **DQ6.** Why would a firm amortize a patent over fewer years than the patent's life?
- LO 6 **DQ7.** Why would a company spend millions of dollars on goodwill?
- LO 7 **DQ8. BUSINESS APPLICATION** ► What major advantage does a company that has positive free cash flow have over a company that has negative free cash flow?

### SHORT EXERCISES

#### LO 2 **Classifying Cost of Long-Term Assets**

**SE1. CONCEPT** ► Gallon Auto purchased a neighboring lot for a new building and parking lot. Indicate whether each of the following expenditures is properly charged to (a) Land, (b) Land Improvements, or (c) Buildings:

- |  |                                      |
|--|--------------------------------------|
| 1. Paving costs                        | 5. Building construction costs       |
| 2. Architects' fee for building design | 6. Lights around the property        |
| 3. Cost of clearing the property       | 7. Building permit                   |
| 4. Cost of the property                | 8. Interest on the construction loan |

#### LO 2 **Group Purchase**

**SE2.** Pattia Company purchased property with a warehouse and parking lot for \$1,500,000. An appraiser valued the components of the property if purchased separately as follows.

Land	\$ 400,000
Land improvements	200,000
Building	<u>1,000,000</u>
Total	<u>\$1,600,000</u>

Determine the cost to be assigned to each component.

**LO 3 Straight-Line Method**

**SE3.** Sunburn Fitness Center purchased a new step machine for \$8,250. The apparatus is expected to last four years and have a residual value of \$750. What will the depreciation expense be for each year under the straight-line method?

**LO 3 Production Method**

**SE4.** Assume that the step machine in **SE3** has an estimated useful life of 8,000 hours and was used for 2,400 hours in year 1; 2,000 hours in year 2; 2,200 hours in year 3; and 1,400 hours in year 4. How much would depreciation expense be in each year? (Round to the nearest dollar.)

**LO 3 Double-Declining-Balance Method**

**SE5.** Assume that the step machine in **SE3** is depreciated using the double-declining-balance method. How much would depreciation expense be in each year? (Round to two decimal places.)

**LO 4 Disposal of Plant Assets: No Trade-In**

**SE6.** Times Printing owned a piece of equipment that cost \$32,400 and on which it had recorded \$18,000 of accumulated depreciation. The company disposed of the equipment on January 2, the first day of business of the current year.

1. Calculate the carrying value of the equipment.
2. Calculate the gain or loss on the disposal under each of the following assumptions:
  - a. The equipment was discarded as having no value.
  - b. The equipment was sold for \$6,000 cash.
  - c. The equipment was sold for \$16,000 cash.

**LO 5 Natural Resources**

**SE7.** Walden Green Company purchased land containing an estimated 4,000,000 tons of ore for \$16,000,000. The land will be worth \$2,400,000 without the ore after 8 years of active mining. Although the equipment needed for the mining will have a useful life of 20 years, it is not expected to be usable and will have no value after the mining on this site is complete. Compute the depletion charge per ton and the amount of depletion expense for the first year of operation, assuming that 600,000 tons of ore are mined and sold. Also, compute the first-year depreciation on the mining equipment using the production method, assuming a cost of \$19,200,000 with no residual value.

**LO 6 Intangible Assets: Computer Software**

**SE8.** Satyam Company has created a new software application for PCs. Its costs during research and development were \$500,000. Its costs after the working program was developed were \$350,000. Although the company's copyright may be amortized over 40 years, management believes that the product will be viable for only 5 years. How should the costs be accounted for? At what value will the software appear on the balance sheet after 1 year?

**LO 7 Management Issues**

**SE9. BUSINESS APPLICATION** ► Indicate whether each of the following actions is primarily related to (a) acquisition of long-term assets, (b) evaluating the adequacy of financing of long-term assets, or (c) applying accrual accounting to long-term assets:

1. Deciding between common stock and long-term notes for the raising of funds.
2. Relating the acquisition cost of a long-term asset to the cash flows generated by the asset.
3. Determining how long an asset will benefit the company.
4. Deciding to use cash flows from operations to purchase long-term assets.
5. Determining how much an asset will sell for when it is no longer useful to the company.
6. Calculating free cash flow.



LO 7 **Free Cash Flow**


**SE10. BUSINESS APPLICATION** ► Maki Corporation had cash flows from operating activities during the past year of \$194,000. During the year, the company expended \$25,000 for dividends; expended \$158,000 for property, plant, and equipment; and sold property, plant, and equipment for \$12,000. Calculate the company's free cash flow. What does the result tell you about the company?

## EXERCISES: SET A

LO 1 **Recognition and Classification of Capital Expenditures**

**E1A. CONCEPT** ► Tell whether each of the following transactions related to an office building is a revenue expenditure (RE) or a capital expenditure (CE). In addition, indicate whether each transaction is an ordinary repair (OR), an extraordinary repair (ER), an addition (A), a betterment (B), or none of these (N).

1. The hallways and ceilings in the building are repainted at a cost of \$4,150.
2. The hallways, which have tile floors, are carpeted at a cost of \$14,000.
3. A new wing is added to the building at a cost of \$87,500.
4. Furniture is purchased for the entrance to the building at a cost of \$8,250.
5. The air-conditioning system is overhauled at a cost of \$14,250. The overhaul extends the useful life of the air-conditioning system by 10 years.
6. A cleaning firm is paid \$100 per week to clean the newly installed carpets.

LO 2 **Recognizing and Classifying the Cost of Long-Term Assets**

**E2A. CONCEPT** ► Fraser Manufacturing purchased land next to its factory to be used as a parking lot. The following expenditures were incurred by the company: purchase price, \$300,000; broker's fees, \$24,000; title search and other fees, \$2,200; demolition of a cottage on the property, \$8,000; general grading of property, \$4,200; paving parking lots, \$40,000; lighting for parking lots, \$32,000; and signs for parking lots, \$6,400. Determine the amounts that should be debited to the Land account and the Land Improvements account.

LO 2 **Group Purchase**

**E3A.** Sea Scout purchased a car wash for \$240,000. If purchased separately, the land would have cost \$60,000, the building \$135,000, and the equipment \$105,000. Determine the amount that should be recorded in the new business's records for land, building, and equipment.

LO 2, 3 **Cost of Long-Term Asset and Depreciation**

**E4A.** Melissa Mertz purchased a used tractor for \$17,500. Before the tractor could be used, it required new tires, which cost \$1,100, and an overhaul, which cost \$1,400. Its first tank of fuel cost \$75. The tractor is expected to last six years and have a residual value of \$2,000. Determine the cost and depreciable cost of the tractor and calculate the first year's depreciation under the straight-line method.

LO 3 **Depreciation Methods**

**E5A.** On January 13, 2013, Precision Oil Company purchased a drilling truck for \$90,000. Precision expects the truck to last five years or 200,000 miles, with an estimated residual value of \$15,000 at the end of that time. During 2014, the truck is driven 48,000 miles. Precision's year end is December 31. Compute the depreciation for 2014 under each of the following methods: (1) straight-line, (2) production, and (3) double-declining-balance. Using the amount computed in (3), prepare the journal entry to record depreciation expense for the second year, and show how the Drilling Truck account would appear on the balance sheet.



**LO 3 Double-Declining-Balance Method**

**E6A.** Crescendo Company purchased a computer for \$1,120. It has an estimated useful life of four years and an estimated residual value of \$120. Compute the depreciation charge for each of the four years using the double-declining-balance method.

**LO 3 Revision of Depreciation Rates**

**E7A.** NewLife Hospital purchased a special X-ray machine. The machine, which cost \$623,120, was expected to last ten years, with an estimated residual value of \$63,120. After two years of operation (and depreciation charges using the straight-line method), it became evident that the X-ray machine would last a total of only seven years. The estimated residual value, however, would remain the same. Given this information, determine the new depreciation charge for the third year on the basis of the revised estimated useful life.

**LO 4 Disposal of Plant Assets**

**E8A.** A piece of equipment that cost \$64,800 and on which \$36,000 of accumulated depreciation had been recorded was disposed of on January 2, the first day of business of the current year. For each of the following assumptions, compute the gain or loss on the disposal:

1. The equipment was discarded as having no value.
2. The equipment was sold for \$12,000 cash.
3. The equipment was sold for \$36,000 cash.

**LO 4 Disposal of Plant Assets**

**E9A.** Star Company purchased a computer on January 2, 2012, at a cost of \$2,500. The computer is expected to have a useful life of five years and a residual value of \$250. Assume that the computer is disposed of on July 1, 2015. Using the straight line method, record the depreciation expense for half a year and the disposal under each of the following assumptions:

1. The computer is discarded.
2. The computer is sold for \$400.
3. The computer is sold for \$1,100.

**LO 5 Natural Resource Depletion and Depreciation of Related Plant Assets**

**E10A.** Mertz Company purchased land containing an estimated 5 million tons of ore for a cost of \$8,800,000. The land without the ore is estimated to be worth \$500,000. During its first year of operation, the company mined and sold 750,000 tons of ore. Compute the depletion charge per ton. (Round to two decimal places.) Compute the depletion expense that Mertz should record for the year.

**LO 6 Amortization of Copyrights and Trademarks**

**E11A.** Complete the following requirements regarding amortizing copyrights and trademarks:

1. Argyle Publishing Company purchased the copyright to a basic computer textbook for \$40,000. The usual life of a textbook is about four years. However, the copyright will remain in effect for another 50 years. Calculate the annual amortization of the copyright.
2. **ACCOUNTING CONNECTION** ► Scion Company purchased a trademark from a well-known supermarket for \$320,000. The company's management argued that the trademark's useful life was indefinite. Explain how the cost should be accounted for.

**LO 6 Accounting for a Patent**

**E12A.** At the beginning of the fiscal year, David Company purchased for \$1,030,000 a patent that applies to the manufacture of a unique tamper-proof lid for medicine bottles. David incurred legal costs of \$450,000 in successfully defending use of the lid by a competitor. David estimated that the patent would be valuable for at least ten years.

(Continued)

During the first two years of operations, David successfully marketed the lid. At the beginning of the third year, a study appeared in a consumer magazine showing that children could in fact remove the lid. As a result, all orders for the lids were canceled, and the patent was rendered worthless.

Prepare journal entries to record the following: (a) purchase of the patent, (b) successful defense of the patent, (c) amortization expense for the first year, and (d) write-off of the patent as worthless.

LO 7

**Management Issues**

CASH FLOW

**E13A. BUSINESS APPLICATION** ► Indicate whether each of the following actions is primarily related to (a) acquisition of long-term assets, (b) evaluating the financing of long-term assets, or (c) applying accrual accounting to long-term assets:

1. Deciding whether to rent or buy a piece of equipment.
2. Allocating costs on a group purchase.
3. Deciding to use the production method of depreciation.
4. Determining the total units a machine will produce.
5. Deciding to borrow funds to purchase equipment.
6. Estimating the savings a new machine will produce and comparing that amount to cost.
7. Examining the trend of free cash flow over several years.

LO 7

**Free Cash Flow**

CASH FLOW

**E14A. BUSINESS APPLICATION** ► Zee Corporation had net cash flows from operating activities during the past year of \$432,000. During the year, the company expended \$924,000 for property, plant, and equipment; sold property, plant, and equipment for \$108,000; and paid dividends of \$100,000. Calculate the company's free cash flow. What does the result tell you about the company?

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS**

LO 1

**Identification of Long-Term Assets Terminology**

CASH FLOW

**P1.** Common terms associated with long-term assets follow.

- |                         |                        |
|-------------------------|------------------------|
| a. Tangible assets      | g. Depreciation        |
| b. Natural resources    | h. Depletion           |
| c. Intangible assets    | i. Amortization        |
| d. Additions            | j. Revenue expenditure |
| e. Betterments          |                        |
| f. Extraordinary repair |                        |

**REQUIRED**

1. For each of the statements that follow, identify the term with which it is associated. (If two terms apply, choose the one that is most closely associated.)
  1. Periodic cost associated with intangible assets.
  2. Cost of constructing a new wing on a building.
  3. A group of assets encompassing property, plant, and equipment.
  4. Cost associated with enhancing a building but not expanding it.
  5. Periodic cost associated with tangible assets.
  6. A group of assets that gain their value from contracts or rights.
  7. Cost of normal repairs to a building.

8. Assets whose value derives from what can be extracted from them.
  9. Periodic cost associated with natural resources.
  10. Cost of a repair that extends the useful life of a building.
2. **ACCOUNTING CONNECTION** ► Assuming the company uses cash for all its expenditures, which of the terms listed above would you expect to see on the income statement? Which ones would not result in an outlay of cash?

## LO 2

- ✓ 1: Land: \$723,900
- ✓ 1: Land Improvements: \$142,000
- ✓ 1: Buildings: \$1,383,600
- ✓ 1: Equipment: \$210,800

**Determining Cost of Assets**

**P2.** Cergo Computers constructed a new training center in 2014, which you have been hired to manage. A review of the accounting records shows the following expenditures debited to an asset account called Training Center:

Attorney's fee, land acquisition	\$ 34,900
Cost of land	598,000
Architect's fee, building design	102,000
Building	1,020,000
Parking lot and sidewalk	135,600
Electrical wiring, building	164,000
Landscaping	55,000
Cost of surveying land	9,200
Training equipment, tables, and chairs	136,400
Installation of training equipment	68,000
Cost of grading the land	14,000
Cost of changes in building to soundproof rooms	59,200
Total account balance	<u>\$2,396,300</u>

During the center's construction, an employee of Cergo worked full-time overseeing the project. He spent two months on the purchase and preparation of the site, six months on the construction, one month on land improvements, and one month on equipment installation and training-room furniture purchase and setup. His salary of \$64,000 during this ten-month period was charged to Administrative Expense. The training center was placed in operation on November 1.

**REQUIRED**

1. Prepare a schedule with the following four column (account) headings: Land, Land Improvements, Building, and Equipment. Place each of the above expenditures in the appropriate column. Total the columns.
2. **CONCEPT** ► What impact does the classification of the items among several accounts have on evaluating the profitability performance of the company?

## LO 3, 4



- ✓ 1a: Depreciation, year 3: \$165,000
- ✓ 1b: Depreciation, year 3: \$132,000
- ✓ 1c: Depreciation, year 3: \$90,000

**Comparison of Depreciation Methods**

**P3.** Zeigler Manufacturing Company purchased a robot for \$720,000 at the beginning of year 1. The robot has an estimated useful life of four years and an estimated residual value of \$60,000. The robot, which should last 20,000 hours, was operated 6,000 hours in year 1; 8,000 hours in year 2; 4,000 hours in year 3; and 2,000 hours in year 4.

**REQUIRED**

1. Compute the annual depreciation and carrying value for the robot for each year assuming the following depreciation methods: (a) straight-line, (b) production, and (c) double-declining-balance.
2. If the robot is sold for \$750,000 after year 2, what would be the amount of gain or loss under each method?
3. **ACCOUNTING CONNECTION** ► What conclusions can you draw from the patterns of yearly depreciation and carrying value in requirement 1? Do the three methods differ in their effect on the company's profitability? Do they differ in their effect on the company's operating cash flows? Explain.

## LO 3, 4

CASH FLOW

SPREADSHEET

- ✓ 1a: Depreciation, year 3: \$54,250
- ✓ 1b: Depreciation, year 3: \$81,375
- ✓ 1c: Depreciation, year 3: \$53,407

**Comparison of Depreciation Methods**

**P4.** Italian Construction Company purchased a new crane for \$360,500 at the beginning of year 1. The crane has an estimated residual value of \$35,000 and an estimated useful life of six years. The crane is expected to last 10,000 hours. It was used 1,800 hours in year 1; 2,000 hours in year 2; 2,500 hours in year 3; 1,500 hours in year 4; 1,200 hours in year 5; and 1,000 hours in year 6.

**REQUIRED**

1. Compute the annual depreciation and carrying value for the new crane for each of the six years under each of the following methods: (a) straight-line, (b) production, and (c) double-declining-balance (round percentage to two decimal places.)
2. If the crane is sold for \$250,000 after year 3, what would be the amount of gain or loss under each method?
3. **ACCOUNTING CONNECTION** ► Do the three methods differ in their effect on the company's profitability? Do they differ in their effect on the company's operating cash flows? Explain.

## LO 5

CASH FLOW

SPREADSHEET

- ✓ 2: Depletion expense: \$121,500

**Natural Resource Depletion and Depreciation of Related Plant Assets**

**P5.** Bychowski Company purchased land containing an estimated 10 million tons of ore for a cost of \$3,300,000. The land without the ore is estimated to be worth \$600,000. The company expects that all the usable ore can be mined in 10 years. Buildings costing \$300,000 with an estimated useful life of 20 years were erected on the site. Equipment costing \$360,000 with an estimated useful life of 10 years was installed. Because of the remote location, neither the buildings nor the equipment has an estimated residual value. During its first year of operation, the company mined and sold 450,000 tons of ore.

**REQUIRED**

1. Compute the depletion charge per ton.
2. Compute the depletion expense that Bychowski should record for the year.
3. Determine the depreciation expense for the year for the buildings, making it proportional to the depletion.
4. Determine the depreciation expense for the year for the equipment under two alternatives: (a) making the expense proportional to the depletion and (b) using the straight-line method.
5. **ACCOUNTING CONNECTION** ► Suppose the company mined and sold 250,000 tons of ore (instead of 450,000) during the first year. Would the change in the results in requirements 2 or 3 affect earnings or cash flows? Explain.

**ALTERNATE PROBLEMS**

## LO 2

**Determining Cost of Assets**

- ✓ 1: Land: \$426,212
- ✓ 1: Land Improvements: \$166,560
- ✓ 1: Buildings: \$833,940
- ✓ 1: Machinery: \$1,262,640
- ✓ 1: Expense: \$18,120

**P6.** Krall Company was formed on January 1, 2014, and began constructing a new plant. At the end of 2014, its auditor discovered that all expenditures involving long-term assets had been debited to an account called Fixed Assets. An analysis of the Fixed Assets account, which had a year-end balance of \$2,644,972, disclosed that it contained the following items:

Cost of land	\$ 316,600
Surveying costs	4,100
Transfer of title and other fees required by the county	920
Broker's fees for land	21,144
Attorney's fees associated with land acquisition	7,048
Cost of removing timber from land	50,400
Cost of grading land	4,200
Cost of digging building foundation	34,600
Architect's fee for building and land improvements (80 percent building)	64,800
Cost of building construction	710,000
Cost of sidewalks	11,400
Cost of parking lots	54,400
Cost of lighting for grounds	80,300
Cost of landscaping	11,800
Cost of machinery	989,000
Shipping cost on machinery	55,300
Cost of installing machinery	176,200
Cost of testing machinery	22,100
Cost of changes in building to comply with safety regulations pertaining to machinery	12,540
Cost of repairing building that was damaged in the installation of machinery	8,900
Cost of medical bill for injury received by employee while installing machinery	2,400
Cost of water damage to building during heavy rains prior to opening the plant for operation	6,820
Account balance	<u>\$2,644,972</u>

Krall sold the timber it cleared from the land to a firewood dealer for \$5,000. This amount was credited to Miscellaneous Income. During the construction period, two of Krall's supervisors devoted full time to the construction project. Their annual salaries were \$48,000 and \$42,000, respectively. They spent two months on the purchase and preparation of the land, six months on the construction of the building (approximately one-sixth of which was devoted to improvements on the grounds), and one month on machinery installation. When the plant began operation on October 1, the supervisors returned to their regular duties. Their salaries were debited to Factory Salaries Expense.

#### REQUIRED

1. Prepare a schedule with the following column headings: Land, Land Improvements, Buildings, Machinery, and Expense. Place each of the above expenditures in the appropriate column. Negative amounts should be shown in parentheses. Total the columns.
2. **CONCEPT** ► What impact does the classification of the items among several accounts have on evaluating the profitability performance of the company?

#### LO 3, 4

#### CASH FLOW

- ✓ 1a: Depreciation, year 3: \$5,000
- ✓ 1b: Depreciation, year 3: \$8,000
- ✓ 1c: Depreciation, year 3: \$2,813

#### Comparison of Depreciation Methods

**P7.** Bao Wao Designs Inc. purchased a computerized blueprint printer that will assist in the design and display of plans for factory layouts. The cost of the printer was \$22,500, and its expected useful life is four years. The company can probably sell the printer for \$2,500 at the end of four years. The printer is expected to last 6,000 hours. It was used 1,200 hours in year 1; 1,800 hours in year 2; 2,400 hours in year 3; and 600 hours in year 4.

#### REQUIRED

1. Compute the annual depreciation and carrying value for the new blueprint printer for each of the four years (round to the nearest dollar where necessary) under each of the following methods: (a) straight-line, (b) production, and (c) double-declining-balance.

(Continued)

- If the printer is sold for \$12,000 after year 2, what would be the gain or loss under each method?
- ACCOUNTING CONNECTION** ► What conclusions can you draw from the patterns of yearly depreciation and carrying value in requirement 1? Do the three methods differ in their impact on profitability? Do they differ in their effect on the company's operating cash flows? Explain.

LO 3, 4

CASH FLOW

SPREADSHEET

- ✓ 1a: Depreciation, year 3: \$51,667
- ✓ 1b: Depreciation, year 3: \$77,500
- ✓ 1c: Depreciation, year 3: \$51,852

### Comparison of Depreciation Methods

**P8.** Niles Construction Company purchased a new crane for \$350,000 at the beginning of year 1. The crane has an estimated residual value of \$40,000 and an estimated useful life of six years. The crane is expected to last 10,000 hours. It was used 1,800 hours in year 1; 2,000 hours in year 2; 2,500 hours in year 3; 1,500 hours in year 4; 1,200 hours in year 5; and 1,000 hours in year 6.

#### REQUIRED

- Compute the annual depreciation and carrying value for the new crane for each of the six years (round to the nearest dollar where necessary) under each of the following methods: (a) straight-line, (b) production, and (c) double-declining-balance (round percentage to two decimal places).
- If the crane is sold for \$500,000 after year 3, what would be the amount of gain or loss under each method?
- ACCOUNTING CONNECTION** ► Do the three methods differ in their effect on the company's profitability? Do they differ in their effect on the company's operating cash flows? Explain.

LO 5

CASH FLOW

SPREADSHEET

- ✓ 2: Depletion expense: \$288,000

### Natural Resource Depletion and Depreciation of Related Plant Assets

**P9.** Crystler Mining Company purchased land containing an estimated 10 million tons of ore for a cost of \$4,400,000. The land without the ore is estimated to be worth \$800,000. The company expects that all the usable ore can be mined in 10 years. Buildings costing \$400,000 with an estimated useful life of 30 years were erected on the site. Equipment costing \$480,000 with an estimated useful life of 10 years was installed. Because of the remote location, neither the buildings nor the equipment has an estimated residual value. During its first year of operation, the company mined and sold 800,000 tons of ore.

#### REQUIRED

- Compute the depletion charge per ton.
- Compute the depletion expense that Crystler Mining should record for the year.
- Determine the depreciation expense for the year for the buildings, making it proportional to the depletion.
- Determine the depreciation expense for the year for the equipment under two alternatives: (a) making the expense proportional to the depletion and (b) using the straight-line method.
- ACCOUNTING CONNECTION** ► Suppose the company mined and sold 1,000,000 tons of ore (instead of 800,000) during the first year. Would the change in the results in requirements 2 or 3 affect earnings or cash flows? Explain.

## CASES

LO 7

CASH FLOW

### Conceptual Understanding: Effect of Change in Estimates

**C1.** The airline industry was hit particularly hard after the 9/11 attacks on the World Trade Center in 2001. In 2002, **Southwest Airlines**, one of the healthier airline companies, decided to lengthen the useful lives of its aircraft from 22 to 27 years. Shortly thereafter, following Southwest's lead, other airlines made the same move.<sup>22</sup> What advantage, if any, did the airlines gain by making this change in estimate? Would it have changed earnings or cash flows, and if it did, would the change have been favorable or negative?



Some people argue that the useful lives and depreciation of airplanes are irrelevant. They claim that because of the extensive maintenance and testing that airline companies are required by law to perform, the planes theoretically can be in service for an indefinite future period. What is wrong with this argument?

LO 1

### Conceptual Understanding: Impairment Test



**C2. BUSINESS APPLICATION** ► An annual report of **Costco Wholesale Corporation**, the large discount company, contained the following statement:

*The Company periodically evaluates long-lived assets for impairment when ... circumstances occur that may indicate the carrying amount of the asset group ... may not be fully recoverable.*<sup>23</sup>

What does the concept of impairment mean in accounting? What effect does impairment have on profitability and cash flows? Why would the concept of impairment be referred to as a conservative accounting approach?

LO 3

### Conceptual Understanding: Accounting Estimates

**C3. IBM**, the large computer equipment and services company, stated in one of its annual reports that “Property, plant and equipment are carried at cost and depreciated over their estimated useful lives using the straight-line method.”<sup>24</sup> What estimates are necessary to carry out this policy? What factors should be considered in making each of the estimates?

LO 6

### Interpreting Financial Reports: Brands

**C4. CONCEPT** ► **Starwood Hotels & Resorts Worldwide, Inc.**, and **Marriott International** provide hospitality services. Starwood Hotels’ well-known brands include St. Regis, The Luxury Collection, W Hotels, Westin Hotels & Resorts, Le Meridien, Sheraton Hotels & Resorts, Four Points by Sheraton, Aloft by W Hotels, and Element by Westin. Marriott also owns or manages properties with recognizable brand names, such as Marriott Hotels & Resorts, Ritz-Carlton Hotel Company and Destination Club, Bulgari Hotels & Resorts, Marriott ExecuStay, Marriott Executive Apartments, Marriott Vacation Club, Grand Residences by Marriott, Spring Hill Suites by Marriott, Renaissance Hotels & Resorts, AC Hotels by Marriott, JW Marriott Hotels & Resorts, EDITION Hotels, Autograph Collection, Courtyard by Marriott, Residence Inn by Marriott, Fairfield Inn & Suites by Marriott, TownePlace Suites by Marriott, and Marriott Conference Centers.

On its balance sheet, Starwood Hotels & Resorts includes brands of \$313 million (see note 7), or 3.3 percent of total assets. Marriott International, however, does not list brands among its intangible assets.<sup>25</sup> What principles of accounting for intangibles require Starwood to record brands as an asset while Marriott does not? How do these differences in accounting for brands generally affect the net income and return on assets of these two competitors?

LO 1, 2, 3

### Annual Report Case: Long-Term Assets

**C5.** To answer the following questions, refer to the **CVS** annual report in the Supplement to Chapter 16. Examine the balance sheets, as well as the summary of significant accounting policies on property and equipment in the notes to the financial statements.

1. What percentage of total assets in 2011 was property and equipment, net? Identify the major categories of CVS’s property and equipment. Which types of property and equipment are most significant? What are leasehold improvements? How significant are these items, and what are their effects on CVS’s earnings?
2. What method of depreciation does CVS use? How long does management estimate its buildings will last as compared with furniture and equipment? What does this say about the company’s need to remodel its stores?
3. How does the company determine if it has impaired assets?



LO 7

CASH FLOW

**Comparison Analysis: Long-Term Assets and Free Cash Flows**

**C6.** To complete the assignments listed below, refer to the **CVS** annual report and the financial statements of **Southwest Airlines Co.** in the Supplement to Chapter 16.

1. Prepare a table that shows the net amount each company spent on property and equipment (from the statement of cash flows), the net amount of its property and equipment (from the balance sheet), and the percentage of net amount spent to the net amount of property and equipment for each of the past two years. (Round percentages to one decimal place.) In which company did the amount of property and equipment grow more rapidly?
2. **BUSINESS APPLICATION** ► Calculate free cash flow for both companies for the past two years. What conclusions can you draw about each company's need to raise funds from debt and equity and its ability to grow?

LO 2

CASH FLOW

**Ethical Dilemma: Ethics and Allocation of Acquisition Costs**

**C7. BUSINESS APPLICATION** ► Hamlin Company has purchased land and a warehouse for \$18,000,000. The warehouse is expected to last 20 years and to have a residual value equal to 10 percent of its cost. The chief financial officer (CFO) and the controller are discussing the allocation of the purchase price. The CFO believes that the largest amount possible should be assigned to the land because that would improve reported net income in the future. Depreciation expense would be lower because land is not depreciated. He suggests allocating one-third, or \$6,000,000, of the cost to the land. This would result in depreciation expense each year of \$540,000 [ $(\$12,000,000 - \$1,200,000) \div 20$  years].

The controller disagrees. She argues that the smallest amount possible, say one-fifth of the purchase price, should be allocated to the land because the depreciation of the warehouse, which is tax-deductible, would be greater and thus reduce income taxes. Under this plan, annual depreciation would be \$648,000 [ $(\$14,400,000 - \$1,440,000) \div 20$  years]. The annual tax savings at a 30 percent tax rate is \$32,400 [ $(\$648,000 - \$540,000) \times 0.30$ ].

How would each decision affect the company's cash flows? Ethically, how should the purchase cost be allocated? Who would be affected by the decision?

**Continuing Case: Annual Report Project**

CASH FLOW

**C8.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the balance sheet and the statement of cash flows and accompanying notes of your company. Answer the following questions:

1. **CONCEPT** ► What percentage of total assets is property, plant, and equipment? What items are classified in this category?
2. **CONCEPT** ► What percentage of total assets are intangible assets? What items are classified in this category?
3. How much did the company invest in property, plant, and equipment during the year?
4. **BUSINESS APPLICATION** ► Compute free cash flow for the most recent year.
5. Find the disclosures about property, plant, and equipment in the notes to the financial statements. What depreciation methods does the company use?
6. Find the disclosures about intangible assets in the notes to the financial statements. What intangible assets are amortized and which are not? Has the company recognized any impairments of intangible assets?

# CHAPTER 11

## Current Liabilities and Fair Value Accounting

### BUSINESS INSIGHT

#### Teresa's Fitness Center

In January 2014, Teresa Madej started a business called Teresa's Fitness Center. In addition to offering exercise classes, the center sells nutritional supplements. Teresa has limited experience in running a business, but she knows that it is important for a company to manage its liabilities so that it has enough cash on hand to pay debts when they come due.

Teresa is also well aware that incurring liabilities is a necessary part of doing business. When she started her business, Teresa signed a promissory note to her bank for \$16,000. To help operate the business, she hired two exercise instructors to whom she pays monthly salaries, and she has incurred debt in maintaining an inventory of nutritional supplements. Other liabilities include taxes owed to both the federal and state governments, as well as \$3,600 in annual property taxes that the business owes the city government.

As the company approaches the end of its second fiscal year, Teresa is anxious to assess its liquidity.

- 1. CONCEPT** ► How do the concepts of recognition, valuation, classification, and disclosure apply to current liabilities?
- 2. ACCOUNTING APPLICATION** ► What are the company's current liabilities and their total amount?
- 3. BUSINESS APPLICATION** ► Why is it important for Teresa Madej to identify and account for all her company's current liabilities?

### LEARNING OBJECTIVES

- LO 1** Define *current liabilities*, and identify the concepts underlying them.
- LO 2** Identify, compute, and record definitely determinable and estimated current liabilities.
- LO 3** Distinguish contingent liabilities from commitments.
- LO 4** Identify the valuation approaches to fair value accounting, define *time value of money* and *interest*, and apply them to present values.
- LO 5** Apply the present value concept to simple valuation situations.
- LO 6** Use ratio analysis to manage the impact of current liabilities' impact on liquidity.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Recognition
- Valuation
- Classification
- Disclosure

RELEVANT  
LEARNING OBJECTIVE

- LO 1** Define *current liabilities*, and identify the concepts underlying them.

## LO 1 Concepts Underlying Current Liabilities

**Current liabilities** are debts and obligations that a company expects to satisfy within one year or within its normal operating cycle, whichever is longer. They require not only careful management of liquidity and cash flows but also close monitoring. Managers must understand how current liabilities should be *recognized*, *valued*, *classified*, and *disclosed*.

### Recognition

Timing is important in the *recognition* of liabilities. Failure to record a liability often goes along with failure to record an expense. The two errors lead to an understatement of expense and an overstatement of income.

Generally accepted accounting principles require that a liability be recorded when an obligation occurs, as when goods are bought on credit. However, some current liabilities are not the result of direct transactions. One reason for making adjusting entries is to *recognize* unrecorded liabilities that accrue during the period. Accrued liabilities include salaries payable and interest payable. Other liabilities that can only be estimated, such as taxes payable, must also be recognized through adjusting entries.

Agreements for future transactions do not have to be *recognized*. For instance, **Microsoft** might agree to pay an executive \$250,000 a year for a period of three years, or it might agree to buy an unspecified amount of advertising at a certain price over the next five years. Such contracts, though they are definite commitments, are not considered liabilities because they are for future—not past—transactions. Because there is no current obligation, no liability is recognized. However, if the amounts involved are material, these commitments would be mentioned in the notes to the financial statements.

### Valuation

On the balance sheet, a liability is generally *valued* at the amount of money needed to pay the debt or reported at the fair market value of the goods or services to be delivered. For most liabilities, at least one of these amounts is definitely known. For example, **Amazon.com** sells a large number of gift certificates that are redeemable in the future. The amount of the liability (unearned revenue) is known, but the exact timing is not known.

Some companies, however, must estimate future liabilities. For example, if an automobile dealer sells a car with a one-year warranty on parts and service, the obligation is definite because the sale has occurred; but the amount of the obligation can only be estimated.

### Classification

As discussed earlier, current liabilities are due in the next year or within the normal operating cycle, whichever is longer, and are normally paid out of current assets or with cash generated by operations. They contrast with **long-term liabilities**, which are liabilities due beyond one year or beyond the normal operating cycle. For example, Teresa's Fitness Center may incur long-term liabilities to finance its expansion to a larger location. The distinction between current and long-term liabilities affects the evaluation of a company's liquidity.

**STUDY NOTE:** Disclosure of the fair value and the bases for estimating the fair value of short-term notes payable, loans payable, and other short-term debt are required unless it is not practical to estimate the value.

## Disclosure

In addition to reporting current liabilities in the balance sheet, a company may need to include additional explanation in the notes to its financial statements. For example, if a company's Notes Payable account is large, it should *disclose* the balances, maturity dates, interest rates, and other features of the debts in an explanatory note. Any special credit arrangements should also be disclosed. For example, in this note to its 2011 financial statements, **Hershey Foods Corporation** discloses the nature of its credit arrangements:

### Short-Term Debt

*As a source of short-term financing, . . . we entered into a new five-year agreement establishing an unsecured revolving [letter of credit] to borrow up to \$1.1 billion, with an option to increase borrowings by an additional \$400 million with the consent of the lenders.<sup>1</sup>*

A **line of credit** with a bank allows a company to borrow funds when they are needed to finance current operations. Unused lines of credit allow a company to borrow on short notice up to the credit limit, with little or no negotiation. Thus, the type of *disclosure* in Hershey's note is helpful in assessing whether a company has additional borrowing power.

## APPLY IT!

Indicate whether each of the following actions relates to (a) recognition of liabilities, (b) valuation of liabilities, (c) classification of liabilities, or (d) disclosure of liabilities:

1. Determining whether a liability is current or long-term.
2. Determining the dollar amount of a liability.
3. Determining what information should be reported about a liability.
4. Determining that a liability exists.

### SOLUTION

1. c; 2. b; 3. d; 4. a

**TRY IT! SE1, E1A, E1B**



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Record definitely determinable current liabilities
- Record estimated current liabilities
- Account for contingent liabilities
- Compute present value

## RELEVANT LEARNING OBJECTIVES

**LO 2** Identify, compute, and record definitely determinable and estimated current liabilities.

**LO 3** Distinguish contingent liabilities from commitments.

**LO 4** Identify the valuation approaches to fair value accounting, define *time value of money and interest*, and apply them to present values.

**LO 5** Apply the present value concept to simple valuation situations.

## LO 2 Common Types of Current Liabilities

As noted earlier, a company incurs current liabilities to meet its needs for cash during the operating cycle. These liabilities fall into two major groups: definitely determinable liabilities and estimated liabilities.

### Definitely Determinable Liabilities

Current liabilities that are set by contract or statute and that can be measured exactly are called **definitely determinable liabilities**. The objectives in accounting for these liabilities are to:

- determine their existence and amount
- record them properly

The most common definitely determinable liabilities are described in the sections that follow.

**Accounts Payable** **Accounts payable** (or *trade accounts payable*) are short-term obligations to suppliers for goods and services. The amount in the Accounts Payable control account is supported by an accounts payable subsidiary ledger. This separate ledger contains an individual account for each person or company to whom money is owed.

**Notes Payable** **Short-term notes payable** are represented by **promissory notes**, which are written agreements to pay according to certain terms. A company may sign promissory notes to obtain bank loans, pay suppliers for goods and services, or secure credit from other sources. The interest rate is usually stated separately on the face of the note, as shown in Exhibit 1.

#### Exhibit 1 Promissory Note

<u>Chicago, Illinois</u>	<u>January 1, 2013</u>
<p><u>Sixty days</u> after date I promise to pay First Federal Bank the sum of <u>\$16,000</u> with interest at the rate of 3% per annum.</p>	
<p><u>Teresa Madej</u> Teresa's Fitness Center</p>	

© Cengage Learning 2014

#### Issuance of Note Payable

**Transaction** Borrowed \$16,000 from bank and signed 60-day, 3% promissory note.

**Analysis** The journal entry to record the issuance of the note payable

- ▲ *increases* the *Cash* account
- ▲ *increases* the *Notes Payable* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
Cash			Notes Payable				
Dr.	Cr.		Dr.	Cr.			
Jan. 1	16,000		Jan. 1	16,000			

**A** = **L** + **OE**  
 +16,000 = +16,000

**Journal Entry**

		Dr.	Cr.
Jan. 1	Cash	16,000	
	Notes Payable		16,000
	Issued 60-day, 3% promissory note		

**Comment** The transaction is *recognized* by an increase in assets and liabilities.

**Payment of Note with Interest**

**Transaction** On March 1, Teresa repays the \$16,000 plus interest.

**Analysis** The journal entry to record the payment of the note with interest after 60 days

- ▲ *increases* the *Interest Expense* account
- ▼ *decreases* the *Notes Payable* account
- ▼ *decreases* the *Cash* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
Cash			Notes Payable			Interest Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	Mar. 1	16,078.90	Mar. 1	16,000.00		Mar. 1	78.90

**A** = **L** + **OE**  
 -16,078.90 = -16,000.00 - 78.90

**Journal Entry**

		Dr.	Cr.
Mar. 1	Notes Payable	16,000.00	
	Interest Expense	78.90	
	Cash		16,078.90
	Payment of promissory note with interest		
	$\$16,000 \times \frac{3}{100} \times \frac{60}{365} = \$78.90^*$		
	*Rounded		

**Comment** The transaction is *recognized* by a decrease in assets and liabilities and an increase in interest expense.

**Bank Loans and Commercial Paper** Although a company signs a promissory note for the full amount of a line of credit, it has great flexibility in using the available funds. It can increase its borrowing up to the limit when it needs cash and reduce the amount borrowed when it generates enough cash of its own. Both the amount borrowed and the interest rate charged by the bank may change daily. The bank may require the company to meet certain financial goals (such as maintaining specific profit margins, current ratios, or debt to equity ratios) to retain its line of credit.

Companies with excellent credit ratings can borrow short-term funds by issuing commercial paper. **Commercial paper** refers to unsecured loans (i.e., loans not backed

up by any specific assets) that are sold to the public, usually investment firms. Companies can quickly lose access to commercial paper if their credit rating drops. Because of disappointing operating results in recent years, well-known companies like **Chrysler**, **Lucent Technologies**, and **Motorola** have lost some or all of their ability to issue commercial paper.

The portion of a line of credit currently used and the amount of commercial paper issued are usually combined with notes payable in the current liabilities section of the balance sheet. Details are disclosed in a note to the financial statements.

**STUDY NOTE:** Only the used portion of a line of credit is recognized as a liability in the financial statements.

**Accrued Liabilities** As noted earlier, a key reason for making adjusting entries is to *recognize* liabilities that are not already in the accounting records. **Accrued liabilities** (or *accrued expenses*) can include estimated liabilities.

Interest payable, a definitely determinable liability, is an accrued liability. Interest accrues daily on interest-bearing notes. An adjusting entry is made at the end of each period to record the interest obligation up to that point.

**Recognizing Accrual Interest Expense**

**Transaction** The accounting period of Teresa’s note in Exhibit 1 ends on January 31, or 30 days after the issuance of the 60-day note.

**Analysis** The adjusting entry to record the payment of the note with interest after 30 days

- ▲ increases the *Interest Expense* account
- ▲ increases the *Interest Payable* account

**Application of Double Entry**

Assets		Liabilities		Owner’s Equity
	=	<b>Interest Payable</b>	+	<b>Interest Expense</b>
		Dr.      Cr.		Dr.      Cr.
		Jan. 31   39.45		Jan. 31   39.45

**Journal Entry**

		Dr.	Cr.
Jan. 31	Interest Expense	39.45	
	Interest Payable		39.45
	To record 30 days’ interest expense on promissory note		
	$\$16,000 \times \frac{3}{100} \times \frac{30}{365} = \$39.45^*$		
	*Rounded		

**Comment** The accrued interest is *recognized* by an increase in expense and liabilities.

**Dividends Payable** **Cash dividends** are a distribution of earnings to a corporation’s stockholders, and a corporation’s board of directors has the sole authority to declare them. The corporation has no liability for dividends until the date of declaration. During the brief time between that date and the date of payment, the dividends declared are considered current liabilities of the corporation.

**Sales and Excise Taxes Payable** Most states and many cities levy a sales tax on retail transactions, and the federal government imposes an excise tax on some products, such as gasoline. A merchant that sells goods subject to these taxes must collect the taxes and forward them periodically to the appropriate government agency. Until the merchant remits the amount it has collected to the government, that amount represents a current liability.



**Recording Sales and Excise Taxes**

**Transaction** On June 1, Teresa’s Fitness Center makes a \$200 sale of nutritional supplements that is subject to a 5 percent sales tax and a 10 percent excise tax.

**Analysis** The journal entry to record the sale

- ▲ increases the *Cash* account
- ▲ increases the *Sales* account
- ▲ increases the *Sales Tax Payable* account
- ▲ increases the *Excise Tax Payable* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
Cash			Sales Tax Payable			Sales	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
June 1	230		June 1	10		June 1	200
			Excise Tax Payable				
			Dr.	Cr.			
			June 1	20			

**Journal Entry**

		<b>Dr.</b>		<b>Cr.</b>
June 1	Cash	230		
	Sales		200	
	Sales Tax Payable		10	
	Excise Tax Payable		20	
	Sales of merchandise and collection of sales and excise tax			

<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>OE</b>
+230		+10		+200
		+20		

**Comment** The sale is properly *recognized* at \$200, and the taxes collected, which are not revenues, are *classified* as liabilities to be remitted to the appropriate government agencies.

Companies that have a physical presence in many cities and states require a complex accounting system for sales taxes because the rates vary from state to state and city to city. For Internet companies, the sales tax situation is simpler. For example, **Amazon.com** is an Internet company without a physical presence in most states. Thus, it does not always have to collect sales tax from its customers. This situation may change in the future, but so far Congress has exempted most Internet sales from sales tax.

**Current Portion of Long-Term Debt** The portion of long-term debt that is due within the next year and is to be paid from current assets is *classified* as a current liability. No journal entry is necessary when this is the case. The total debt is simply reclassified as short-term and long-term when the company prepares its balance sheet and other financial statements.

**Payroll Liabilities** In the banking and airlines industries, payroll costs represent more than half of all operating costs. Payroll accounting is important because complex laws and significant liabilities are involved. The employer is liable to employees for wages and salaries and to various agencies for amounts withheld from wages and salaries and for related taxes. **Wages** are compensation of employees at an hourly rate; **salaries** are compensation of employees at a monthly or yearly rate.

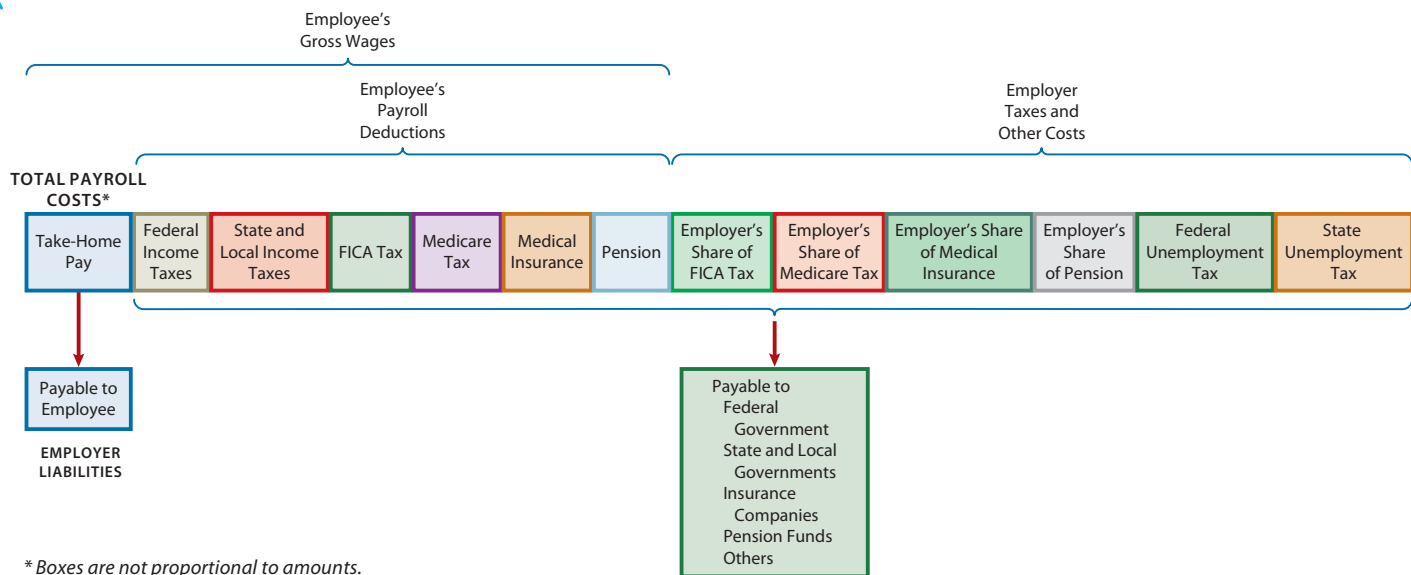
Because payroll accounting applies only to an organization's employees, it is important to distinguish between employees and independent contractors, as follows.

- An **employee** is paid a wage or salary by the organization and is under its direct supervision and control.
- An **independent contractor** offers services for a fee but is not under the organization's direct control or supervision. Certified public accountants, advertising agencies, and lawyers, for example, often act as independent contractors.

Exhibit 2 shows how payroll liabilities relate to employee earnings and employer taxes and other costs. When accounting for payroll liabilities, it is important to keep the following in mind:

- The amount payable to employees is less than the amount of their earnings. This occurs because employers are required by law or are requested by employees to withhold certain amounts from wages and send them directly to government agencies or other organizations.
- An employer's total liabilities exceed employees' earnings because the employer must pay additional taxes and make other contributions (e.g., for pensions and medical care) that increase the payroll costs and liabilities.

### Exhibit 2 Illustration of Payroll Costs



© Cengage Learning 2014

**STUDY NOTE:** Vacation pay, sick pay, personal days, health insurance, life insurance, and pensions are additional costs that may be negotiated between employers and employees.

The most common withholdings, taxes, and other payroll costs are described below.

- **Federal income taxes:** Employers are required to withhold federal income taxes from employees' paychecks and pay them to the U. S. Treasury. These taxes are collected each time an employee is paid.
- **State and local income taxes:** Most states and some local governments levy income taxes. In most cases, the procedures for withholding are similar to those for federal income taxes.
- **Social security (FICA) tax:** The social security program (the Federal Insurance Contribution Act) provides retirement and disability benefits and survivor's benefits. The 2012 Social Security tax rate of 6.2 percent was paid by both employee and employer on the first \$110,100 earned by an employee during the calendar year.\* Both the rate and the base to which it applies are subject to change in future years.

\*A temporary reduction in the employee social security contribution to 4.2 percent was enacted in 2011 and continued in 2012; but since it is not possible to predict if it will continue, the full 6.2 percent rate is used in the examples in this text.

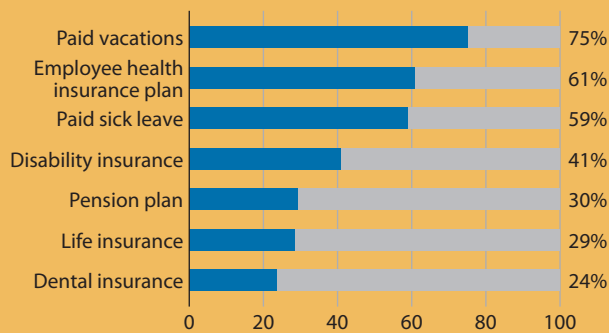


## Business Perspective

### Small and Mid-Sized Businesses Offer Benefits Too

A national survey of small and mid-sized businesses focused on the employee benefits that these companies offer. The graph at the right presents the results. As you can see, 75 percent of respondents provided paid vacation and 61 percent provided health/medical benefits.<sup>2</sup>

© Alija / iStockphoto.com



- **Medicare tax:** A major extension of the social security program is Medicare, which provides hospitalization and medical insurance for persons over age 65. In 2012, the Medicare tax rate was 1.45 percent of gross income, with no limit, paid by *both* employee and employer.
- **Medical insurance:** Many organizations provide medical benefits to employees. Often, the employee contributes a portion of the cost through withholdings from income and the employer pays the rest—usually a greater amount—to the insurance company.

- **Pension contributions:** Many organizations also provide pension benefits to employees. A portion of the pension contribution is withheld from the employee's income, and the organization pays the rest of the amount into the pension fund.
- **Federal unemployment insurance (FUTA) tax:** This tax pays for programs for unemployed workers. It is paid *only* by employers and recently was 6.2 percent of the first \$7,000 earned by each employee. (This rate may vary from state to state.) The employer is allowed a credit for unemployment taxes it pays to the state. The maximum credit is 5.4 percent of the first \$7,000 earned by each employee. Most states set their rate at this maximum. Thus, the FUTA tax most often paid is 0.8 percent (6.2 percent – 5.4 percent) of the taxable wages.
- **State unemployment insurance tax:** State unemployment programs provide compensation to eligible unemployed workers. The compensation is paid out of the fund provided by the 5.4 percent of the first \$7,000 (or the amount the state sets) earned by each employee. In some states, employers with favorable employment records may be entitled to pay less than 5.4 percent.

**STUDY NOTE:** The employee pays all federal, state, and local taxes on income. The employer and employee share FICA and Medicare taxes. The employer bears FUTA and state unemployment taxes.

### Recording Payroll and Related Withholdings

**Transaction** On February 15, Teresa's Fitness Center's wages for employees total \$65,000, and withholdings for employees are as follows.

- \$10,800 for federal income taxes
- \$2,400 for state income taxes
- \$4,030 for social security tax
- \$942 for Medicare tax
- \$1,800 for medical insurance
- \$2,600 for pension contributions

**Analysis** The journal entry to record payroll and related withholdings

- ▲ increases the *Wages Expense* account
- ▲ increases a *Payable* account for each type of withholding
- ▲ increases the *Wages Payable* account

## Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
		+10,800		-65,000
		+2,400		
		+4,030		
		+942		
		+1,800		
		+2,600		
		+42,428		

Feb. 15	Wages Expense	65,000	
	Employees' Federal Income Taxes Payable		10,800
	Employees' State Income Taxes Payable		2,400
	Social Security Tax Payable		4,030
	Medicare Tax Payable		942
	Medical Insurance Premiums Payable		1,800
	Pension Contributions Payable		2,600
	Wages Payable		42,428
	To record the payroll		

**Comment** Wages Expense is recorded for the gross wages, but the various withholding are *recognized* as liabilities before net amount payable to employees is determined. Although the employees earned at total of \$65,000, their take-home pay total was only \$42,428.

## Recording Employer Payroll Taxes and Health Insurance Cost and Pension Benefits

**Transaction** On February 15, Teresa records the fitness center's share of payroll taxes (50 percent), the health insurance premiums (80 percent) and the pension contributions (50 percent).

**Analysis** The journal entry to record employer payroll taxes, health insurance costs, and pension benefits

- ▲ increases the *Payroll Taxes and Benefits Expense* account
- ▲ increases each *Tax Payable* account
- ▲ increases the *Medical Insurance Premiums Payable* account
- ▲ increases the *Pension Contributions Payable* account

## Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
		+4,030		-18,802
		+942		
		+7,200		
		+2,600		
		+520		
		+3,510		

Feb. 15	Payroll Taxes and Benefits Expense	18,802	
	Social Security Tax Payable		4,030
	Medicare Tax Payable		942
	Medical Insurance Premiums Payable		7,200*
	Pension Contributions Payable		2,600
	Federal Unemployment Tax Payable		520
	State Unemployment Tax Payable		3,510
	To record payroll taxes and other costs		

\*The employees' share of premiums is 20%. Thus, the employer's share is:  $(\$1,800 \div 0.20) - \$1,800 = \$7,200$

**Comment** Note that the payroll taxes and benefits expense increases the total cost of the payroll to \$83,802 ( $\$18,802 + \$65,000$ ), which exceeds the amount earned by the employees by almost 29 percent.

**Unearned Revenues** **Unearned revenues** are advance payments for goods or services that a company must provide in a future period. The company *recognizes* the revenue over that period.

### Recording Unearned Revenues

**Transaction** On June 1, Teresa’s Fitness Center receives cash from a customer in advance for a one-year membership in the fitness center in the amount of \$360.

**Analysis** The journal entry to record unearned revenues

- ▲ increases the *Cash* account
- ▲ increases the *Unearned Revenue* account

#### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
Cash			Unearned Revenue				
Dr.	Cr.		Dr.	Cr.			
June 1	360			June 1		360	

#### Journal Entry

$$A = L + OE$$

$$+360 = +360$$

Date	Account	Dr.	Cr.	Date	Account	Dr.	Cr.
June 1	Cash	360					
	Unearned Revenue						360
	Membership received in advance						

**Comment** Teresa’s Fitness Center has a liability of \$360 that will slowly be reduced over the year as it provides the service.

### Recognizing Unearned Revenues That Are Now Earned

**Transaction** On June 30, Teresa needs to record the amount of revenues earned at the end of the first month.

**Analysis** The journal entry to record unearned revenues that have been earned

- ▲ increases the *Revenue* account
- ▼ decreases the *Unearned Revenue* account

#### Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
			Unearned Revenue			Revenue	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
			June 30	30		June 30	30

#### Journal Entry

$$A = L + OE$$

$$-30 = -30 + 30$$

Date	Account	Dr.	Cr.	Date	Account	Dr.	Cr.
	Unearned Revenue		30				
	Revenue						30
	Recognition of revenue for services provided						

**Comment** Many businesses, including special-order firms, repair companies, and construction companies, ask for a deposit. Until they deliver the goods or services, these deposits are *classified* as current liabilities.

## Estimated Liabilities

**STUDY NOTE:** *Estimated liabilities are recorded and presented on the financial statements in the same way as definitely determinable liabilities. The only difference is that the computation of estimated liabilities involves some uncertainty.*

**Estimated liabilities** are definite debts or obligations whose exact dollar amount cannot be known until a later date. The primary accounting problem is to estimate and record the amount of the liability. The following are examples of estimated liabilities.

**Income Taxes Payable** The federal government, most state governments, and some cities and towns levy a tax on a corporation's income. The amount of the liability depends on the results of a corporation's operations, which are often not known until after the end of the corporation's fiscal year. However, because income taxes are an expense in the year in which income is earned, an adjusting entry is necessary to record the estimated tax liability.

Sole proprietorships and partnerships do *not* pay income taxes. However, their owners must report their share of the firm's income on their individual tax returns.

**Property Taxes Payable** Property taxes are a main source of revenue for local governments. They are levied annually on real property, such as land and buildings, and on personal property, such as inventory and equipment. Because the fiscal years of local governments rarely correspond to a company's fiscal year, it is necessary to estimate the amount of property taxes that applies to each month of the year.

**Promotional Costs** Coupons and rebates are part of many companies' marketing programs. Because of frequent flyer programs, for example, U.S. airline companies today have more than 10 trillion "free miles" outstanding. What are the accounting implications of these promotional programs? Companies usually record the costs as a reduction in sales (a contra-sales account) rather than as an expense with a corresponding current liability.

**Hershey Foods Corporation** accrues almost \$1 billion in promotional costs each year. In its annual report, Hershey acknowledged the difficulty of estimating the accrued liability for promotional programs:

*Accrued liabilities requiring the most difficult or subjective judgments include liabilities associated with marketing promotion programs. . . . We determine the amount of the accrued liability by analysis of programs offered, historical trends, expectations regarding customer and consumer participation, sales and payment trends; and experience with payment patterns associated with similar, previously offered programs. The estimated costs of these programs are reasonably likely to change in the future due to changes in trends with regard to customer and consumer participation, particularly for new programs and for programs related to the introduction of new products.<sup>3</sup>*

**STUDY NOTE:** *Recording a product warranty expense in the period of the sale is an application of accrual accounting.*

**Product Warranty Liability** When a firm sells a product or service with a warranty, it has a liability for the length of the warranty. The warranty is a feature of the product and is included in the selling price. Its cost should therefore be debited to an expense account in the period of the sale. Based on past experience, it should be possible to estimate the amount the warranty will cost the company in the future. Warranties on some products will cost the company very little; others may cost a lot.



## Business Perspective

### What Is the Cost of Frequent Flyer Miles?

In the early 1980s, **American Airlines** developed a frequent flyer program that awards free trips and other bonuses to customers based on the number of miles they fly on the airline. It is estimated that 180 million people now participate in similar programs. Estimated liabilities for these tickets have become an important consideration in evaluating an airline's financial position. Complicating the estimate is that almost half the miles have been earned through purchases from hotels, car rental and telephone companies, Internet service providers like **AOL**, and bank credit cards.<sup>4</sup>

### Recording Product Liability

**Transaction** A muffler company like **Midas** guarantees that it will replace free of charge any muffler it sells that fails during the time the buyer owns the car. The company charges a small service fee for replacing the muffler. In the past, 6 percent of the mufflers sold have been returned for replacement under the warranty. The average cost of a muffler is \$50. On July 31, Midas must record the accrued liability and related expense. The company sold 700 mufflers during the month.

**Analysis** The journal entry to record the accrued liability and related expense

- ▲ increases the *Product Warranty Expense* account
- ▲ increases the *Estimated Product Warranty Liability* account

### Application of Double Entry

Assets	=	Liabilities	+	Owner's Equity
		<b>Estimated Product Warranty Liability</b>		<b>Product Warranty Expense</b>
		Dr.      Cr.		Dr.      Cr.
		July 31   2,100		July 31   2,100

### Journal Entry

$$A = L + OE$$

$$+2,100 \qquad -2,100$$

		Dr.	Cr.
July 31	Product Warranty Expense	2,100	
	Estimated Product Warranty Liability		2,100
	To record estimated product warranty expense:		
	Number of units sold	700	
	Rate of replacement under warranty	<u>× 0.06</u>	
	Estimated units to be replaced	42	
	Estimated cost per unit	<u>× \$50</u>	
	Estimated liability for product warranty	<u>\$2,100</u>	

**Comment** The expense and liability for the estimated warranty are *recognized* at the time of sale of the product.

### Recording Product Liability and Service

**Transaction** On December 5, a customer returns with a defective muffler, which cost \$60, and pays a \$30 service fee to have it replaced.

**Analysis** The journal entry to record this liability and service

- ▲ increases the *Cash* account
- ▲ increases the *Service Revenue* account
- ▼ decreases the *Merchandise Inventory* account
- ▼ decreases the *Estimated Product Warranty Liability* account



Application of Double Entry

Assets		=	Liabilities		+	Owner's Equity	
<b>Cash</b>			<b>Estimated Product Warranty Liability</b>			<b>Service Revenue</b>	
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
Dec. 5	30		Dec. 5	60		Dec. 5	30
<b>Merchandise Inventory</b>							
<i>Dr.</i>	<i>Cr.</i>						
	Dec. 5						
	60						

Journal Entry

		<i>Dr.</i>	<i>Cr.</i>
Dec. 5	Cash	30	
	Estimated Product Warranty Liability	60	
	Service Revenue		30
	Merchandise Inventory		60
	Replacement of muffler under warranty		

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+30		-60		+30
-60				

**Comment** When a muffler is returned for replacement under the warranty, the cost of the muffler reduces the Merchandise Inventory account and the Estimated Product Warranty Liability account. This is an example of an entry for a transaction with two components: providing a service (revenue) and fulfilling an obligation (liability).



**Business Perspective**  
Those Little Coupons Can Add Up

Many companies promote their products by issuing coupons that offer “cents off” or other enticements. Because four out of five shoppers use coupons, companies are forced by competition to distribute them. The total value of unredeemed coupons, each of which represents a potential liability for the issuing company, is staggering. In 2011, marketers distributed approximately 305 billion coupons, of which less than 1% of all coupons were digital coupons. In total, the coupons were worth about \$470 billion, but consumers redeemed only \$4.6 billion in savings.<sup>5</sup> Thus, a big advertiser can issue millions of coupons and expect less than 1 percent to be redeemed.

**Vacation Pay Liability** In most companies, employees accrue paid vacation as they work during the year. For example, an employee may earn 52 weeks’ salary for 50 weeks’ work. The cost of the two weeks’ vacation should be allocated as an expense over the year so that month-to-month costs will not be distorted. The vacation pay represents 4 percent (two weeks’ vacation divided by 50 weeks) of an employee’s pay.

**Recording Vacation Pay Expense**

**Transaction** Diviney Company has a vacation policy of two weeks of paid vacation for each 50 weeks of work, has a payroll of \$42,000, and paid \$2,000 of that amount to employees on vacation for the week ended April 20. Because of past experience with employee turnover, the company assumes that only 75 percent of the employees will ultimately collect vacation pay. The computation of vacation pay expense based on the payroll of employees not on vacation (\$42,000 – \$2,000) is as follows.

$$\$40,000 \times 4 \text{ percent} \times 75 \text{ percent} = \$1,200$$

Diviney must record vacation pay expense for the week ended April 20.

**Analysis** The journal entry to record vacation pay expense

- ▲ increases the *Vacation Pay Expense* account
- ▲ increases the *Estimated Liability for Vacation Pay* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
			<b>Estimated Liability for Vacation Pay</b>			<b>Vacation Pay Expense</b>	
			Dr.	Cr.		Dr.	Cr.
				Apr. 20 1,200		Apr. 20 1,200	

$$A = L + OE$$

$$+1,200 = -1,200$$

**Journal Entry**

		Dr.	Cr.
Apr. 20	Vacation Pay Expense	1,200	
	→ Estimated Liability for Vacation Pay		1,200
	Estimated vacation pay expense		

**Comment** Vacation Pay Expense and corresponding liability are *recognized* on this date because the employee earned the vacation pay in the week working rather than when the vacation is taken.

Just as employees earn paid vacation days and holidays when working, employers incur expenses and liabilities for those paid days off.



YanLevy/Shutterstock.com

**Recording Payment When Vacation is Taken**

**Transaction** On August 31, Diviney Company needs to record the \$2,000 paid to employees on vacation during August.

**Analysis** The journal entry for a company to record payment for employees on vacation

- ▼ decreases the *Estimated Liability for Vacation Pay* account
- ▼ decreases the *Cash* account

**Application of Double Entry**

Assets		=	Liabilities		+	Owner's Equity	
			<b>Estimated Liability for Vacation Pay</b>				
	<b>Cash</b>		Dr.	Cr.			
			Aug. 31 2,000	Aug. 31 2,000			

$$A^* = L + OE$$

$$-2,000 = -2,000$$

\*Assumes Cash paid.

**Journal Entry**

		Dr.	Cr.
Aug. 31	Estimated Liability for Vacation Pay	2,000	
	→ Cash		2,000
	Wages of employees on vacation		

**Comment** The treatment of vacation pay presented here can also be applied to other payroll costs, such as bonus plans and contributions to pension plans.

## APPLY IT!

Tellex Corp. manufactures and sells clocks. Each clock costs \$30 to produce and sells for \$60. In addition, each clock carries a warranty that provides for free replacement if it fails during the two years following the sale. In the past, 2 percent of the clocks sold have had to be replaced under the warranty. During May, Tellex sold 20,000 clocks, and 350 clocks were replaced under the warranty. Prepare journal entries to record the estimated liability for product warranties during the month and the clocks replaced under warranty during the month (use May 31).

### SOLUTION

May 31	Product Warranty Expense	12,000	
	Estimated Product Warranty Liability		12,000
	To record estimated product warranty expense:		
	Number of units sold	20,000	
	Rate of replacement under warranty	× 0.02	
	Estimated units to be replaced	400	
	Estimated cost per unit	× \$30	
	Estimated liability for product warranty	<u>\$12,000</u>	
May 31	Estimated Product Warranty Liability	10,500	
	Merchandise Inventory		10,500
	Replacement of clocks under warranty		
	350 clocks × \$30 = \$10,500		

**TRY IT! SE2, SE3, SE4, E2A, E3A, E4A, E5A, E6A, E2B, E3B, E4B, E5B, E6B**

## LO 3 Contingent Liabilities and Commitments

The FASB requires companies to *disclose* in a note to their financial statements any contingent liabilities and commitments. A **contingent liability** is a *potential* liability because it depends on a future event arising out of a past transaction. Contingent liabilities often involve the following:

- Lawsuits
- Income tax disputes
- Discounted notes receivable
- Guarantees of debt
- Failure to follow government regulations

For instance, a construction company that signed a contract with a state to build a bridge may be sued by the state for using poor materials. The past transaction is the contract for building the bridge. The future event is the outcome of the lawsuit, which is not yet known.

The FASB has established two conditions for determining when a contingency should be entered in the accounting records:

- The liability must be probable.
- The liability can be reasonably estimated.<sup>6</sup>

Estimated liabilities like those for income taxes, warranties, and vacation pay that we described earlier meet those conditions. They are, therefore, accrued in the accounting records.

**STUDY NOTE:** Contingencies are recorded when they are probable and can be reasonably estimated.



## International Perspective

IFRS

### Balance Sheet Liabilities Are Often Greater Under IFRS

U.S. GAAP do not record commitments, such as purchase agreements, as liabilities even though they are a *legal* obligation, since they do not meet the technical definition of a liability. *Disclosure* in a note to the financial statements is required. Under IFRS, however, these agreements are *recognized* when an entity has a demonstrable commitment.

© loops7 / Stockphoto.com

© Cengage Learning 2014

In a survey of large companies, lawsuits involving many different issues and environmental concerns, including toxic waste cleanup, were among the most common types of contingencies reported.<sup>7</sup> In a note to its 2011 financial statements, **Microsoft** described its contingent liabilities as lawsuits involving infringement of European competition law, antitrust and overcharge actions, and patent and intellectual property claims, among other matters. Microsoft's management stated:

*We also are subject to a variety of other claims and suits . . . While we intend to vigorously defend these matters, there exists the possibility of adverse outcomes that we estimate could reach approximately \$800 million in aggregate beyond recorded amounts. Were unfavorable final outcomes to occur, there exists the possibility of a material adverse impact on our financial statements for the period in which the effects become reasonably estimable.<sup>8</sup>*

A **commitment** is a legal obligation that does not meet the technical requirements for *recognition* as a liability and so is not recorded. Common examples are purchase agreements, construction or acquisition of long-term assets, and leases.<sup>9</sup> For example, **Microsoft** also reported in its notes to its financial statements that it had construction commitments of \$263 million and purchase commitments of \$5.6 billion.<sup>10</sup> Knowledge of these amounts is very important for planning cash flows in the coming years.

## APPLY IT!

Indicate whether each of the following is (a) a contingent liability or (b) a commitment:

1. A tax dispute with the IRS
2. A long-term lease agreement
3. An agreement to purchase goods in the future
4. A potential lawsuit over a defective product

### SOLUTION

1. a; 2. b; 3. b; 4. a

TRY IT! SE5, E7A, E7B

## LO 4 Valuation Approaches to Fair Value Accounting

Recall that *fair value* is the price for which an asset or liability could be sold, or exit the company, as opposed to the price for which the company could buy the asset or liability. As pointed out previously, the concept of fair value applies to some financial assets, such as cash equivalents and investments, and to some liabilities, such as notes payable. Fair value is also applicable to determining whether tangible assets such as inventories and long-term assets have sustained a permanent decline in value below their cost. The FASB identifies three approaches to measurement of fair value:<sup>11</sup>

- **Market approach:** External market transactions are ideal for *valuing* investments and liabilities for which there is an active market and quoted prices are available



## International Perspective

IFRS

### Do the FASB and IASB Agree on Fair Value Measurement?

As part of their effort to converge U.S. GAAP with IFRS, the FASB and the IASB agreed in 2011, after almost ten years of effort, to issue a converged fair value measurement standard ASU 2011-04 (Topic 820) by the FASB and IFRS 13 by the IASB. In this standard, they agree on a common definition of fair value, including concepts and assumptions as well as *disclosures*. This is a major step forward in the effort to bring U.S. GAAP closer to global accounting standards.<sup>12</sup>

© iStockphoto.com

#### CASH FLOW

for the specific asset or liability. However, an active market or a quoted price is not always available. For example, there may not be a market for special-purpose equipment. In these cases, it may be possible to observe quoted prices for comparable types of equipment.

- **Income (or cash flow) approach:** The income approach, as defined by the FASB, converts future cash flows to a single present value. This approach is used when the market approach cannot be used because there are no identical or comparable quoted prices available. It is based on management's best determination of the future cash amounts generated by an asset or payments that will be made for a liability. It is based on internally generated information, which should be reasonable for the circumstances. For instance, management may estimate the cash flows or cost savings expected to be generated by the special-purpose equipment.
- **Cost approach:** The cost approach is based on the amount that currently would be required to replace an asset with the same or a comparable asset. For example, inventory is usually *valued* at lower of cost or market, where market is the replacement cost. For plant assets like special-purpose equipment, the replacement cost of a new asset must be adjusted to take into account the asset's age, condition, depreciation, and obsolescence.

The following sections, which focus on the income or cash flow approach, require knowledge of interest and the time value of money and present value techniques.

## Interest, the Time Value of Money, and Future Value

The concept of the **time value of money** refers to the costs or benefits of holding or not holding money over time. **Interest** is the cost of using money for a specific period. For example, if you have \$100 and hold that amount for one year without putting it in a savings account, you have forgone the interest that the money would have earned. However, if you put the \$100 in an interest-bearing checking account, you will have the \$100 plus the interest at the end of the year.

The amount of principal plus interest after one or more periods is known as **future value**. Future value may be computed using either simple interest or compound interest.

- **Simple interest** is the interest cost for one or more periods when the principal sum—the amount on which interest is computed—stays the same from period to period.
- **Compound interest** is the interest cost for two or more periods when, after each period, the interest earned in that period is added to the amount on which interest is computed in future periods. In other words, the principal sum is increased at the end of each period by the interest earned in that period.

**STUDY NOTE:** Compound interest is useful in business because it helps decision makers choose among alternative courses of action.

The examples that follow illustrate these concepts.

### Future Value Using Simple Interest

**Measure** *Simple interest* is the interest cost for one or more periods when the principal sum stays the same from period to period.

**Example** Willy Wang accepts an 8 percent, \$15,000 note due in 90 days. How much will he receive at that time? The interest is calculated as follows.

$$\begin{aligned}\text{Interest} &= \text{Principal} \times \text{Rate} \times \text{Time} \\ &= \$15,000.00 \times 8/100 \times 90/365 \\ &= \$295.89\end{aligned}$$

Therefore, the future value that Wang will receive is \$15,295.89, calculated as follows.

$$\begin{aligned}\text{Total} &= \text{Principal} + \text{Interest} \\ &= \$15,000.00 + \$295.89 \\ &= \$15,295.89\end{aligned}$$

### Future Value Using Compound Interest

**Measure** *Compound interest* is the interest cost for two or more periods when, after each period, the interest earned in that period is added to the amount on which interest is computed in future periods.

**Example** Terry Soma deposits \$10,000 in an account that pays 6 percent interest. She expects to leave the principal and accumulated interest in the account for three years. If the interest is paid at the end of each year and is then added to the principal and this amount in turn earns interest, how much will Soma's account total at the end of three years? The amount is computed as follows.

Year	Principal Amount at Beginning of Year	Annual Amount of Interest (Principal at Beginning of Year $\times$ 6%)	Accumulated Amount at End of Year (Principal at Beginning of Year + Annual Amount of Interest)
1	\$10,000.00	\$600.00	\$10,600.00
2	10,600.00	636.00	11,236.00
3	11,236.00	674.16	11,910.16

Soma will have \$11,910.16 in her account at the end of three years. Note that the amount of interest increases each year by the interest rate times the interest of the previous year. For example, between year 1 and year 2, the interest increased by \$36, which equals 6 percent times \$600.

## Present Value

**STUDY NOTE:** *Present value is a method of determining today the value of future cash flows. Financial analysts commonly compute present value to determine the value of potential investments.*

Suppose you had the choice of receiving \$100 today or one year from today. No doubt you would choose to receive it today. Why? If you have the money today, you can put it in a savings account to earn interest so you will have more than \$100 a year from today. In other words, because the amount today (present value) does not include any interest, it is less than the amount in the future (future value). **Present value** is the amount that must be invested today at a given rate of interest to produce a given future value. Thus, present value and future value are closely related.

### Present Value

**Measure** *Present value* is the amount that must be invested today at a given rate of interest to produce a given future value.



**Example** Lucia Fontaine needs \$10,000 one year from now. How much does she have to invest today to achieve that goal if the interest rate is 5 percent? From earlier examples, we can establish the following equation:

$$\begin{aligned} \text{Present Value} \times (1.0 + \text{Interest Rate}) &= \text{Future Value} \\ \text{Present Value} \times 1.05 &= \$10,000.00 \\ \text{Present Value} &= \$10,000.00 \div 1.05 \\ \text{Present Value} &= \$9,523.81^* \end{aligned}$$

\*Rounded

To achieve a future value of \$10,000, Fontaine must invest a present value of \$9,523.81. Interest of 5 percent on \$9,523.81 for one year equals \$476.19, and these two amounts added together equal \$10,000.

**Present Value of a Single Sum Due in the Future**

**Measure** The present value of a single amount of cash is the amount to be received at a specified date in the future.

**Example** Ron Moore wants to be sure of having \$8,000 at the end of three years. How much must he invest today in a 5 percent savings account to achieve this goal?

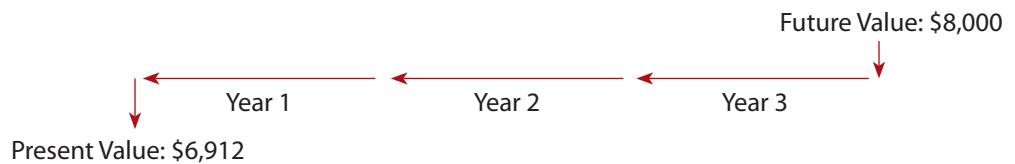
**Manual Computation** We can compute the present value of \$8,000 at compound interest of 5 percent for three years by adapting the above equation:

Year	Amount at End of Year		Divide by		Present Value at Beginning of Year
3	\$8,000.00	÷	1.05	=	\$7,619.05*
2	7,619.05	÷	1.05	=	7,256.24*
1	7,256.24	÷	1.05	=	6,910.70*

\*Rounded

Moore must invest \$6,910.70 today to achieve a value of \$8,000 in three years.

**Table Computation** We can simplify the calculation by using a table of present values. Refer to Table 1 in Appendix B. The point at which the 5 percent column and the row for period 3 intersect shows a factor of 0.864, as shown in Exhibit 3. This factor, when multiplied by \$1, gives the present value of \$1 to be received three years from now at 5 percent interest. Thus, we solve the problem as follows.



$$\begin{aligned} \text{Future Value} \times \text{Factor} &= \text{Present Value} \\ \$8,000 \times 0.864 &= \$6,912 \end{aligned}$$

Except for a rounding difference of \$1.30, this result is the same as our earlier one.

**Exhibit 3**  
Present Value of \$1 to Be Received at the End of a Given Number of Periods

Period	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826
3	0.971	0.942	0.915	0.889	<b>0.864</b>	0.840	0.816	0.794	0.772	0.751

© Cengage Learning 2014

## Present Value of an Ordinary Annuity

It is often necessary to compute the present value of a series of receipts or payments equally spaced over time, with compound interest—in other words, the present value of an **ordinary annuity**.

### Present Value of an Ordinary Annuity

**Measure** An *ordinary annuity* is a series of equal payments or receipts that will begin one time period from the current date.

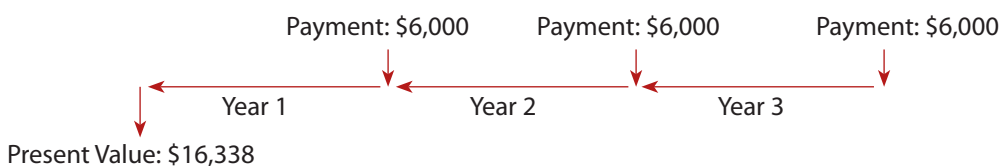
**Example** Vickie Long has sold a piece of property and is to receive \$18,000 in three equal annual payments of \$6,000 beginning one year from today. What is the present value of this sale if the current interest rate is 5 percent?

**Manual Computation** Using Table 1 in Appendix B, we can compute the present value by calculating a separate value for each of the three payments and summing the results, as follows.

Future Receipts (Annuity)				Present Value Factor at 5 Percent (from Exhibit 3)	Present Value
Year 1	Year 2	Year 3			
\$6,000			×	0.952	= \$ 5,712
	\$6,000		×	0.907	= 5,442
		\$6,000	×	0.864	= 5,184
Total Present Value					<u>\$16,338</u>

The present value of the sale is \$16,338. Thus, there is an implied interest cost (given the 5 percent rate) of \$1,662 (\$18,000 – \$16,338) associated with the payment plan.

**Table Computation** We can make this calculation more easily by using Table 2 in Appendix B. The point at which the 5 percent column intersects the row for period 3 shows a factor of 2.723 (as shown in Exhibit 4), which is the sum of the three present value factors in the table above (0.952 + 0.907 + 0.864 = 2.723). When multiplied by \$1, this factor gives the present value of a series of three \$1 payments (spaced one year apart) at compound interest of 5 percent. Thus, we solve the problem as follows.



$$\begin{array}{rcl} \text{Periodic Payment} & \times & \text{Factor} = \text{Present Value} \\ \$6,000 & \times & 2.723 = \$16,338 \end{array}$$

This result is the same as the one we computed earlier.

**Exhibit 4**  
Present Value of an Ordinary \$1 Annuity Received in Each Period for a Given Number of Periods

© Cengage Learning 2014

Period	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736
3	2.941	2.884	2.829	2.775	<b>2.723</b>	2.673	2.624	2.577	2.531	2.487

**Time Periods** As in all our examples, the compounding period is in most cases one year, and the interest rate is stated on an annual basis. However, in Tables 1 and 2 in Appendix B, the far left columns refer not to years but to periods. This wording

**STUDY NOTE:** The interest rate used when compounding interest for less than one year is the annual rate divided by the number of periods in a year.

accommodates compounding periods of less than one year. Savings accounts that record interest quarterly and bonds that pay interest semiannually are cases in which the compounding period is less than one year. To use the tables in these cases, you must divide the annual interest rate by the number of periods in the year and multiply the number of periods in one year by the number of years.

### Present Value When Compounding Period Is Less than One Year

**Measure** The present value is the amount of interest calculated or compounded more than once per year.

**Example** Compute the present value of a \$6,000 payment that is to be made in two years. The annual interest rate of 8 percent, and the compounding period is semiannual.

**Manual Computation** Before using present value tables in this computation, we must compute the interest rate that applies to each compounding period and the total number of compounding periods.

- The interest rate to use is 4 percent (8% annual rate ÷ 2 periods per year).
- The total number of compounding periods is 4 (2 periods per year × 2 years).

**Table Computation** We can then use Table 1 in Appendix B to compute the present value of the payment, \$5,130, as follows.

$$\begin{array}{rcl} \text{Principal} & \times & \text{Factor} = \text{Present Value} \\ \$6,000 & \times & 0.855 = \$5,130 \end{array}$$

This procedure is used whenever the corresponding period is less than one year. For example, a monthly compounding requires dividing the annual interest rate by 12 and multiplying the number of years by 12 to use the tables. This method can be used with the present value tables in Appendix B.

## APPLY IT!

Use Tables 1 and 2 in Appendix B to determine the present value of the following:

1. A single payment of \$10,000 at 5 percent for 10 years
2. 10 annual payments of \$1,000 at 5 percent
3. A single payment of \$10,000 at 7 percent for 5 years
4. 10 annual payments of \$1,000 at 9 percent

### SOLUTION

1. From Table 1:  $\$10,000 \times 0.614 = \$6,140$
2. From Table 2:  $\$1,000 \times 7.722 = \$7,722$
3. From Table 1:  $\$10,000 \times 0.713 = \$7,130$
4. From Table 2:  $\$1,000 \times 6.418 = \$6,418$

**TRY IT! SE6, SE7, SE8, E8A, E9A, E10A, E11A, E12A, E13A, E8B, E9B, E10B, E11B, E12B, E13B**

## LO 5 Applications Using Present Value

The concept of present value is widely used in business decision making and financial reporting. For example, the *value* of a long-term note receivable or payable can be determined by calculating the present value of the future interest payments. As mentioned earlier, the FASB has made present value an important component of its approach in determining the fair value of assets and liabilities when a market price is not available.

The SEC has issued guidance on how to apply fair value accounting.<sup>13</sup> For instance, it states that management's internal assumptions about expected cash flows may be used to measure fair value and that market quotes may be used when they are from an orderly, active market. Thus, **Microsoft** may determine the expected present value of the future cash flows of an investment by using its internal cash flow projections and a market rate of interest. By comparing the result to the current value of the investment, Microsoft can determine if an adjustment needs to be made to record a gain or loss.

In the sections that follow, we illustrate two useful applications of present value. These applications will be helpful in understanding the uses of present value that we discuss in later chapters.

## Valuing an Asset at Present Value

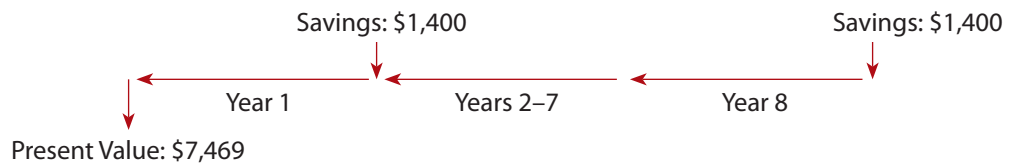
As already discussed, an asset is something that will provide future benefits to the company that owns it. Usually, the purchase price of an asset represents the present value of those future benefits. It is possible to evaluate a proposed purchase price by comparing it with the present value of the asset to the company.

### The Present Value of an Asset

**Measure** The present value of an asset is based on the saving it will generate over its useful life.

**Example** Mike Yeboah is thinking of buying a new machine that will reduce his annual labor cost by \$1,400 per year. The machine will last eight years. The interest rate that Yeboah assumes for making equipment purchases is 10 percent. What is the maximum amount (present value) that Yeboah should pay for the machine?

**Table Computation** The present value of the machine is equal to the present value of an ordinary annuity of \$1,400 per year for eight years at compound interest of 10 percent. Using the present value factor from Appendix B, we compute the present value as follows.



$$\begin{array}{rclcl} \text{Periodic Savings} & \times & \text{Factor} & = & \text{Present Value} \\ \$1,400 & \times & 5.335 & = & \$7,469 \end{array}$$

Yeboah should not pay more than \$7,469 for the machine because this amount equals the present value of the benefits he would receive from owning it.

## Present Value of a Deferred Payment

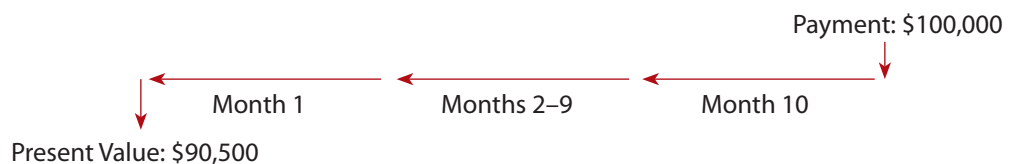
To encourage buyers to make a purchase, sellers sometimes agree to defer payment for a sale. This practice is common among companies that sell agricultural equipment to farmers who need new equipment in the spring but cannot pay for it until they sell their crops in the fall.

### Present Value of a Deferred Payment

**Measure** The present value is the amount of a payment to be received later.

**Example** Field Helpers Corporation sells a tractor to Sasha Ptak for \$100,000 on February 1 and agrees to take payment ten months later, on December 1. With such an agreement, the future payment includes not only the selling price but also an implied (imputed) interest cost.

**Table Computation** If the prevailing annual interest rate for such transactions is 12 percent compounded monthly, the actual price of the tractor would be the present value of the future payment, computed using the factor from Appendix B [10 periods, 1 percent (12 percent ÷ 12 months)], as follows.



$$\begin{array}{rclcl} \text{Future Payment} & \times & \text{Factor} & = & \text{Present Value} \\ \$100,000 & \times & 0.905 & = & \$90,500 \end{array}$$

Ptak records the present value, \$90,500, in his purchase records, and Field Helpers Corporation records it in its sales records. The balance consists of interest expense or interest income.

## Other Applications

Other applications of present value in accounting include the following:

- Computing imputed interest on non-interest-bearing notes
- Accounting for installment notes
- Valuing a bond
- Recording lease obligations
- Pension obligations
- Valuing debt
- Depreciating property, plant, and equipment
- Making capital expenditure decisions
- Accounting for any item in which time is a factor

## Current Liabilities and the Financial Statements

As presented in Exhibit 5, the application of *accrual accounting* to unearned revenues and accrued expenses impacts the amount of current liabilities on the balance sheet and revenues and expenses on the income statement.

**Exhibit 5**  
Accrued Expenses and  
Related Accrued Liabilities

Income Statement	Balance Sheet	
For the Year Ended December 31, 2014	December 31, 2014	
Net sales Operating expenses <b>Accrued expenses</b> Other revenues and expenses Net income	<b>Assets</b> Current assets Investments Property, plant, and equipment Intangible assets	<b>Liabilities</b> Current liabilities <b>Accrued liabilities</b> Other current liabilities Long-term liabilities Total liabilities <b>Owner's Equity</b> Owner's capital Total owner's equity  <b>Total Assets = Total Liabilities + Owner's Equity</b>

© Cengage Learning 2014

## APPLY IT!

Jerry owns a restaurant and has the opportunity to buy a high-quality espresso coffee machine for \$5,000. After carefully studying expected costs and revenues, Jerry estimates that the machine will produce a net cash inflow of \$1,600 annually and will last for five years. He determines that an interest rate of 10 percent is an adequate return on his investment.

Calculate the present value of the machine to Jerry. Based on your calculation, do you think Jerry would be wise to purchase the machine? Explain your answer.

### SOLUTION

Calculation of the present value:

Annual cash inflow	\$ 1,600.00
Factor from Table 2, Appendix B (5 years at 10%)	× 3.791
Present value of net cash flows	\$ 6,065.60
Less purchase price	−5,000.00
Net present value	<u>\$ 1,065.60</u>

The present value of the net cash flows from the machine exceeds the purchase price. Thus, the investment will return more than 10 percent to Jerry's business. A decision to purchase the machine would, therefore, be wise.

**TRY IT! SE8, E11A, E12A, E13A, E11B, E12B, E13B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Liquidity
- Cash flows

## RELEVANT LEARNING OBJECTIVE

**LO 6** Use ratio analysis to manage the impact of current liabilities' impact on liquidity.

## LO 6 Business Issues Related to Current Liabilities

The primary reason a company incurs current liabilities is to meet its needs for cash during the operating cycle. Failure to manage the cash flows related to current liabilities can have serious consequences for a business. For instance, if suppliers are not paid on time, they may withhold vital shipments. Continued failure to pay current liabilities can lead to bankruptcy.

## RATIO

### Working Capital and the Current Ratio

As explained in Chapter 6, the *operating cycle* is the length of time it takes to purchase inventory, sell the inventory, and collect the resulting receivable. Most current liabilities arise from purchases of inventory, accrued expenses arise from operating costs, and unearned revenues arise from customers' advance payments. Companies incur short-term debt to raise cash during periods of inventory buildup or while waiting for the collection of receivables. They use the cash to pay the portion of long-term debt that is currently due and to pay liabilities arising from operations.

To evaluate a company's ability to pay its current liabilities, analysts often use two measures of liquidity, both of which we defined in an earlier chapter:

- Working Capital = Current Assets – Current Liabilities
- Current Ratio = Current Assets ÷ Current Liabilities

As shown below (in millions), **Nike's** short-term liquidity as measured by working capital and the current ratio was positive in 2010 but decreased in 2011.

	Current Assets	–	Current Liabilities	=	Working Capital	Current Ratio*
2010	\$10,959	–	\$3,364	=	\$7,595	3.26**
2011	\$11,297	–	\$3,958	=	\$7,339	2.85**

\*Current Assets ÷ Current Liabilities  
\*\*Rounded

The decrease in Nike's working capital and current ratio was caused primarily by a large decrease in cash and equivalents and an increase in all current liabilities. Overall, Nike is in a strong current situation.

### Evaluating Accounts Payable

Another consideration in managing liquidity and cash flows is the time suppliers give a company to pay for purchases. Measurements commonly used to assess a company's ability to pay within a certain time frame are payables turnover and days' payable.

**Payables Turnover** **Payables turnover** is the number of times, on average, that a company pays its accounts payable in an accounting period. This measure reflects the relative size of accounts payable, the credit terms offered by suppliers, and a company's diligence in paying its suppliers.



To measure payables turnover for **Nike**, we must first calculate purchases by adjusting the cost of goods sold for the change in inventory.

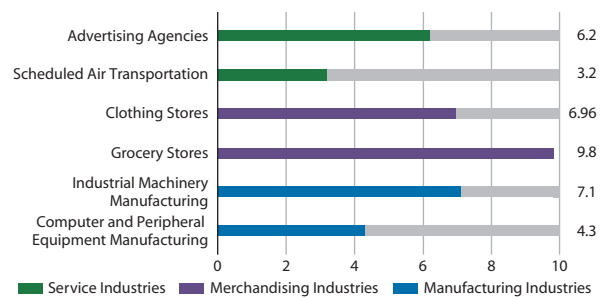
- ▲ An *increase* in inventory means purchases were more than the cost of goods sold.
- ▼ A *decrease* means purchases were less than the cost of goods sold.

Nike's cost of goods sold in 2011 was \$20,862 million, and its inventory increased by \$674 million. Using these data, we can compute Nike's payables turnover as follows (in millions).

### RATIO

## How Many Times Does a Company Pay Its Accounts Payable During an Accounting Period?

$$\begin{aligned} \text{Payables Turnover} &= \frac{\text{Cost of Goods Sold} \pm \text{Change in Merchandise Inventory}}{\text{Average Accounts Payable}} \\ &= \frac{\$20,862 + \$674}{[(\$1,255 + \$1,469) \div 2]} \\ &= \frac{\$21,536}{\$1,362} = 15.8 \text{ times} \end{aligned}$$



Based on Bizmin Industry Financial Report, December 2011.

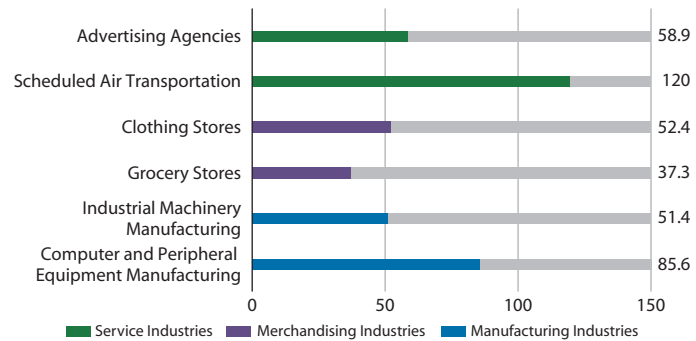
As you can see, Nike's payables turnover is greater than the industries illustrated. This indicates that Nike pays its suppliers very quickly.

**Days' Payable** **Days' payable** shows how long, on average, a company takes to pay its accounts payable. For **Nike**, it is computed as follows.

## RATIO

## How Many Days Did It Take to Pay Accounts Payable?

$$\text{Days' Payable} = \frac{365 \text{ days}}{\text{Payables Turnover}} = \frac{365 \text{ days}}{15.8 \text{ times}} = 23.1 \text{ days}$$



Based on Bizmin Industry Financial Report, December 2011.

As shown, Nike's days' payable of 23.1 days, like its payables turnover of 15.8 times, indicates that Nike is prompt in paying its suppliers.

## APPLY IT!

Jackie's Cookie Company has current assets of \$30,000 and current liabilities of \$20,000, of which accounts payable are \$15,000. Jackie's cost of goods sold is \$125,000, its merchandise inventory increased by \$5,000, and accounts payable were \$11,000 the prior year. Calculate Jackie's working capital, payables turnover, and days' payable.

### SOLUTION

$$\begin{aligned} \text{Working Capital} &= \text{Current Assets} - \text{Current Liabilities} \\ &= \$30,000 - \$20,000 \\ &= \$10,000 \end{aligned}$$

$$\begin{aligned} \text{Payables Turnover} &= \frac{\text{Cost of Goods Sold} \pm \text{Change in Inventory}}{\text{Average Accounts Payable}} \\ &= \frac{\$125,000 + \$5,000}{(\$15,000 + \$11,000) \div 2} = \frac{\$130,000}{\$13,000} \\ &= 10 \text{ Times} \end{aligned}$$

$$\begin{aligned} \text{Days' Payable} &= 365 \text{ days} \div \text{Payables Turnover} \\ &= \frac{365 \text{ days}}{10 \text{ times}} = 36.5 \text{ days} \end{aligned}$$

### TRY IT! SE9, E15A, E15B

## TriLevel Problem



kristian.sekalic/stockphoto.com

**Teresa's Fitness Center**

### Identification and Evaluation of Current Liabilities, Contingencies, and Commitments

The beginning of this chapter focused on Teresa Madej, the owner of Teresa's Fitness Center, who was anxious to assess her company's status at the end of the first year of operations. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*How do the concepts of recognition, valuation, classification, and disclosure apply to current liabilities?*

#### Section 2: Accounting Applications

Madej has not yet filed any tax reports for her business and, therefore, owes taxes. Because she has limited experience in running a business, she has brought you all her business records—a checkbook, canceled checks, deposit slips, suppliers' invoices, a notice of annual property taxes of \$3,600 due to the city, and a promissory note to her bank for \$16,000. She wants you to determine what her business owes the government and other parties.

You analyzed all her records and determined the following as of December 31, 2014:

Unpaid invoices for nutritional supplements	\$12,000
Sales of nutritional supplements (excluding sales tax)	57,000
Cost of supplements sold	33,600
Exercise instructors' salaries	22,800
Exercise revenues	81,400
Current assets	40,000
Supplements inventory, December 31, 2014	27,000
Supplements inventory, December 31, 2013	21,000

You learned that the company sold gift certificates in the amount of \$700 that have not been redeemed and that it deducted \$1,374 from its two employees' salaries for federal income taxes owed to the government. The current social security tax is 6.2 percent on maximum earnings of \$110,100 for each employee, and the current Medicare tax is 1.45 percent (no maximum earnings). The FUTA tax is 5.4 percent to the state and 0.8 percent to the federal government on the first \$7,000 earned by each employee; both employees earned more than \$7,000. Madej has not filed a sales tax report to the state (6 percent of supplements sales).

*What are the company's current liabilities and their total amount? (Ignore tax on company income.)*

**RATIO**

#### Section 3: Business Applications

*Why is it important for Teresa Madej to identify and account for all her company's current liabilities? To answer this question, evaluate the company's liquidity by calculating working capital, payables turnover, and days' payable. Comment on the results. (Note: Assume average accounts payable were the same as year-end accounts payable.)*

## SOLUTION

#### Section 1: Concepts

First of all, generally accepted accounting principles require that a liability be recorded when an obligation occurs, which refers to the *recognition* of liabilities. In addition, liabilities must be properly *valued*, which refers to knowing or properly estimating the amount of money needed to pay the debt. Furthermore, because of the impact that *classification* can have on a company's reported liquidity, it is very important to distinguish between



It is important for Teresa Madej to identify and account for all her current liabilities because these amounts are taken into consideration when evaluating her company's liquidity. Working capital shows a company's ability to pay its current liabilities. Payables turnover shows the relative size of accounts payable, the credit terms offered by suppliers, and a company's diligence in paying its suppliers, and days' payable shows how long, on average, a company takes to pay its accounts payables.

Teresa's Fitness Center has a negative working capital of \$1,495.40, its payables turnover is only 3.3 times, and it takes an average of 110.6 days to pay its accounts payable. Its liquidity is, therefore, highly questionable. Many of its current assets are inventory, which it must sell to generate cash, and it must pay most of its current liabilities sooner than the 110.6 days would indicate.

## Chapter Review

**Define current liabilities, and identify the concepts underlying them.** **LO 1**

Liabilities result from past transactions and should be recognized at the time a transaction obligates a company to make future payments. They are valued at the amount of money necessary to satisfy the obligation or at the fair value of the goods or services to be delivered. Liabilities are classified as current or long-term. Companies are required to provide supplemental disclosure when the nature or details of the obligations would help in understanding the liability.

**Identify, compute, and record definitely determinable and estimated current liabilities.** **LO 2**

The two major categories of current liabilities are definitely determinable liabilities and estimated liabilities. Definitely determinable liabilities include accounts payable, bank loans and commercial paper, notes payable, accrued liabilities, dividends payable, sales and excise taxes payable, the current portion of long-term debt, payroll liabilities, and unearned revenues. Estimated liabilities definitely exist, but their amounts are uncertain and must be estimated. They include liabilities for income taxes, property taxes, promotional costs, product warranties, and vacation pay.

**Distinguish contingent liabilities from commitments.** **LO 3**

A contingent liability is a potential liability that arises from a past transaction and is dependent on a future event. Contingent liabilities often involve lawsuits, income tax disputes, discounted notes receivable, guarantees of debt, and failure to follow government regulations. A commitment is a legal obligation, such as a purchase agreement, that is not recorded as a liability.

**Identify the valuation approaches to fair value accounting, define time value of money and interest, and apply them to present values.** **LO 4**

The FASB identifies three approaches to measuring fair value. The market approach is useful when there is an active market in which quoted prices are available for the specific asset or liability. The income (or cash flow) approach converts future cash flows to a single present value. The cost approach is based on the amount that currently would be required to replace an asset with a comparable one.

The time value of money refers to the costs or benefits derived from holding or not holding money over time. Interest is the cost of using money for a specific period. The amount on which simple interest is computed stays the same from period to period. In the computation of compound interest, the interest for a period is added to the principal amount before the interest for the next period is computed.

Future value is the amount an investment will be worth at a future date if invested at compound interest. Present value is the amount that must be invested today at a given rate of interest to produce a given future value. An ordinary annuity is a series of equal payments made at the end of equal intervals of time, with compound interest on the payments. The present value of an ordinary annuity is the present value of a series of payments. Calculations of present values are simplified by using the appropriate tables, which appear in an appendix to this book.

Apply the present value concept to simple valuation situations. **LO 5**

Present value is commonly used in determining fair value and may be used in determining the value of an asset, in computing the present value of deferred payments, and in establishing a fund for loan repayment. Present value can also be applied to numerous other accounting situations in which time is a factor.

Use ratio analysis to manage the impact of current liabilities' impact on liquidity. **LO 6**

Current liabilities are an important consideration in managing a company's liquidity and cash flows. Key measures of liquidity are working capital, payables turnover, and days' payable.

## Key Terms and Ratios

**accounts payable** 412 (LO2)  
**accrued liabilities** 414 (LO2)  
**cash dividends** 414 (LO2)  
**commercial paper** 413 (LO2)  
**commitment** 425 (LO3)  
**compound interest** 426 (LO4)  
**contingent liability** 424 (LO3)  
**current liabilities** 410 (LO1)  
**definitely determinable liabilities** 412 (LO2)

**employee** 416 (LO2)  
**estimated liabilities** 420 (LO2)  
**future value** 426 (LO4)  
**independent contractor** 416 (LO2)  
**interest** 426 (LO4)  
**line of credit** 411 (LO1)  
**long-term liabilities** 410 (LO1)  
**ordinary annuity** 429 (LO4)  
**present value** 427 (LO4)  
**promissory notes** 412 (LO2)

**salaries** 415 (LO2)  
**short-term notes payable** 412 (LO2)  
**simple interest** 426 (LO4)  
**time value of money** 426 (LO4)  
**unearned revenues** 418 (LO2)  
**wages** 415 (LO2)

### RATIOS

**days' payable** 434 (LO6)  
**payables turnover** 433 (LO6)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1, 2** **DQ1. CONCEPT** ► James Williams, a star college basketball player, received a contract from the Midwest Blazers to play professional basketball. The contract calls for a salary of \$420,000 a year for four years, dependent on his making the team in each of those years. Should this contract be considered a liability and recorded on the books of the basketball team? Why or why not?
- LO 1, 3** **DQ2. CONCEPT** ► When would a commitment be recognized in the accounting records?
- LO 2** **DQ3.** Do adjusting entries involving estimated liabilities and accruals ever affect cash flows?
- LO 4** **DQ4.** Is a friend who borrows money from you for three years and agrees to pay you interest after each year paying you simple or compound interest?
- LO 4** **DQ5.** Ordinary annuities assume that the first payment is made at the end of each year. In a transaction, who is better off in this arrangement, the payer or the receiver? Why?
- LO 4, 5** **DQ6.** Why is present value one of the most useful concepts in making business decisions?
- LO 6** **DQ7. BUSINESS APPLICATION** ► Is increasing payables turnover good or bad for a company? Why or why not?



## SHORT EXERCISES

LO 1, 6

CASH FLOW

### Issues in Accounting for Liabilities

**SE1. CONCEPT** ▶ Indicate whether each of the following actions relates to (a) managing liquidity and cash flow, (b) recognition of liabilities, (c) valuation of liabilities, (d) classification of liabilities, or (e) disclosure of liabilities:

1. Determining that a liability will be paid in less than one year.
2. Estimating the amount of a liability.
3. Providing information about when liabilities are due and their interest rates.
4. Determining when a liability arises.
5. Assessing working capital and payables turnover.

LO 2

### Interest Expense on Note Payable

**SE2.** On the last day of August, Broadway Company borrowed \$120,000 on a bank note for 60 days at 10 percent interest. Assume that interest is stated separately. Prepare the following journal entries: (1) August 31, recording of note; and (2) October 30, payment of note plus interest. (Round to the nearest cent.)

LO 2

### Payroll Expenses

**SE3.** The following payroll totals for the month of April are from the payroll register of Myth Corporation: salaries, \$446,000; federal income taxes withheld, \$62,880; Social Security tax withheld, \$27,652; Medicare tax withheld, \$6,467; medical insurance deductions, \$13,160; and salaries subject to unemployment taxes, \$313,200.

Determine the total and components of (1) the monthly payroll and (2) employer payroll expenses, assuming Social Security and Medicare taxes equal to the amounts for employees, a federal unemployment insurance tax of 0.8 percent, a state unemployment tax of 5.4 percent, and medical insurance premiums for which the employer pays 80 percent of the cost.

LO 2

### Product Warranty Liability

**SE4.** Maiden Corp. manufactures and sells travel clocks. Each clock costs \$12.50 to produce and sells for \$25. In addition, each clock carries a warranty that provides for free replacement if it fails during the two years following the sale. In the past, 5 percent of the clocks sold have had to be replaced under the warranty. During October, Maiden sold 52,000 clocks, and 2,800 clocks were replaced under the warranty. Prepare journal entries to record the estimated liability for product warranties during the month and the clocks replaced under warranty during the month.

LO 2, 3

### Types of Liabilities

**SE5.** Indicate whether each of the following is (a) a definitely determinable liability, (b) an estimated liability, (c) a commitment, or (d) a contingent liability:

1. Dividends payable
2. Pending litigation
3. Income taxes payable
4. Current portion of long-term debt
5. Vacation pay liability
6. Guaranteed loans of another company
7. Purchase agreement

LO 4

### Simple and Compound Interest

**SE6.** Maruti Motors, Inc., receives a one-year note that carries a 12 percent annual interest rate on \$3,000 for the sale of a used car. Compute the maturity value under each of the following assumptions: (1) Simple interest is charged. (2) The interest is compounded semiannually. (3) The interest is compounded quarterly. (Round to the nearest cent.)

**LO 4 Present Value Calculations**

**SE7.** Find the present value of (1) a single payment of \$24,000 at 6 percent for 12 years, (2) 12 annual payments of \$2,000 at 6 percent, (3) a single payment of \$5,000 at 9 percent for five years, and (4) five annual payments of \$5,000 at 9 percent. (*Hint:* Use Tables 1 and 2 in Appendix B.)

**LO 4, 5 Valuing an Asset for the Purpose of Making a Purchasing Decision**

**SE8. ACCOUNTING CONNECTION** ▶ Luke Ricci owns a machine shop and has the opportunity to purchase a new machine for \$60,000. After carefully studying projected costs and revenues, Ricci estimates that the new machine will produce a net cash flow of \$14,400 annually and will last for eight years. Ricci believes that an interest rate of 10 percent is adequate for his business.

Calculate the present value of the machine to Ricci. Does the purchase appear to be a smart business decision? Why? (*Hint:* Use Table 2 in Appendix B.)

**LO 6 Measuring Short-Term Liquidity****RATIO**

**SE9. BUSINESS APPLICATION** ▶ Luster Company has current assets of \$130,000 and current liabilities of \$80,000, of which accounts payable are \$70,000. Luster's cost of goods sold is \$460,000, its merchandise inventory increased by \$20,000, and accounts payable were \$50,000 the prior year. Calculate Luster's working capital, payables turn-over, and days' payable. (Round to one decimal place.)

**EXERCISES: SET A****LO 1, 6****CASH FLOW****Issues in Accounting for Liabilities**

**E1A. CONCEPT** ▶ Indicate whether each of the following actions relates to (a) managing liquidity and cash flows, (b) recognition of liabilities, (c) valuation of liabilities, (d) classification of liabilities, or (e) disclosure of liabilities:

1. Providing information about financial instruments on the balance sheet.
2. Measuring working capital.
3. Setting a liability at the fair market value of goods to be delivered.
4. Relating the payment date of a liability to the length of the operating cycle.
5. Recording a liability in accordance with the accrual accounting.
6. Estimating the amount of "cents-off" coupons that will be redeemed.
7. Categorizing a liability as long-term debt.
8. Comparing days' payable with last year.

**LO 2 Interest Expense on Note Payable**

**E2A.** On the last day of October, Lake Company borrows \$60,000 on a bank note for 60 days at 12 percent interest. Interest is not included in the face amount. Prepare the following journal entries: (1) October 31, recording of note; (2) November 30, accrual of interest expense (round to the nearest cent); and (3) December 30, payment of note plus interest.

**LO 2 Sales and Excise Taxes**

**E3A.** Lindstrom Design Services billed its customers a total of \$245,100 for the month of August, including 9 percent federal excise tax and 5 percent sales tax.

1. Determine the proper amount of service revenue to report for the month.
2. Prepare a journal entry to record the revenue and related liabilities for the month.

**LO 2 Payroll Expenses**

**E4A.** At the end of October, the payroll register for Noir Tool Corporation contained the following totals: wages, \$371,000; federal income taxes withheld, \$94,884; state income taxes withheld, \$15,636; Social Security tax withheld, \$23,002; Medicare tax

*(Continued)*

withheld, \$5,379.50; medical insurance deductions, \$12,870; and wages subject to unemployment taxes, \$57,240.

Determine the total and components of the (1) monthly payroll and (2) employer payroll expenses, assuming Social Security and Medicare taxes equal to the amount for employees, a federal unemployment insurance tax of 0.8 percent, a state unemployment tax of 5.4 percent, and medical insurance premiums for which the employer pays 80 percent of the cost.

#### LO 2 Product Warranty Liability

**E5A.** Boulware Company manufactures and sells electronic games. Each game costs \$25 to produce, sells for \$45, and carries a warranty that provides for free replacement if it fails during the two years following the sale. In the past, 7 percent of the games sold had to be replaced under the warranty. During July, Boulware sold 13,000 games, and 1,400 games were replaced under the warranty.

1. Prepare a journal entry to record the estimated liability for product warranties during the month.
2. Prepare a journal entry to record the games replaced under warranty during the month.

#### LO 2 Vacation Pay Liability

**E6A.** Funz Corporation gives three weeks' paid vacation to each employee who has worked at the company for one year. Based on studies of employee turnover and previous experience, management estimates that 65 percent of the employees will qualify for vacation pay this year.

1. Assume that Funz's July payroll is \$300,000, of which \$20,000 is paid to employees on vacation. Figure the estimated employee vacation benefit for the month. (Round to the nearest thousandth.)
2. Prepare a journal entry to record the employee benefit for July.
3. Prepare a journal entry to record the pay to employees on vacation.

#### LO 3 Contingencies and Commitments

**E7A.** Indicate whether each of the following related to an airline company relates to (a) contingency or (b) commitment:

1. The company has agreed to purchase 10 new airplanes over the next three years.
2. The company has a lawsuit pending against it.

#### LO 4 Determining an Advance Payment

**E8A.** Katie Davis is contemplating paying five years' rent in advance. Her annual rent is \$12,600. Calculate the single sum that would have to be paid now for the advance rent. Assume compound interest of 8 percent. (*Hint:* Use Table 2 in Appendix B.)

#### LO 4 Present Value Calculations

**E9A.** Find the present value of (1) a single payment of \$12,000 at 6 percent for 12 years, (2) 12 annual payments of \$1,000 at 6 percent, (3) a single payment of \$2,500 at 9 percent for five years, and (4) 5 annual payments of \$2,500 at 9 percent. (*Hint:* Use Tables 1 and 2 in Appendix B.)

#### LO 4 Present Value of a Lump-Sum Contract

**E10A.** A contract calls for a lump-sum payment of \$30,000. Find the present value of the contract, assuming that (1) the payment is due in five years and the current interest rate is 9 percent; (2) the payment is due in ten years and the current interest rate is 9 percent; (3) the payment is due in five years and the current interest rate is 5 percent; and (4) the payment is due in ten years and the current interest rate is 5 percent. (*Hint:* Use Table 1 in Appendix B.)

LO 4, 5 **Present Value of an Annuity Contract**

**E11A.** A contract calls for annual payments of \$2,400. Find the present value of the contract, assuming that (1) the number of payments is 7 and the current interest rate is 6 percent; (2) the number of payments is 14 and the current interest rate is 6 percent; (3) the number of payments is 7 and the current interest rate is 8 percent; and (4) the number of payments is 14 and the current interest rate is 8 percent. (*Hint:* Use Table 2 in Appendix B.)

LO 4, 5 **Valuing an Asset for the Purpose of Making a Purchasing Decision**

**E12A. ACCOUNTING CONNECTION** ► Sid Patel owns a service station and has the opportunity to purchase a car-wash machine for \$15,000. After carefully studying projected costs and revenues, Patel estimates that the car-wash machine will produce a net cash flow of \$2,600 annually and will last for eight years. He determines that an interest rate of 14 percent is adequate for his business. Calculate the present value of the machine to Patel. (*Hint:* Use Table 2 in Appendix B.) Does the purchase appear to be a smart business decision? Why?

LO 4, 5 **Deferred Payment**

**E13A.** Alligood Equipment Corporation sold a precision tool machine with computer controls to Kauai Corporation for \$400,000 on January 2 and agreed to take payment nine months later on October 2. Assuming that the prevailing annual interest rate for such a transaction is 16 percent compounded quarterly, what is the actual sale (purchase) price of the machine tool? (*Hint:* Use Table 1 in Appendix B.)

LO 4, 5 **Negotiating the Sale of a Business**



**E14A.** Helen Knight is attempting to sell her business to Chris Bosh. The company has assets of \$1,800,000, liabilities of \$1,600,000, and owner's equity of \$200,000. Both parties agree that the proper rate of return to expect is 12 percent; however, they differ on other assumptions. Knight believes that the business will generate at least \$200,000 per year of cash flows for 20 years. Bosh thinks that \$160,000 in cash flows per year is more reasonable and that only 10 years in the future should be considered. Determine the range for negotiation by computing the present value of Knight's offer to sell and of Bosh's offer to buy. (*Hint:* Use Table 2 in Appendix B.)

LO 6 **Measuring Short-Term Liquidity**



**E15A. BUSINESS APPLICATION** ► In 2013, Copia Company had current assets of \$155,000 and current liabilities of \$100,000, of which accounts payable were \$65,000. Cost of goods sold was \$425,000, merchandise inventory increased by \$40,000, and accounts payable were \$55,000 in the prior year. In 2014, Copia had current assets of \$210,000 and current liabilities of \$160,000, of which accounts payable were \$75,000. Cost of goods sold was \$475,000, and merchandise inventory decreased by \$15,000. Calculate Copia's working capital, payables turnover, and days' payable for 2013 and 2014. Assess Copia's liquidity and cash flows in relation to the change in payables turnover from 2013 to 2014. (Round to one decimal place.)

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

LO 1, 2, 3

### Identification of Current Liabilities, Contingencies, and Commitments

**P1.** Common types of current liabilities, contingencies, and commitments follow.

- |                                      |                               |
|--------------------------------------|-------------------------------|
| a. Accounts payable                  | i. Income taxes payable       |
| b. Bank loans and commercial paper   | j. Property taxes payable     |
| c. Notes payable                     | k. Promotional costs          |
| d. Dividends payable                 | l. Product warranty liability |
| e. Sales and excise taxes payable    | m. Vacation pay liability     |
| f. Current portion of long-term debt | n. Contingent liability       |
| g. Payroll liabilities               | o. Commitment                 |
| h. Unearned revenues                 |                               |

### REQUIRED

- For each of the following statements, identify the type of current liability, contingency, or commitment to which it gives rise or with which it is most closely associated:
  - A company agrees to replace parts of a product if they fail.
  - An employee earns one day off for each month worked.
  - A company signs a contract to lease a building for five years.
  - A company puts discount coupons in the newspaper.
  - A company agrees to pay insurance costs for employees.
  - A portion of a mortgage on a building is due this year.
  - The board of directors declares a dividend.
  - A company has trade payables.
  - A company has a pending lawsuit against it.
  - A company arranges for a line of credit.
  - A company signs a note due in 60 days.
  - A company operates in a state that has a sales tax.
  - A company earns a profit that is taxable.
  - A company owns buildings that are subject to property taxes.

- ACCOUNTING CONNECTION** ► Of the items listed from a to o, which ones would you not expect to see listed on the balance sheet with a dollar amount? Of those items that would be listed on the balance sheet with a dollar amount, which ones would you consider to involve the most judgment or discretion on the part of management?

LO 2

### Notes Payable and Wages Payable

**P2.** Part A: Blue Blaze Company, whose fiscal year ends December 31, completed the following transactions involving notes payable:

2013

- Nov. 25 Purchased a new loading cart by issuing a 60-day 10 percent note for \$43,200.
- Dec. 31 Made the end-of-year adjusting entry to accrue interest expense. (Round to the nearest cent.)

2014

- Jan. 24 Paid off the loading cart note. (Round to the nearest cent.)

### REQUIRED

- Prepare journal entries for Blue Blaze's notes payable transactions.
- ACCOUNTING CONNECTION** ► When notes payable appears on the balance sheet, what other current liability would you look for to be associated with the notes? What would it mean if this other current liability did not appear?

**Part B:** At the end of October, the payroll register for Blue Blaze Company contained the following totals: wages, \$92,750; federal income taxes withheld, \$23,721; state

SPREADSHEET

GENERAL LEDGER

- ✓ 1: Part A: December 31 Interest Expense: \$426.08  
 ✓ 2: Part B: October 31 Payroll Taxes and Benefits Expense: \$23,444.88

income taxes withheld, \$3,909; Social Security tax withheld, \$5,751; Medicare tax withheld, \$1,345; medical insurance deductions, \$3,200; and wages subject to unemployment taxes, \$57,240.

### REQUIRED

Prepare journal entries to record the (1) monthly payroll and (2) employer payroll expenses, assuming Social Security and Medicare taxes equal to the amount for employees, a federal unemployment insurance tax of 0.8 percent, a state unemployment tax of 5.4 percent, and medical insurance premiums for which the employer pays 80 percent of the cost.

### LO 2

#### GENERAL LEDGER

✓ 2: End of month estimated product warranty liability: \$168,160

### Product Warranty Liability

**P3.** Reliance Company manufactures and sells wireless video cell phones, which it guarantees for five years. If a cell phone fails, it is replaced free, but the customer is charged a service fee for handling. In the past, management has found that only 3 percent of the cell phones sold required replacement under the warranty. The average cell phone costs the company \$240. At the beginning of September, the account for estimated liability for product warranties had a credit balance of \$208,000. During September, 250 cell phones were returned under the warranty. The company collected \$9,860 of service fees for handling. During the month, the company sold 2,800 cell phones.

### REQUIRED

1. Prepare journal entries to record (a) the cost of cell phones replaced under warranty and (b) the estimated liability for product warranties for cell phones sold during the month.
2. Compute the balance of the Estimated Product Warranty Liability account at the end of the month.
3. **ACCOUNTING CONNECTION** ► If the company's product warranty liability is underestimated, what are the effects on current and future years' income?

### LO 2, 6

#### RATIO

✓ 1: Total current liabilities: \$20,152.10

### Identification and Evaluation of Current Liabilities

**P4.** Stan Styka opened a small dryer repair shop, Styka Repair Shop, on January 2, 2014. The shop also sells a limited number of dryer parts. In January 2015, Styka realized he had never filed any tax reports for his business and therefore probably owes a considerable amount of taxes. Since he has limited experience in running a business, he has brought you all his business records, including a checkbook, canceled checks, deposit slips, suppliers' invoices, a notice of annual property taxes of \$2,310 due to the city, and a promissory note to his father-in-law for \$2,500. He wants you to determine what his business owes the government and other parties (but not employees).

You analyze all his records and determine the following as of December 31, 2014:

Unpaid invoices for dryer parts	\$ 9,000
Parts sales (excluding sales tax)	44,270
Cost of parts sold	31,125
Workers' salaries	18,200
Repair revenues	60,300
Current assets	16,300
Dryer parts inventory	11,750

You learn that the company has deducted \$476 from the two employees' salaries for federal income taxes owed to the government. The current Social Security tax is 6.2 percent on maximum earnings of \$110,100 for each employee, and the current Medicare tax is 1.45 percent (no maximum earnings). The FUTA tax is 5.4 percent to the state and .8 percent to the federal government on the first \$7,000 earned by each employee, and each employee earned more than \$7,000. Styka has not filed a sales tax report to the state (5 percent of sales).

(Continued)



**REQUIRED**

1. Determine Styka Repair Shop's current liabilities as of December 31, 2014.
2. **ACCOUNTING CONNECTION** ► What additional information would you want from Styka to satisfy yourself that all current liabilities have been identified?
3. **BUSINESS APPLICATION** ► Evaluate Styka's liquidity by calculating working capital, payables turnover, and days' payable. (Round to one decimal place.) Comment on the results. (Assume average accounts payable were the same as year-end accounts payable.)

LO 4, 5

SPREADSHEET

- ✓ 1a: Present value of liability: \$187,750  
 ✓ 1b: Cost of buyout: \$79,250

**Applications of Present Value**

**P5.** Austin Corporation's management took the following actions, which went into effect on January 2, 2014. Each action involved an application of present value.

- a. Austin Corporation enters into a purchase agreement that calls for a payment of \$250,000 three years from now.
- b. Bought out the contract of a member of top management for a payment of \$25,000 per year for four years beginning January 2, 2015.

**REQUIRED**

1. Assuming an annual interest rate of 10 percent and using Tables 1 and 2 in Appendix B, answer the following questions:
  - a. In action **a**, what is the present value of the liability for the purchase agreement?
  - b. In action **b**, what is the cost (present value) of the buyout?
2. **ACCOUNTING CONNECTION** ► Many businesses analyze present value extensively when making decisions about investing in long-term assets. Why is this type of analysis particularly appropriate for such decisions?

**ALTERNATE PROBLEMS**

LO 1, 2, 3

**Identification of Current Liabilities, Contingencies, and Commitments**

**P6.** Common types of current liabilities, contingencies, and commitments follow.

- |                                      |                               |
|--------------------------------------|-------------------------------|
| a. Accounts payable                  | i. Income taxes payable       |
| b. Bank loans and commercial paper   | j. Property taxes payable     |
| c. Notes payable                     | k. Promotional costs          |
| d. Dividends payable                 | l. Product warranty liability |
| e. Sales and excise taxes payable    | m. Vacation pay liability     |
| f. Current portion of long-term debt | n. Contingent liability       |
| g. Payroll liabilities               | o. Commitment                 |
| h. Unearned revenues                 |                               |

**REQUIRED**

1. For each of the following statements, identify the type of current liability, contingency, or commitment to which it gives rise or with which it is most closely associated:
  1. The board of directors declares a dividend.
  2. A company signs a note due in 60 days.
  3. A company has a pending lawsuit against it.
  4. A company signs a contract to lease a building for five years.
  5. A company arranges for a line of credit.
  6. A company agrees to pay insurance costs for employees.
  7. A portion of a mortgage on a building is due this year.
  8. A company agrees to replace parts of a product if they fail.
  9. A company has trade payables.
  10. A company operates in a state that has a sales tax.
  11. A company puts discount coupons in the newspaper.
  12. A company earns a profit that is taxable.

13. A company owns buildings that are subject to property taxes.
  14. An employee earns one day off for each month worked.
2. **ACCOUNTING CONNECTION** ▶ Of the items listed from a to o, which ones would you not expect to see listed on the balance sheet with a dollar amount? Of those items that would be listed on the balance sheet with a dollar amount, which ones would you consider to involve the most judgment or discretion on the part of management?

## LO 2

SPREADSHEET

GENERAL LEDGER

- ✓ 1: Part A: June 30 Interest Expense: \$552.33
- ✓ 2: Part B: July 31 Payroll Taxes and Benefits Expense: \$70,334.64

**Notes Payable and Wages Payable**

**P7.** Part A: Candlelight Corporation, whose fiscal year ended June 30, 2014, completed the following transactions involving notes payable:

- May 21 Obtained a 60-day extension on an \$36,000 trade account payable owed to a supplier by signing a 60-day \$36,000 note. Interest is in addition to the face value, at the rate of 14 percent.
- June 30 Made the end-of-year adjusting entry to accrue interest expense. (Round to the nearest cent.)
- July 20 Paid off the note plus interest due the supplier. (Round to the nearest cent.)

**REQUIRED**

1. Prepare journal entries for the notes payable transactions.
2. **ACCOUNTING CONNECTION** ▶ When notes payable appears on the balance sheet, what other current liability would you look for to be associated with the notes? What would it mean if this other current liability did not appear?

**Part B:** The payroll register for Candlelight Corporation contained the following totals at the end of July: wages, \$278,250; federal income taxes withheld, \$71,163; state income taxes withheld, \$11,727; Social Security tax withheld, \$17,253; Medicare tax withheld, \$4,035; medical insurance deductions, \$9,600; and wages subject to unemployment taxes, \$171,720.

**REQUIRED**

Prepare journal entries to record the (1) monthly payroll and (2) employer payroll expenses, assuming Social Security and Medicare taxes equal to the amount for employees, a federal unemployment insurance tax of 0.8 percent, a state unemployment tax of 5.4 percent, and medical insurance premiums for which the employer pays 80 percent of the cost.

## LO 2

GENERAL LEDGER

- ✓ 2: End of the month estimated product warranty liability: \$21,870

**Product Warranty Liability**

**P8.** Treotech Company is engaged in the retail sale of high-definition televisions (HDTVs). Each HDTV has a 24-month warranty on parts. If a repair under warranty is required, a charge for the labor is made. Management has found that 20 percent of the HDTVs sold require some work before the warranty expires. Furthermore, the average cost of replacement parts has been \$120 per repair. At the beginning of January, the account for the estimated liability for product warranties had a credit balance of \$28,600. During January, 112 HDTVs were returned under the warranty. The cost of the parts used in repairing the HDTVs was \$17,530, and \$18,884 was collected as service revenue for the labor involved. During January, the month before the Super Bowl, Treotech sold 450 new HDTVs.

**REQUIRED**

1. Prepare journal entries to record each of the following: (a) the warranty work completed during the month, including related revenue; (b) the estimated liability for product warranties for HDTVs sold during the month.
2. Compute the balance of the Estimated Product Warranty Liability account at the end of the month.
3. **ACCOUNTING CONNECTION** ▶ If the company's product warranty liability is overestimated, what are the effects on current and future years' income?

## LO 1

## RATIO

✓ 1: Total current liabilities:  
\$36,988.20

### Identification and Evaluation of Current Liabilities

**P9.** Daisy Luna opened a small motorcycle repair shop, Luna Cycle Repair, on January 2, 2014. The shop also sells a limited number of motorcycle parts. In January 2015, Luna realized she had never filed any tax reports for her business and therefore probably owes a considerable amount of taxes. Since she has limited experience in running a business, she has brought you all her business records, including a checkbook, canceled checks, deposit slips, suppliers' invoices, a notice of annual property taxes of \$4,620 due to the city, and a promissory note to her father-in-law for \$5,000. She wants you to determine what her business owes the government and other parties (but not employees).

You analyze all her records and determine the following as of December 31, 2014:

Unpaid invoices for motorcycle parts	\$ 18,000
Parts sales (excluding sales tax)	88,540
Cost of parts sold	62,250
Workers' salaries	20,400
Repair revenues	120,600
Current assets	32,600
Motorcycle parts inventory	23,500

You learn that the company has deducted \$952 from the two employees' salaries for federal income taxes owed to the government. The current Social Security tax is 6.2 percent on maximum earnings of \$110,100 for each employee, and the current Medicare tax is 1.45 percent (no maximum earnings). The FUTA tax is 5.4 percent to the state and 0.8 percent to the federal government on the first \$7,000 earned by each employee, and each employee earned more than \$7,000. Luna has not filed a sales tax report to the state (5 percent of sales).

#### REQUIRED

- Determine Luna Cycle Repair's current liabilities as of December 31, 2014.
- ACCOUNTING CONNECTION** ► What additional information would you want from Luna to satisfy yourself that all current liabilities have been identified?
- BUSINESS APPLICATION** ► Evaluate Luna's liquidity by calculating working capital, payables turnover, and days' payable. (Round to one decimal place.) Comment on the results. (Assume average accounts payable were the same as year-end accounts payable.)

## LO 4, 5

## SPREADSHEET

✓ 1a: Present value of initial deposit: \$110,250  
✓ 1b: Purchase price: \$393,300

### Applications of Present Value

**P10.** Lisette, Inc.'s management took the following actions that went into effect on January 2, 2014. Each action involved an application of present value.

- Asked for another fund to be established by a single payment to accumulate to \$150,000 in four years.
- Approved the purchase of a parcel of land for future plant expansion. Payments are to start January 2, 2014, at \$100,000 per year for five years.

#### REQUIRED

- Assuming an annual interest rate of 8 percent and using Tables 1 and 2 in Appendix B, answer the following questions:
  - In action **a**, how much will need to be deposited initially to accumulate the desired amount?
  - In action **b**, what is the purchase price (present value) of the land?
- ACCOUNTING CONNECTION** ► What is the fundamental reason present value analysis is a useful tool in making business decisions?

## CASES

### LO 2 Conceptual Understanding: Frequent Flyer Plan

**C1. CONCEPT** ► JetFly Airways instituted a frequent flyer program in which passengers accumulate points toward a free flight based on the number of miles they fly on the airline. One point was awarded for each mile flown, and a minimum of 750 miles was awarded for any one flight. Because of competition in 2014, the company began a bonus plan in which passengers receive triple the normal mileage points. In the past, about 1.5 percent of passenger miles were flown by passengers who had converted points to free flights; with the triple mileage program, JetFly expects that the rate will increase to 2.5 percent.

During 2014, the company had passenger revenues of \$966.3 million and passenger transportation operating expenses of \$802.8 million before depreciation and amortization. Operating income was \$86.1 million. What is the appropriate rate to use to estimate free miles? What effect would the estimated liability for free travel by frequent flyers have on 2014 net income? Describe several ways to estimate the amount of this liability. Be prepared to discuss the arguments for and against recognizing this liability.

### LO 3 Conceptual Understanding: Lawsuits and Contingent Liabilities

**C2. CONCEPT** ► When faced with lawsuits, many companies recognize a loss and therefore credit a liability or reserve account for any future losses that may result. For instance, in the famous **WorldCom** case, **Citibank**, one of the world's largest financial services firms, announced it was setting up reserves or liabilities of \$5.6 billion because of pending lawsuits due to its relationship with WorldCom.<sup>14</sup> Were these pending lawsuits contingent liabilities? According to the FASB, what conditions must exist before a liability related to a pending lawsuit can be entered in the accounting records?

### LO 4, 5 Conceptual Understanding: Present Value

**C3.** In its “Year-End Countdown Sale,” a local **Cadillac** car dealer advertised “0% interest for 60 months!”<sup>15</sup> What role does the time value of money play in this promotion? Assuming that the car dealer is able to borrow funds at 8 percent interest, what is the cost to the dealer of every customer who takes advantage of this offer? If you could borrow money to buy a car from this dealer, which rate would be more relevant in determining how much you might offer for the car: the rate at which you borrow money, or the rate at which the dealer borrows money?

### LO 6 Interpreting Financial Reports: Comparison of Two Companies' Ratios with Industry Ratios

RATIO

**C4. BUSINESS APPLICATION** ► Both **Oracle Corporation** and **Cisco Systems** are in the computer industry. The data that follows (in millions) are from the end of their fiscal years 2011.<sup>16</sup>

	Oracle	Cisco
Accounts payable	\$ 701	\$ 876
Cost of goods sold	8,398	16,682
Increase (decrease) in inventory	(28)	(147)

Compare the payables turnover and days' payable for both companies. How are cash flows affected by days' payable? How do **Oracle's** and **Cisco Systems'** ratios compare with the computer industry ratios shown in the chapter? (Use year-end amounts for ratios and round to one decimal place.)

### LO 1, 3 Annual Report Case: Commitments and Contingencies

**C5. CONCEPT** ► Read **CVS's** note on commitments and contingencies in the Supplement to Chapter 16. What commitments and contingencies does the company have? Why is it important to consider this information when analyzing accounts payable? What

(Continued)

two conditions have to be met to record commitments and contingencies as liabilities on the balance sheet?

LO 6 **Comparison Case: Payables Analysis**

**RATIO**

**C6. BUSINESS APPLICATION** ▶ Refer to **CVS**'s financial statements in the Supplement to Chapter 16 and to the following data for **Walgreens** (amounts in millions):

	2011	2010	2009
Cost of goods sold	\$51,692	\$48,444	\$45,722
Accounts payable	4,810	4,585	4,308
Increase (decrease) in merchandise inventory	(592)	(307)	533

Compute the payables turnover and days' payable for CVS and Walgreens in 2010 and 2011. (Round to one decimal place.) In 2009, CVS had accounts payable of \$3,560 million, and in 2010, its merchandise inventory decreased by \$352. Which company do you think made the most use of financing from creditors during the operating cycle? Did the trend change?

LO 2 **Ethical Dilemma: Known Legal Violations**

**C7.** Surf and Turf is a large restaurant in the suburbs of Chicago. Ronald Swift, an accounting student at a nearby college, recently secured a full-time accounting job there. He felt fortunate to have a good job that accommodated his class schedule. After a few weeks on the job, Swift realized that his boss, the owner of the business, was paying the kitchen workers in cash and not withholding federal and state income taxes or social security and Medicare taxes. Swift knows that federal and state laws require these taxes to be withheld and paid to the appropriate agency in a timely manner. He also realizes that if he raises this issue, he could lose his job. What alternatives are available to Swift? What action would you take if you were in his position? Why did you make this choice?

LO 4, 5 **Business Communication: Baseball Contract**

**C8.** Devon Turner, who has been playing shortstop for the St. Louis Titans for five years, made the All-Star team in 2014. He has three years left on a contract that pays him \$2.4 million a year. He wants to renegotiate his contract because other players with records similar to his are receiving as much as \$10.5 million per year for five years.

Titans' management has a policy of never renegotiating a current contract but is willing to consider extending Turner's contract to additional years. In fact, the Titans have offered Turner an additional three years at \$6.0 million, \$9.0 million, and \$12.0 million, respectively. They have also added an option year at \$15.0 million. Management points out that this package is worth \$42.0 million, or \$10.5 million per year on average. Turner is considering this offer and is also thinking of asking for a bonus if and when he signs the contract.

Write a memorandum to Turner that comments on management's position and evaluates the offer, assuming a current interest rate of 10 percent. (*Hint:* Use present values.) Propose a range for the signing bonus. Finally, include other considerations that may affect the value of the offer.

**RATIO**

**Continuing Case: Annual Report Project**

**C9. BUSINESS APPLICATION** ▶ Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, identify on the balance sheet the current liabilities that are definitely determinable and those that are probably estimates. Also, calculate the following for the most recent two years:

1. Working capital
2. Payables turnover
3. Days' payable



# CHAPTER 12

## Accounting for Partnerships

### BUSINESS INSIGHT

#### Ankin and Kent Partnership

Patrick Ankin and Eric Kent reached an agreement in 2014 to pool their resources and form a partnership to manufacture and sell university T-shirts. Patrick contributed \$100,000 and Eric contributed \$150,000 to the partnership. Before they prepared their partnership agreement, they had to decide how they would share the income or losses of the business and how they would handle both the admission of new partners and the withdrawal of partners. Later on, they consider the need to bring in another partner, Adele Matiz.

- 1. CONCEPT** ► How does the separate entity concept apply to partners' interest in a partnership?
- 2. ACCOUNTING APPLICATION** ► How would Patrick Ankin and Eric Kent share the income or losses of their business, and how would they handle any changes in ownership that might occur?
- 3. BUSINESS APPLICATION** ► As the partnership grows, what alternate forms of partnership-like entities might the partners consider?

### LEARNING OBJECTIVES

- LO 1** Define the *partnership* form of business, and identify its principal characteristics.
- LO 2** Record partners' investments of cash and other assets when a partnership is formed.
- LO 3** Compute and record the income or losses that partners share, based on stated ratios, capital balance ratios, and partners' salaries and interest.
- LO 4** Record a person's admission to or withdrawal from a partnership.
- LO 5** Compute and record the distribution of assets to partners when they liquidate their partnership.
- LO 6** Identify alternate forms of partnership-type entities.



## SECTION 1

## CONCEPTS

## CONCEPT

- Separate entity

RELEVANT  
LEARNING OBJECTIVE

- LO 1** Define the *partnership* form of business, and identify its principal characteristics.

## LO 1 Concepts Underlying Partnerships

The Uniform Partnership Act, which has been adopted by most states, defines a **partnership** as “an association of two or more persons to carry on as co-owners of a business for profit.” Normally, partnerships are formed when owners of small businesses wish to combine capital or managerial talents for some common business purpose. Partnerships are treated as *separate entities*, with their own accounting records and financial statements. However, legally there is no economic separation between a partnership and its owners. Note that corporations are legal entities (whereas partnerships and sole proprietorships are not), but all three are considered separate accounting entities.

### Characteristics of Partnerships

Some of the important characteristics of partnerships follow.

**Voluntary Association** A partnership is a voluntary association of individuals. Therefore, a partner is responsible under the law for his or her partners’ actions within the scope of the business. Therefore, a partner must be allowed to choose the people who join the partnership.

**Partnership Agreement** To form a partnership, two or more people simply agree to partner in a business enterprise. Their **partnership agreement** does not have to be in writing. However, it is good business practice to have a written document that clearly states the details of the partnership, including:

- Name, location, and purpose of the business
- Names of the partners and their respective duties
- Investments of each partner
- Method of distributing income and losses
- Procedures for the admission and withdrawal of partners, the withdrawal of assets allowed each partner, and the liquidation (termination) of the business

**Limited Life** Because a partnership is formed by an agreement, it has a **limited life**. It may be dissolved when (a) a new partner is admitted; (b) when a partner withdraws, goes bankrupt, is incapacitated (to the point that he or she cannot perform as obligated), retires, or dies; or (c) when the terms of the partnership agreement are met (e.g., when the project for which the partnership was formed is completed). The partnership agreement can be written to cover each of these situations, thus allowing the partnership to continue legally.

**Mutual Agency** Each partner is an agent of the partnership within the scope of the business. Because of this **mutual agency**, any partner can bind the partnership to a business agreement as long as he or she acts within the scope of the company’s normal operations. For example, a partner in a used-car business can bind the partnership through the purchase or sale of used cars. But this partner cannot bind the partnership to a contract for buying men’s clothing or any other goods that are not related to the used-car business.

**Unlimited Liability** Each partner has personal **unlimited liability** for all the debts of the partnership. If a partnership cannot pay its debts, creditors must first satisfy their claims from the assets of the business. If these assets are not enough to pay all debts, the creditors can seek payment from the personal assets of each partner. If a partner’s personal assets are used up before the debts are paid, the creditors can claim additional assets from the remaining partners who are able to pay. Each partner, then, can be required by law to pay all the debts of the partnership.



Andres/Shutterstock.com

Unlimited liability means that potential responsibility for debts is not limited by one's investment, as it is in a corporation. Each person is personally liable for all debts of the partnership, including those arising from contingent liabilities such as lawsuits. Liability can be avoided only by filing for personal bankruptcy.

**STUDY NOTE:** There is no federal income tax on partnerships. Partners are taxed at their personal rates. However, partnerships must file an informational return with the IRS, and some state and local governments levy a tax on them. An example of this is the Michigan Single Business Tax.

## APPLY IT!

Indicate whether each statement that follows is a reflection of (a) voluntary association, (b) a partnership agreement, (c) limited life, (d) mutual agency, (e) unlimited liability, or (f) separate entity.

1. A partner may be required to pay the debts of the partnership out of personal assets.
2. A partnership must be dissolved when a partner is admitted, withdraws, retires, or dies.
3. Any partner can bind the partnership to a business agreement.
4. A partner does not have to remain a partner if he or she does not want to.
5. From an accounting standpoint, the affairs of partnerships are distinct and apart from those of their partners.
6. Details of the arrangements among partners are specified in a written contract.

**Co-Ownership of Partnership Property** When individuals invest property in a partnership, they give up the right to their separate use of the property. The property becomes an asset of the partnership and is owned jointly by the partners.

**Participation in Partnership Income** Each partner has the right to share in the company's income and the responsibility to share in its losses. The partnership agreement should state the method of distributing income and losses to each partner. If the agreement describes how income should be shared but does not mention losses, losses are distributed in the same way as income. If the agreement does not describe the method of income and loss distribution, the partners must share income and losses equally.

## Advantages and Disadvantages of Partnerships Summarized

In sum, partnerships have both advantages and disadvantages.

### Advantages of Partnerships

Partnership has the following advantages:

- It can be easy to form, change, and dissolve.
- It facilitates the pooling of capital resources and individual talents.
- It has no corporate tax burden. Because a partnership is not a legal entity for tax purposes, it does not have to pay a federal income tax, as do corporations, but must file an informational return.
- It gives the partners a certain amount of freedom and flexibility.

### Disadvantages of Partnerships

On the other hand, partnership has the following disadvantages:

- The life of a partnership is limited.
- One partner can bind the partnership to a contract (mutual agency).
- The partners have unlimited personal liability.
- It is more difficult for a partnership to raise large amounts of capital and to transfer ownership interests than it is for a corporation.

#### SOLUTION

1. e; 2. c; 3. d; 4. a; 5. f; 6. b

#### TRY IT! SE1, E1A, E1B

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Record partners' investments
- Compute and record income and loss
- Record a person's admission to or withdrawal from a partnership
- Compute and record distribution of assets to partners when a partnership is liquidated

## RELEVANT LEARNING OBJECTIVES

- LO 2** Record partners' investments of cash and other assets when a partnership is formed.
- LO 3** Compute and record the income or losses that partners share, based on stated ratios, capital balance ratios, and partners' salaries and interest.
- LO 4** Record a person's admission to or withdrawal from a partnership.
- LO 5** Compute and record the distribution of assets to partners when they liquidate their partnership.

**LO 2** Accounting for Partners' Equity

Although accounting for a partnership is very similar to accounting for a sole proprietorship, there are differences. One is that the owner's equity in a partnership is called **partners' equity**. In accounting for partners' equity, it is necessary to maintain separate Capital and Withdrawals accounts for each partner and to divide the income and losses of the company among the partners.

The differences in the Capital accounts of a sole proprietorship and a partnership are as follows.

Sole Proprietorship		Partnership			
Largo, Capital		Sand, Capital		Kira, Capital	
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
	50,000		30,000		40,000
Largo, Withdrawals		Sand, Withdrawals		Kira, Withdrawals	
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
12,000		5,000		6,000	

In the partners' equity section of the balance sheet, the balance of each partner's Capital account is listed separately:

Liabilities and Partners' Equity		Dr.	Cr.
Total liabilities			\$28,000
Partners' equity:			
Sand, capital	\$25,000		
Kira, capital	34,000		
Total partners' equity			<u>59,000</u>
Total liabilities and partners' equity			<u>\$87,000</u>

Each partner invests cash or other assets or both in the partnership, according to the partnership agreement. Noncash assets should be *valued* at their fair market value on the date they are transferred to the partnership. The assets invested by a partner are debited to the proper account, and the total amount is credited to the partner's Capital account.

To illustrate, we will use Lori Mind and Rose Padilla, who have agreed to combine their capital and equipment in a partnership to operate a jewelry store.

**Recording Partners' Investments**

**Transaction** According to their partnership agreement, Mind will invest \$28,000 in cash and \$37,000 worth of furniture and displays, and Padilla will invest \$40,000 in cash and \$30,000 worth of equipment. Related to the equipment is a note payable for \$10,000, which the partnership assumes.

**Analysis** The journal entry to record Mind and Padilla's initial investments

- ▲ *increases Cash* and other assets with debits for their value
- ▲ *increases* each partner's capital with a credit for the amount of the partner's contribution to the partnership

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+28,000				+65,000
+37,000				

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+30,000		+10,000		+60,000
+40,000				

## Journal Entries

2014		Dr.	Cr.
July 1	Cash	28,000	
	Furniture and Displays	37,000	
	Lori Mind, Capital		65,000
	Initial investment of Lori Mind in Mind and Padilla		
1	Cash	40,000	
	Equipment	30,000	
	Notes Payable		10,000
	Rose Padilla, Capital		60,000
	Initial investment of Rose Padilla in Mind and Padilla		

**STUDY NOTE:** Padilla's noncash contribution is equal to the fair market value of the equipment less the amount owed on the equipment because the partnership assumed the liability.

**Comment** The *values* assigned to the assets would be included in the partnership agreement. These values can differ from those carried on the partners' personal books. For example, the equipment that Rose Padilla contributed had a value of only \$22,000 on her books, but its market value had increased considerably after she purchased it. The book value of Padilla's equipment is not important. The fair market value of the equipment at the time of transfer *is* important, however, because it represents the amount of money Padilla has invested in the partnership. Later investments are recorded in the same way.

## APPLY IT!

On June 1, Daisy and Malcolm form a partnership to operate a fitness center. Daisy contributes cash of \$24,000, and Malcolm contributes exercise equipment that cost \$20,000 but is valued at \$16,000. Prepare the journal entry to record the partners' initial investments.

### SOLUTION

		Dr.	Cr.
June 1	Cash	24,000	
	Exercise Equipment	16,000	
	Daisy, Capital		24,000
	Malcolm, Capital		16,000
	Formation of partnership		

**TRY IT! SE2, E2A, E2B**

## LO 3 Distribution of Partnership Income and Losses

A partnership's income and losses can be distributed according to whatever method the partners specify in the partnership agreement. If the agreement says nothing about the distribution of income and losses, the partners share them equally. Income in this form of business normally has three components:

- Return to the partners for the use of their capital (called *interest on partners' capital*)
- Compensation for services the partners have rendered (partners' salaries)
- Other income for any special contributions individual partners may make to the partnership or for risks they may take

The breakdown of total income into its three components helps clarify how much each partner has contributed to the firm.

If all partners contribute equal capital, have similar talents, and spend the same amount of time in the business, then an equal distribution of income and losses would be fair. However, if one partner works full-time in the firm and another devotes only a

**STUDY NOTE:** The division of income is one area in which a partnership differs from a corporation. In corporations, each common share receives an equal dividend. Partners can use any method they agree on to divide partnership income.

fourth of his or her time, then the distribution of income or losses should reflect that difference.

Distributing income and losses among partners can be accomplished by using stated ratios or capital balance ratios or by paying the partners' salaries and interest on their capital and sharing the remaining income according to stated ratios. Salaries and interest here are not salaries expense or interest expense in the ordinary sense of the terms. They do not affect the amount of reported net income. Instead, they refer to ways of determining each partner's share of net income or net loss on the basis of time the partner spends and the money he or she invests in the partnership. The computations of each partner's share of net income are relevant to the closing entries in which the Income Summary account is closed to the partners' Capital accounts.

## Stated Ratios

One method of distributing income and losses is to give each partner a stated ratio of the total income or loss. If each partner is making an equal contribution to the firm, each can assume the same share of income and losses. It is important to understand that an equal contribution to the firm does not necessarily mean an equal capital investment in the firm. One partner may be devoting more time and talent to the firm, whereas another may have made a larger capital investment. If the partners contribute unequally to the firm, unequal stated ratios can be appropriate.

### Distributing Income Using Stated Ratios

**Transaction** Mind and Padilla had a net income last year of \$140,000. The stated ratio is 60 percent for Mind and 40 percent for Padilla.

**Computation** The computation of each partner's share of the income is computed as follows.

Mind ( $\$140,000 \times 0.60$ )	\$ 84,000
Padilla ( $\$140,000 \times 0.40$ )	56,000
Net income	<u>\$140,000</u>

**Analysis** The journal entry to record each partner's share of the income

- closes *Income Summary* with a debit for the amount of net income
- ▲ increases each partner's capital account with a credit for their share of net income

### Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
				-140,000
				+84,000
				+56,000

2015		Dr.	Cr.
July 30	Income Summary	140,000	
	Lori Mind, Capital		84,000
	Rose Padilla, Capital		56,000
	Distribution of income for the year to the partners' Capital accounts		

**Comment** This entry illustrates the *separate entity* concept that the partners as individuals are separate from the partnership entity.

## Capital Balance Ratios

Income and losses may be distributed according to capital balances. The ratio used may be based on each partner's capital balance at the beginning of the year or on the average capital balance of each partner during the year.

**Ratios Based on Beginning Capital Balances** At the start of the fiscal year, July 1, 2014, Lori Mind's Capital account showed a \$65,000 balance and Rose Padilla's Capital

account showed a \$60,000 balance. In this example, these balances reflect the partners' initial investment. The total partners' equity in the firm was \$125,000.

Each partner's capital balance at the beginning of the year divided by the total partners' equity at the beginning of the year is that partner's beginning capital balance ratio:

	<b>Beginning Capital Balance</b>	<b>Beginning Capital Balance Ratio</b>
Lori Mind	\$ 65,000	$\$65,000 \div \$125,000 = 0.52 = 52\%$
Rose Padilla	60,000	$\$60,000 \div \$125,000 = 0.48 = 48\%$
	<u>\$125,000</u>	

The income that each partner should receive is determined by multiplying the total income by each partner's capital ratio. If income for the year was \$140,000, Lori Mind's share of that income was \$72,800, and Rose Padilla's share was \$67,200.

Lori Mind	$\$140,000 \times 0.52 = \$ 72,800$
Rose Padilla	$\$140,000 \times 0.48 = \underline{67,200}$
	<u>\$140,000</u>

**Ratios Based on Average Capital Balances** If Mind and Padilla use beginning capital balance ratios to determine the distribution of income, they do not consider any investments or withdrawals made during the year. If the partners believe their capital balances will change dramatically during the year, they can choose average capital balance ratios as a fairer means of distributing income and losses.

To compute each partner's average capital balance, it's necessary to examine the changes that have occurred during the year in each partner's Capital account as a result of investments and withdrawals.

- **Step 1:** The partner's beginning capital is multiplied by the number of months the balance remains unchanged:

$$\text{Capital Balance} \times \text{Months Unchanged} = \text{Total}$$

- **Step 2:** After the balance changes, the new balance is multiplied by the number of months it remains unchanged. The process continues until the end of the year.
- **Step 3:** The totals of these computations are added, and then they are divided by 12 to determine the average capital balances:

$$\text{Total} \div 12 \text{ months} = \text{Average Capital Balance}$$

- **Step 4:** Once the average capital balances are determined, the method of figuring capital balance ratios for sharing income and losses is the same as the method used for beginning capital balances.

The following T accounts show the activity over the year in Mind and Padilla's partners' Capital and Withdrawals accounts:

Lori Mind, Capital			Lori Mind, Withdrawals		
Dr.	Cr.		Dr.	Cr.	
	7/1/2014	65,000		1/1/2015	10,000
Rose Padilla, Capital			Rose Padilla, Withdrawals		
Dr.	Cr.		Dr.	Cr.	
	7/1/2014	60,000		11/1/2014	10,000
	2/1/2015	8,000			

Lori Mind withdrew \$10,000 on January 1, 2015, and Rose Padilla withdrew \$10,000 on November 1, 2014, and invested an additional \$8,000 of equipment on February 1, 2015. Again, the income for the year's operations (July 1, 2014, to June 30, 2015) was \$140,000. The calculations for the average capital balances and the distribution of income follow.



## Average Capital Balances

Partner	Date	Capital Balance	×	Months Unchanged	=	Total		Average Capital Balance
Mind	July–Dec.	\$65,000	×	6	=	\$390,000		
	Jan.–June	\$55,000	×	6	=	330,000		
				<u>12</u>		<u>\$720,000</u>	÷ 12 =	\$ 60,000
Padilla	July–Oct.	\$60,000	×	4	=	\$240,000		
	Nov.–Jan.	\$50,000	×	3	=	150,000		
	Feb.–June	\$58,000	×	5	=	290,000		
				<u>12</u>		<u>\$680,000</u>	÷ 12 =	56,667*
						Total average capital		<u>\$116,667</u>

\*Rounded

## Average Capital Balance Ratios

$$\text{Mind} = \frac{\text{Mind's Average Capital Balance}}{\text{Total Average Capital}} = \frac{\$60,000}{\$116,667} = 0.514^* = 51.4\%$$

$$\text{Padilla} = \frac{\text{Padilla's Average Capital Balance}}{\text{Total Average Capital}} = \frac{\$56,667}{\$116,667} = 0.486^* = 48.6\%$$

\*Rounded

## Distribution of Income

Partner	Income	×	Ratio	=	Share of Income
Mind	\$140,000	×	0.514	=	\$ 71,960
Padilla	\$140,000	×	0.486	=	68,040
				Total income	<u>\$140,000</u>

## Salaries, Interest, and Stated Ratios

**STUDY NOTE:** Partnership income or losses cannot be divided solely on the basis of salaries or interest. An additional component, such as stated ratios, is needed.

Partners generally do not contribute equally to a firm. To make up for unequal contributions, a partnership agreement can allow for partners' salaries, interest on partners' capital balances, or both in the distribution of income. Again, salaries and interest of this kind are not deducted as expenses before the partnership income is determined.

To illustrate an allowance for partners' salaries, assume that Mind and Padilla agree to annual salaries of \$8,000 and \$7,000, respectively, and to divide any remaining income equally between them. Each salary is charged to the appropriate partner's Withdrawals account when paid. Assuming the same \$140,000 income for the first year, the calculations for Mind and Padilla follow.

	Income of Partner		Income Distributed
	Mind	Padilla	
Total income for distribution			\$ 140,000
Distribution of salaries:			
Mind	\$ 8,000		
Padilla		\$ 7,000	(15,000)
Remaining income after salaries			\$ 125,000
Equal distribution of remaining income:			
Mind (\$125,000 × 0.50)	<u>62,500</u>		
Padilla (\$125,000 × 0.50)		<u>62,500</u>	(125,000)
Remaining income			<u>—</u>
Income of partners	<u>\$70,500</u>	<u>\$69,500</u>	<u>\$ 140,000</u>

Salaries allow for differences in the services that partners provide the business. However, they do not take into account the differences in invested capital. To allow for capital differences, each partner can receive, in addition to salary, a stated interest on his or her invested capital. Suppose that Lori Mind and Rose Padilla agree to annual salaries of \$8,000 and \$7,000, respectively, as well as 10 percent interest on their beginning capital balances. They also agreed to share any remaining income equally. The calculations for Mind and Padilla, assuming income of \$140,000, follow.

	Income of Partner		Income Distributed
	Mind	Padilla	
Total income for distribution			\$ 140,000
Distribution of salaries:			
Mind	\$ 8,000		
Padilla		\$ 7,000	(15,000)
Remaining income after salaries			\$ 125,000
Distribution of interest:			
Mind (\$65,000 × 0.10)	6,500		
Padilla (\$60,000 × 0.10)		6,000	(12,500)
Remaining income after salaries and interest			\$ 112,500
Equal distribution of remaining income:			
Mind (\$112,500 × 0.50)	56,250		
Padilla (\$112,500 × 0.50)		56,250	(112,500)
Remaining income			—
Income of partners	<u>\$70,750</u>	<u>\$69,250</u>	<u>\$ 140,000</u>

**STUDY NOTE:** When negotiating a partnership agreement, be sure to look at (and negotiate) the impact of both profits (net income) and losses.

If the partnership agreement allows for the distribution of salaries or interest or both, the amounts must be allocated to the partners, even if profits are not enough to cover the salaries and interest. In fact, even if the company has a loss, these allocations must nonetheless be made. After the allocation of salaries and interest, the negative balance, or loss, must be distributed according to the stated ratio in the partnership agreement or equally if the agreement does not mention a ratio.

For example, assume that Mind and Padilla agreed to the following conditions, with much higher annual salaries, for the distribution of income and losses:

	Salaries	Interest	Beginning Capital Balance
Mind	\$70,000	10 percent of beginning capital balance	\$65,000
Padilla	\$60,000	10 percent of beginning capital balance	\$60,000

The computations for the distribution of the income and losses, again assuming income of \$140,000, follows.

	Income of Partner		Income Distributed
	Mind	Padilla	
Total income for distribution			\$ 140,000
Distribution of salaries:			
Mind	\$70,000		
Padilla		\$60,000	(130,000)
Remaining income after salaries			\$ 10,000
Distribution of interest:			
Mind (\$65,000 × 0.10)	6,500		
Padilla (\$60,000 × 0.10)		6,000	(12,500)
Negative balance after salaries and interest			\$ (2,500)
Equal distribution of negative balance:*			
Mind (\$2,500 × 0.50)	(1,250)		
Padilla (\$2,500 × 0.50)		(1,250)	2,500
Remaining income			—
Income of partners	<u>\$75,250</u>	<u>\$64,750</u>	<u>\$ 140,000</u>

\*Notice that the negative balance is distributed equally because the agreement does not indicate how income and losses should be distributed after salaries and interest are paid.

**STUDY NOTE:** Using salaries and interest to divide income or losses among partners has no effect on the income statement. Partners' salaries and interest are used only to allow the equitable division of the partnership's net income.

On the partnership income statement, the distribution of income or losses is presented below the net income figure, as shown in Exhibit 1.

**Exhibit 1**  
Partial Income Statement  
for Mind and Padilla

Mind and Padilla Partial Income Statement For the Year Ended June 30, 2015		
Net income		<u>\$140,000</u>
Distribution to the partners:		
Mind:		
Salary distribution	\$70,000	
Interest on beginning capital balance	<u>6,500</u>	
Total	\$76,500	
One-half of remaining negative amount	<u>(1,250)</u>	
Share of net income		\$ 75,250
Padilla:		
Salary distribution	\$60,000	
Interest on beginning capital balance	<u>6,000</u>	
Total	\$66,000	
One-half of remaining negative amount	<u>(1,250)</u>	
Share of net income		<u>64,750</u>
Net income distributed		<u>\$140,000</u>

**APPLY IT!**

Meg and Raphael share income in their partnership in a 1:4 ratio. Meg and Raphael receive salaries of \$16,000 and \$10,000, respectively. How would they share a net income of \$22,000 (before salaries are distributed)?

**SOLUTION**

	Income of Partner		Income Distributed
	Meg	Raphael	
Total income for distribution			\$ 22,000
Distribution of salaries:			
Meg	\$16,000		
Raphael		\$ 10,000	(26,000)
Negative balance after salaries			\$ (4,000)
Distribution of negative balance:			
Meg ( $\$4,000 \times 0.20$ )	(800)		
Raphael ( $\$4,000 \times 0.80$ )		(3,200)	4,000
Remaining income			—
Income of partners	<u>\$15,200</u>	<u>\$ 6,800</u>	<u>\$ 22,000</u>

**TRY IT! SE3, SE4, SE5, E3A, E4A, E5A, E3B, E4B, E5B**

## LO 4 Dissolution of a Partnership

**Dissolution** of a partnership occurs whenever there is a change in the original association of partners. When a partnership is dissolved, the partners lose their authority to continue the business as a *going concern*. This does not mean that the business operation necessarily is ended or interrupted. However, from a legal and accounting standpoint, the *separate entity* ceases to exist. The remaining partners can act for the partnership in finishing the affairs of the business or in forming a new partnership that will be a new accounting entity. The dissolution of a partnership takes place through, among other events, the admission of a new partner, the withdrawal of a partner, or the death of a partner.

### Admission of a New Partner

The admission of a new partner dissolves the old partnership because a new association has been formed. Dissolving the old partnership and creating a new one requires the consent of all the original partners and the ratification of a new agreement.

An individual can be admitted to a partnership in one of two ways:

- Purchasing an interest in the partnership from one or more of the original partners
- Investing assets in the partnership

**Purchasing an Interest from a Partner** When a person purchases an interest in a partnership from an original partner, the transaction is personal between these two people. However, the interest purchased must be transferred from the Capital account of the selling partner to the Capital account of the new partner.

### Purchasing All Interest from a Partner

**Transaction** Lori Mind decides to sell her interest of \$70,000 in Mind and Padilla to Adam Novak for \$100,000 on August 31, 2016. Rose Padilla agrees to the sale.

**Analysis** The journal entry to record this sale

▼ *decreases Lori Mind, Capital* with a debit

▲ *increases Adam Novak, Capital* with a credit

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
				-70,000
				+70,000

2016		<i>Dr.</i>	<i>Cr.</i>
Aug. 31	Lori Mind, Capital	70,000	
	Adam Novak, Capital		70,000
	Transfer of Lori Mind's equity to Adam Novak		

**Comment** Notice that the entry records the book value of the equity, not the amount Novak pays. The amount Novak pays is a personal matter between Novak and Mind. Because the amount paid does not affect the assets or liabilities of the firm, it is not entered in the records.

**Purchasing Partial Interest from Partners**

**Transaction** Adam Novak purchases half of Lori Mind's \$70,000 interest in the partnership and half of Rose Padilla's \$80,000 interest by paying a total of \$100,000 to the two partners on August 31, 2016. The assets of the firm are valued correctly.

**Analysis** The journal entry to record this sale

▼ *decreases Lori Mind, Capital and Rose Padilla, Capital with debits*

▲ *increases Adam Novak, Capital with a credit*

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
				-35,000
				-40,000
				+75,000

2012		<i>Dr.</i>	<i>Cr.</i>
Aug. 31	Lori Mind, Capital	35,000	
	Rose Padilla, Capital	40,000	
	Adam Novak, Capital		75,000
	Transfer of half of Lori Mind's and Rose Padilla's equity to Adam Novak		

**Comment** If the asset accounts did not reflect their current values, the asset accounts (and Capital accounts) would need to be adjusted before admitting the new partner. A new partnership *entity separate* from its partners has now been formed with three partners instead of two.

**Investing Assets in a Partnership** When a new partner is admitted through an investment in the partnership, both the assets and the partners' equity in the firm increase. This is because the assets the new partner invests become partnership assets, and as partnership assets increase, partners' equity increases.

**New Partner Investing Assets in a Partnership**

**Transaction** Adam Novak wants to invest \$75,000 for a one-third interest in the partnership of Mind and Padilla. The Capital accounts of Lori Mind and Rose Padilla are \$70,000 and \$80,000, respectively. The assets of the firm are valued correctly. The partners agree to admit Novak.

**Computation** Novak's \$75,000 investment equals a one-third interest after it is added to the previously existing capital of the partnership:

Lori Mind, Capital	\$ 70,000
Rose Padilla, Capital	80,000
Novak's investment	75,000
Total capital after Novak's investment	<u>\$225,000</u>
One-third interest = \$225,000 ÷ 3 =	<u>\$ 75,000</u>

**Analysis** The journal entry to record the admission of a new partner

- ▲ increases *Cash* with a debit
- ▲ increases *Adam Novak, Capital* with a credit

**Journal Entry**

$$A = L + OE$$

$$+75,000 = +75,000$$

2016		Dr.	Cr.
Aug. 31	Cash	75,000	
	Adam Novak, Capital		75,000
Admission of Adam Novak for a one-third interest in the company			

**Comment** A new partnership *entity separate* from its partners has now been formed. The cash from the new partner, Adam Novak, goes to the partnership and not to the partners. The partnership assets and partnership equity have grown by \$75,000.

**STUDY NOTE:** The original partners receive a bonus because the entity is worth more as a going concern than the fair market value of the net assets would otherwise indicate. That is, the new partner is paying for unrecorded partnership value.

**Bonus to the Old Partners** A partnership is sometimes so profitable or otherwise advantageous that a new investor is willing to pay more than the actual dollar interest he or she receives in the partnership. For instance, suppose an individual pays \$100,000 for an \$80,000 interest in a partnership. The \$20,000 excess of the payment over the interest purchased is a **bonus** to the original partners. The bonus must be distributed to the original partners according to the partnership agreement. When the agreement does not cover the distribution of bonuses, it should be distributed to the original partners in accordance with the method for distributing income and losses.

**Bonus to the Old Partners**

**Transaction** Assume that Mind and Padilla’s firm has operated for several years and that the partners’ capital balances and the stated ratios for distribution of income and loss are as follows.

Partners	Capital Balances	Stated Ratios
Mind	\$160,000	55%
Padilla	140,000	45
	<u>\$300,000</u>	<u>100%</u>

Adam Novak wants to join the firm. He offers to invest \$100,000 on December 1 for a one-fifth interest in the business and income. The original partners agree to the offer.

**Computation** The computation of the bonus to the original partners follows.

Partners’ equity in the original partnership		\$300,000
Cash investment by Adam Novak		<u>100,000</u>
Partners’ equity in the new partnership		\$400,000
Partners’ equity assigned to Adam Novak ( $\$400,000 \times \frac{1}{5}$ )		<u>\$ 80,000</u>
Bonus to the original partners:		
Investment by Adam Novak	\$100,000	
Less equity assigned to Adam Novak	<u>80,000</u>	<u>\$ 20,000</u>
Distribution of bonus to original partners:		
Lori Mind ( $\$20,000 \times 0.55$ )	\$ 11,000	
Rose Padilla ( $\$20,000 \times 0.45$ )	<u>9,000</u>	<u>\$ 20,000</u>

**Analysis** The journal entry to record the bonus for the existing partners

- ▲ increases *Cash* by \$100,000 with a debit
- ▲ increases each partner’s capital account with a credit



<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+100,000				+11,000
				+9,000
				+80,000

### Journal Entry

2016		Dr.	Cr.
Dec. 1	Cash	100,000	
	Lori Mind, Capital		11,000
	Rose Padilla, Capital		9,000
	Adam Novak, Capital		80,000
	Investment by Adam Novak for a one-fifth interest in the firm, and the bonus distributed to the original partners		

**Comment** A new partnership *entity separate* from its partners has now been formed. The partners, Lori Mind and Rose Padilla, receive an increase in their capital accounts for part of Adam Novak's contribution to the partnership. Novak's desire to join the partnership makes him willing to accept less than the share would have been if he had not paid a bonus to the other partners.

**Bonus to the New Partner** A partnership might want a new partner for several reasons. A partnership in financial trouble might need additional cash, or the partners might want to expand the firm's markets and need more capital. Also, the partners might know a person who would bring a unique talent to the firm. Under these conditions, a new partner may be admitted to the partnership with the understanding that part of the original partners' capital will be transferred (credited) to the new partner's Capital account as a bonus.

### Bonus to the New Partner

**Transaction** Suppose that Lori Mind and Rose Padilla have invited Adam Novak to join the firm. Novak is going to invest \$60,000 on December 1 for a one-fourth interest in the company. The stated ratios for distribution of income or loss for Mind and Padilla are 55 percent and 45 percent, respectively. If Novak is to receive a one-fourth interest in the firm, the interest of the original partners represents a three-fourths interest in the business.

**Computation** The computation of Novak's bonus follows.

Total equity in partnership:		
Lori Mind, Capital		\$160,000
Rose Padilla, Capital		140,000
Investment by Adam Novak		60,000
Partners' equity in the new partnership		<u>\$360,000</u>
Partners' equity assigned to Adam Novak ( $\$360,000 \times \frac{1}{4}$ )		<u>\$ 90,000</u>
Bonus to new partner:		
Equity assigned to Adam Novak	\$90,000	
Less cash investment by Adam Novak	<u>60,000</u>	<u>\$ 30,000</u>
Distribution of bonus from original partners:		
Lori Mind ( $\$30,000 \times 0.55$ )	\$16,500	
Rose Padilla ( $\$30,000 \times 0.45$ )	<u>13,500</u>	<u>\$ 30,000</u>

**Analysis** The journal entry to record the bonus to the new partner

- ▲ *increases Cash* with a debit
- ▼ *decreases Lori Mind, Capital* and *Rose Padilla, Capital* with debits
- ▲ *increases Adam Novak, Capital* with a credit

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+60,000				-16,500
				-13,500
				+90,000

**Journal Entry**

2016		<i>Dr.</i>	<i>Cr.</i>
Dec. 1	Cash	60,000	
	Lori Mind, Capital	16,500	
	Rose Padilla, Capital	13,500	
	Adam Novak, Capital		90,000
	To record the investment by Adam Novak of cash and a bonus from Mind and Padilla		

**Comment** A new partnership *entity separate* from its partners has now been formed. The partners, Lori Mind and Rose Padilla, were willing to accept a decrease in their capital accounts to get Adam Novak to join the new partnership.

**STUDY NOTE:** There is no impact on the income statement when a partner withdraws. The only change is on the balance sheet.

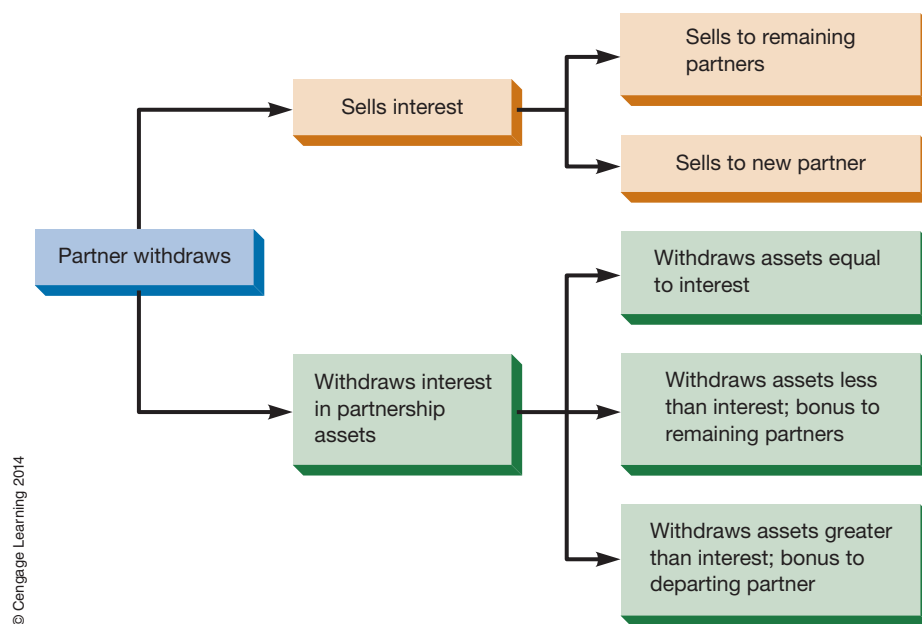
**Withdrawal of a Partner**

Generally, a partner has the right to withdraw from a partnership in accord with legal requirements. However, to avoid disputes when a partner does decide to withdraw or retire from the firm, the partnership agreement should describe the procedures to be followed. The agreement should specify:

- Whether an audit will be performed
- How the assets will be reappraised
- How a bonus will be determined
- By what method the withdrawing partner will be paid

A partner who wants to withdraw from a partnership can do so in one of several ways. The partner can sell his or her interest to another partner or to an outsider, with the consent of the remaining partners, or the partner can withdraw assets equal to his or her capital balance, less than his or her capital balance (with a bonus to the remaining partners), or greater than his or her capital balance (with a bonus to the withdrawing partner). These alternatives are illustrated in Exhibit 2.

**Exhibit 2**  
Alternative Ways for a Partner to Withdraw



**Withdrawal by Selling Interest** When a partner sells his or her interest to another partner or to an outsider, with the consent of the other partners, the transaction is personal. It does not change the partnership assets or the partners' equity.

### Withdrawal by Selling Interest

**Transaction** The capital balances of Mind, Padilla, and Novak are \$140,000, \$100,000, and \$60,000, respectively, for a total of \$300,000. Padilla wants to withdraw from the partnership and is reviewing two offers for her interest. The offers are (1) to sell her interest to Novak for \$110,000 or (2) to sell her interest to Mary Smith for \$120,000. The remaining partners have agreed to either potential transaction. Because Novak and Smith would pay for Padilla's interest from their personal assets, the partnership accounting records would show only the transfer of Padilla's interest to Novak or Smith.

**Analysis** In either case, the journal entry to record the partner's withdrawal by selling her interest

- ▼ *decreases Rose Padilla, Capital* with a debit
- ▲ *increases Adam Novak, Capital* or *Mary Smith, Capital* with a credit

#### Journal Entries

$$\begin{array}{rclcl} \mathbf{A} & = & \mathbf{L} & + & \mathbf{OE} \\ & & & & -100,000 \\ & & & & +100,000 \end{array}$$

$$\begin{array}{rclcl} \mathbf{A} & = & \mathbf{L} & + & \mathbf{OE} \\ & & & & -100,000 \\ & & & & +100,000 \end{array}$$

1. If Padilla's interest is purchased by Novak:			
Rose Padilla, Capital	100,000		
Adam Novak, Capital		100,000	
Sale of Padilla's partnership interest to Novak			
2. If Padilla's interest is purchased by Smith:			
Rose Padilla, Capital	100,000		
Mary Smith, Capital		100,000	
Sale of Padilla's partnership interest to Smith			

**Comment** Selling a partnership interest does not affect the assets and liabilities of the partnership. Therefore, total equity remains unchanged. The only effect of a partner's selling his or her interest to the existing partners or to a new partner is that a new *separate entity* is formed with a change of names in the partners' equity section of the balance sheet.

**Withdrawal by Removing Assets** A partnership agreement can allow a withdrawing partner to remove assets from the firm equal to his or her capital balance.

### Withdrawal by Removing Assets

**Transaction** Adam Novak decides to withdraw from Mind, Padilla, and Novak on January 21, 2016. Novak's capital balance is \$60,000. The partnership agreement states that he can withdraw cash from the firm equal to his capital balance. If there is not enough cash, he must accept a promissory note from the new partnership for the balance. The remaining partners ask that Novak take only \$50,000 because of a cash shortage at the time of his withdrawal, and he agrees to this request.

**Analysis** The journal entry to record Novak's withdrawal

- ▼ *decreases Adam Novak, Capital* with a debit
- ▼ *decreases Cash* with a credit
- ▲ *increases Notes Payable, Adam Novak* with a credit

#### Journal Entry

$$\begin{array}{rclcl} \mathbf{A} & = & \mathbf{L} & + & \mathbf{OE} \\ -50,000 & & +10,000 & & -60,000 \end{array}$$

2016		<i>Dr.</i>	<i>Cr.</i>
Jan. 21	Adam Novak, Capital	60,000	
	Cash		50,000
	Notes Payable, Adam Novak		10,000
	Withdrawal of Adam Novak from the partnership		

**Comment** Since Adam Novak is no longer a partner, the partnership entity had changed again. The *separate entity* now consists of the two remaining partners.

The preceding example showed the case when the partner withdraws taking an amount equal to his or her capital. It is not always the case that the withdrawal is equal to the capital account.

- When a withdrawing partner removes assets that represent less than his or her capital balance, the equity that the partner leaves in the business is divided among the remaining partners according to their stated ratios. This distribution is considered a bonus to the remaining partners.
- When a withdrawing partner takes out assets that are greater than his or her capital balance, the excess is treated as a bonus to the withdrawing partner. The remaining partners absorb the bonus by reducing their capital accounts according to their stated ratios. Alternative arrangements can be spelled out in the partnership agreement.

## Death of a Partner

When a partner dies, the partnership is dissolved because the original association has changed. The partnership agreement should state the actions to be taken. Normally, the books are closed, and financial statements are prepared. These actions are necessary to determine the capital balance of each partner on the date of the death. The agreement may also indicate whether an audit should be conducted, assets appraised, and a bonus recorded, as well as what procedures have been established for settling with the deceased partner's heirs. The remaining partners may purchase the deceased's equity, sell it to outsiders, or deliver certain business assets to the estate. If the firm intends to continue, a new partnership must be formed.

### APPLY IT!

Alpha and Beta each own a \$50,000 interest in a partnership. They agree to admit Gamma as a partner by selling her a one-third interest for \$80,000. How large a bonus will be distributed to Alpha and Beta?

#### SOLUTION

Partners' equity in the original partnership		\$100,000	
Cash investment by Gamma		80,000	
Partners' equity in the new partnership		<u>\$180,000</u>	
Partners' equity assigned to Gamma ( $\$180,000 \times \frac{1}{3}$ )		<u>\$ 60,000</u>	
Bonus to the original partners:			
Investment by Gamma	\$80,000		
Less equity assigned to Gamma	<u>60,000</u>		<u>\$ 20,000</u>
Distribution of bonus to original partners:			
Alpha ( $\$20,000 \times 0.50$ )	\$10,000		
Beta ( $\$20,000 \times 0.50$ )	<u>10,000</u>		<u>\$ 20,000</u>

**TRY IT! SE6, SE7, SE8, SE9, E6A, E7A, E6B, E7B**

## LO 5 Liquidation of a Partnership

The **liquidation** of a partnership is the process of selling enough assets to pay the partnership's liabilities and distributing any remaining assets among the partners. Liquidation is a special form of dissolution. When a partnership is liquidated, the business will not continue. As the assets of the business are sold, any gain or losses should be

distributed to the partners according to the stated ratios. As cash becomes available, it must be applied first to outside creditors, then to loans from partners, and finally to the partners' capital balances.

The process of liquidation can have a variety of financial outcomes. We look at two: (1) assets sold for a gain and (2) assets sold for a loss. To illustrate both alternatives, assume that the books have been closed for Mind, Padilla, and Novak, and that the following balance sheet exists before liquidation:

Assets		Liabilities	
Cash	\$ 60,000	Accounts payable	<u>\$120,000</u>
Accounts receivable	40,000		
Merchandise inventory	100,000		
Plant assets (net)	<u>200,000</u>	Partners' Equity	
		Mind, capital	\$ 85,000
		Padilla, capital	95,000
		Novak, capital	<u>100,000</u>
		Total partners' equity	<u>\$280,000</u>
Total assets	<u>\$400,000</u>	Total liabilities and partners' equity	<u>\$400,000</u>

The stated ratios of Mind, Padilla, and Novak are 3:3:4, or 30, 30, and 40 percent, respectively.

## Gain on Sale of Assets

The following transactions took place in the liquidation of Mind, Padilla, and Novak:

1. On February 13, the accounts receivable were collected for \$35,000.
2. On February 14, the inventory was sold for \$110,000.
3. On February 15, the plant assets were sold for \$200,000.
4. On February 16, the accounts payable of \$120,000 were paid.
5. On February 20, the net gain of \$5,000 from the realization of the assets was distributed according to the partners' stated ratios.
6. On February 20, the partners received cash equal to the balances of their Capital accounts.

These transactions are summarized in the statement of liquidation in Exhibit 3. The entries with their assumed transaction dates follow.

### Journal Entries

		Explanation on Statement of Liquidation		
		2017	Dr.	Cr.
<b>A</b> = <b>L</b> + <b>OE</b> +35,000 -40,000	=	Feb. 13	Cash	35,000
			Gain or Loss from Realization	5,000
			Accounts Receivable	40,000
			Collection of accounts receivable	
		14	Cash	110,000
			Merchandise Inventory	100,000
			Gain or Loss from Realization	10,000
			Sale of inventory	

Journal Entries

<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>OE</b>	
+200,000					
-200,000					
<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>OE</b>	
-120,000		-120,000			
<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>OE</b>	
				-5,000	
				+1,500	
				+1,500	
				+2,000	
<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>OE</b>	
-285,000				-86,500	
				-96,500	
				-102,000	

		Explanation on Statement of Liquidation		
		Dr.	Cr.	
Feb. 15	Cash	200,000		3.
	Plant Assets		200,000	
	Sale of plant assets			
16	Accounts Payable	120,000		4.
	Cash		120,000	
	Payment of accounts payable			
20	Gain or Loss from Realization	5,000		5.
	Lori Mind, Capital		1,500	
	Rose Padilla, Capital		1,500	
	Adam Novak, Capital		2,000	
	Distribution of the net gain on assets (\$10,000 gain minus \$5,000 loss) to the partners			
20	Lori Mind, Capital	86,500		6.
	Rose Padilla, Capital	96,500		
	Adam Novak, Capital	102,000		
	Cash		285,000	
	Distribution of cash to the partners			

**Exhibit 3**  
Statement of Liquidation Showing Gain on Sale of Assets

<b>Mind, Padilla, and Novak Statement of Liquidation February 2–20, 2017</b>							
Explanation	Cash	Other Assets	Accounts Payable	Mind, Capital (30%)	Padilla, Capital (30%)	Novak, Capital (40%)	Gain (or Loss) from Realization
Balance 2/2/17	\$ 60,000	\$ 340,000	\$ 120,000	\$ 85,000	\$ 95,000	\$ 100,000	
1. Collection of Accounts Receivable	35,000	(40,000)					\$ (5,000)
	<u>\$ 95,000</u>	<u>\$ 300,000</u>	<u>\$ 120,000</u>	<u>\$ 85,000</u>	<u>\$ 95,000</u>	<u>\$ 100,000</u>	<u>\$ (5,000)</u>
2. Sale of Inventory	110,000	(100,000)					10,000
	<u>\$ 205,000</u>	<u>\$ 200,000</u>	<u>\$ 120,000</u>	<u>\$ 85,000</u>	<u>\$ 95,000</u>	<u>\$ 100,000</u>	<u>\$ 5,000</u>
3. Sale of Plant Assets	200,000	(200,000)					
	<u>\$ 405,000</u>	<u>—</u>	<u>\$ 120,000</u>	<u>\$ 85,000</u>	<u>\$ 95,000</u>	<u>\$ 100,000</u>	<u>\$ 5,000</u>
4. Payment of Liabilities	(120,000)		(120,000)				
	<u>\$ 285,000</u>		<u>—</u>	<u>\$ 85,000</u>	<u>\$ 95,000</u>	<u>\$ 100,000</u>	<u>\$ 5,000</u>
5. Distribution of Gain (or Loss) from Realization				1,500	1,500	2,000	(5,000)
	<u>\$ 285,000</u>			<u>\$ 86,500</u>	<u>\$ 96,500</u>	<u>\$ 102,000</u>	<u>—</u>
6. Distribution of Cash to Partners	(285,000)			(86,500)	(96,500)	(102,000)	
	<u>—</u>			<u>—</u>	<u>—</u>	<u>—</u>	

© Cengage Learning 2014



Notice that the cash distributed to the partners is the balance in their respective Capital accounts. Cash is not distributed according to the partners' stated ratios.

## Loss on Sale of Assets

When a firm's assets are sold at a loss, the partners share the loss on liquidation according to their stated ratios. For example, assume that during the liquidation of Mind, Padilla, and Novak, the total cash received from the collection of accounts receivable and the sale of inventory and plant assets was \$140,000. The statement of liquidation appears in Exhibit 4.

**STUDY NOTE:** Because losses are allocated on the same basis as gains, the only difference in accounting for them is that debits and credits are switched.

### Exhibit 4 Statement of Liquidation Showing Loss on Sale of Assets

<b>Mind, Padilla, and Novak Statement of Liquidation February 2–20, 2017</b>							
Explanation	Cash	Other Assets	Accounts Payable	Mind, Capital (30%)	Padilla, Capital (30%)	Novak, Capital (40%)	Gain (or Loss) from Realization
Balance 2/2/17	\$ 60,000	\$ 340,000	\$ 120,000	\$ 85,000	\$ 95,000	\$100,000	
1. Collection of Accounts Receivable and Sale of Inventory and Plant Assets	140,000	(340,000)					\$(200,000)
	<u>\$200,000</u>	<u>—</u>	<u>\$ 120,000</u>	<u>\$ 85,000</u>	<u>\$ 95,000</u>	<u>\$100,000</u>	<u>\$(200,000)</u>
2. Payment of Liabilities	(120,000)		(120,000)				
	<u>\$ 80,000</u>		<u>—</u>	<u>\$ 85,000</u>	<u>\$ 95,000</u>	<u>\$100,000</u>	<u>\$(200,000)</u>
3. Distribution of Gain (or Loss) from Realization				(60,000)	(60,000)	(80,000)	200,000
	<u>\$ 80,000</u>			<u>\$ 25,000</u>	<u>\$ 35,000</u>	<u>\$ 20,000</u>	<u>—</u>
4. Distribution of Cash to Partners	(80,000)			(25,000)	(35,000)	(20,000)	
	<u>—</u>			<u>—</u>	<u>—</u>	<u>—</u>	

© Cengage Learning 2014

The entries for the transactions summarized in the statement of liquidation in Exhibit 4 are as follows.

### Journal Entries

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+140,000				−200,000
−40,000				
−100,000				
−200,000				

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
−120,000		−120,000		

		Explanation on Statement of Liquidation	
		Dr.	Cr.
2017			
Feb. 15	Cash	140,000	
	Gain or Loss from Realization	200,000	
	Accounts Receivable		40,000
	Merchandise Inventory		100,000
	Plant Assets		200,000
	Collection of accounts receivable and the sale of inventory and plant assets.		
16	Accounts Payable	120,000	
	Cash		120,000
	Payment of accounts payable		

	<b>A</b>	=	<b>L</b>	+	<b>OE</b>	
					-60,000	
					-60,000	
					-80,000	
					+200,000	
	<b>A</b>	=	<b>L</b>	+	<b>OE</b>	
-80,000					-25,000	
					-35,000	
					-20,000	

**Journal Entries**

		Explanation on Statement of Liquidation		
2017		Dr.	Cr.	
Feb. 20	Lori Mind, Capital	60,000		4.
	Rose Padilla, Capital	60,000		
	Adam Novak, Capital	80,000		
	Gain or Loss from Realization		200,000	
	Distribution of the loss on assets to the partners			
20	Lori Mind, Capital	25,000		5.
	Rose Padilla, Capital	35,000		
	Adam Novak, Capital	20,000		
	Cash		80,000	
	Distribution of cash to the partners			

In some liquidations, a partner’s share of the loss is greater than his or her capital balance. In such a situation, because partners are subject to unlimited liability, the partner must make up the deficit in his or her Capital account from personal assets.

**Liquidations Where Loss Is Greater than a Partners’ Capital Balance**

**Transaction** After the sale of assets and the payment of liabilities, the remaining assets and partners’ equity of Mind, Padilla, and Novak look like this:

Assets:			
Cash			<u>\$30,000</u>
Partners’ equity:			
Mind, capital	\$25,000		
Padilla, capital	20,000		
Novak, capital	<u>(15,000)</u>		<u>\$30,000</u>

Adam Novak must pay \$15,000 into the partnership from personal funds to cover his deficit.

**Analysis** Two journal entries are required. First, the journal entry to record Novak’s \$15,000 payment

- ▲ *increases Cash* increased with a debit
- ▲ *increases Adam Novak, Capital* with a credit

**Journal Entry**

	<b>A</b>	=	<b>L</b>	+	<b>OE</b>	
	+15,000				+15,000	

2017		Dr.	Cr.
Feb. 20	Cash	15,000	
	Adam Novak, Capital		15,000
	Additional investment of Adam Novak to cover the negative balance in his Capital account		

After Novak pays \$15,000, there is enough cash to pay Mind and Padilla their capital balances and, thus, to complete the liquidation. This journal entry

- ▼ *decreases Lori Mind, Capital* and *Rose Padilla, Capital* with debits
- ▼ *decreases Cash* with a credit

**Journal Entry**

	<b>A</b>	=	<b>L</b>	+	<b>OE</b>	
	-45,000				-25,000	
					-20,000	

2017		Dr.	Cr.
Feb. 20	Lori Mind, Capital	25,000	
	Rose Padilla, Capital	20,000	
	Cash		45,000
	Distribution of cash to the partners		

**Comment** The *separate partnership entity* is now ended and the partners have received their share of the cash.

If a partner does not have the cash to cover his or her obligations to the partnership, the remaining partners share the loss according to their established stated ratios. Remember that all partners have unlimited liability.

### Liquidations Where Partners Share the Loss

**Transaction** If Adam Novak cannot pay the \$15,000 deficit in his Capital account, Mind and Padilla must share the deficit according to their stated ratios. Each has a 30 percent stated ratio, so each must bear 50 percent of the deficit that Novak cannot pay.

**Computation** The new stated ratios are computed as follows.

	Old Ratios	New Ratios
Mind	30%	$30 \div 60 = 0.50 = 50\%$
Padilla	30	$30 \div 60 = 0.50 = 50$
	<u>60%</u>	<u>100%</u>

**Analysis** The journal entry to record the partners' payment of the \$15,000 deficit

- ▼ decreases Lori Mind, Capital and Rose Padilla, Capital with debits
- ▲ increases Adam Novak, Capital with a credit

THEN,

- ▼ decreases Lori Mind, Capital and Rose Padilla, Capital with debits
- ▼ decreases Cash with a credit

### Journal Entries

<b>A</b>	=	<b>L</b>	+	<b>OE</b>			
					-7,500		
					-7,500		
					+15,000		
<b>A</b>	=	<b>L</b>	+	<b>OE</b>			
-30,000					-17,500		
					-12,500		

2017		Dr.	Cr.
Feb. 20	Lori Mind, Capital	7,500	
	Rose Padilla, Capital	7,500	
	Adam Novak, Capital		15,000
	Transfer of Novak's deficit to Mind and Padilla		
20	Lori Mind, Capital	17,500	
	Rose Padilla, Capital	12,500	
	Cash		30,000
	Distribution of cash to the partners		

**Comment** Novak's inability to meet his obligations at the time of liquidation does not relieve him of his liabilities to Mind and Padilla. If he is able to pay his liabilities at some time in the future, Mind and Padilla can collect the amount of Novak's deficit that they absorbed.

## The Balance Sheet and Partner's Equity

Exhibit 5 shows how the assets, liabilities, and each partner's equity are reported on a balance sheet for a partnership.

**Exhibit 5**  
Partnership Balance Sheet

© Cengage Learning 2014

<b>Balance Sheet</b>	
December 31, 2014	
<b>Assets</b>	<b>Liabilities</b>
Current assets	Current liabilities
Investments	Long-term liabilities
Property, plant, and equipment	Total liabilities
Intangible assets	
	<b>Partner's Equity</b>
	Partner 1, capital
	Partner 2, capital
	Total partner's capital
<b>Total Assets = Total Liabilities + Partner's Equity</b>	

**APPLY IT!**

After the partnership between Tim and John has been operating for a year, their Capital accounts are \$30,000 and \$20,000, respectively. The firm has cash of \$24,000 and inventory of \$26,000. The partners decide to liquidate the partnership. The inventory is liquidated for only \$8,000. Assuming the partners share income and losses in the ratio of one-third to Tim and two-thirds to John, how much cash will be distributed to each partner in liquidation?

**SOLUTION**

Loss on inventory computed:  
 $\$26,000 - \$8,000 = \$18,000$

	<b>Tim</b>	<b>John</b>
Distribution of cash to partners:		
Capital balances	\$30,000	\$ 20,000
Distribution of loss:		
Tim ( $\$18,000 \times \frac{1}{3}$ )	(6,000)	
John ( $\$18,000 \times \frac{2}{3}$ )		(12,000)
Cash to partners	<u>\$24,000</u>	<u>\$ 8,000</u>

**TRY IT! SE10, E8A, E9A, E8B, E9B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATION

- Identify alternate forms of partnership-type entities

RELEVANT  
LEARNING OBJECTIVE

- LO 6 Identify alternate forms of partnership-type entities.

## LO 6 Alternate Forms of Partnership-Type Entities

### Limited Partnerships and Joint Ventures

Other common forms of association that are a type of partnership or similar to a partnership are limited partnerships, joint ventures, and companies with some partnership-like characteristics.

#### Limited Partnerships

A **limited partnership (LP)** is a special type of partnership that, like corporations, confines the limited partner's potential loss to the amount of his or her investment. Under this type of partnership, the unlimited liability disadvantage of a partnership can be overcome. Usually, the limited partnership has a general partner who has unlimited liability but allows other partners to limit their potential loss. The potential loss of all partners in an ordinary partnership is limited only by personal bankruptcy laws.

Limited partnerships resemble corporations in that the liability of the partners is restricted to the amount of their investment in the business. Because limited partnerships curtail an investor's risk, they are sometimes used in place of corporations to raise funds from the public to finance large projects, such as the exploration and drilling of oil and gas wells, the manufacture of airplanes, and the development of real estate (including shopping centers, office buildings, and apartment complexes). For example, **Alliance Capital Management Limited Partnership**, a large investment advisor, manages more than \$90 billion in assets for corporate and individual investors in various projects. The company's partnership units, or shares of ownership, sell on the New York Stock Exchange and can be purchased by the individual investor.

#### Joint Ventures

In today's global environment, more companies are looking to form joint ventures with other companies. These alliances are similar to partnerships. A **joint venture** is an association of two or more entities for the purpose of achieving a specific goal, such as the manufacture of a product in a new market. Many joint ventures have an agreed-upon limited life. The entities forming joint ventures usually involve companies but sometimes involve governments, especially in emerging economies. A joint venture brings together the resources, technical skills, political ties, and other assets of each of the parties for a common goal. Profits and losses are shared on an agreed-upon basis.

When U.S. companies make investments abroad, they often find it wise to partner with a local company. Because many countries require that local investors own a substantial percentage of a newly formed business, partnering with a local company is often a necessary step. One way of accomplishing this is to form a joint venture, which matches a country's need for outside capital and operational know-how with the investors' interest in business expansion and profitability. Joint ventures frequently take the form of partnerships among two or more corporations and other investors. Any income or losses from operations are divided among the participants according to a predetermined agreement.



## Business Perspective

### What Are the Risks of Being a Partner in an Accounting Firm?

Partners in large accounting firms can make over \$250,000 per year, with top partners drawing over \$800,000. However, consideration of those incomes should take into account the risks that partners take and the fact that the incomes of partners in small accounting firms are often much lower.

Partners are not compensated in the same way as managers in corporations. Partners' income is not guaranteed; rather, it is based on the performance of the partnership. Also, each partner is required to make a substantial investment of capital in the partnership. This capital remains at risk for as long as the partner chooses to stay in the partnership. For instance, in one notable case, when a large firm was convicted of destroying evidence in the **Enron** case, the partners lost their total investments as well as their income when their firm was subjected to lawsuits and other losses. The firm was eventually liquidated.

© Allija / iStockphoto.com

© Cengage Learning 2014

## Companies That Look Like Partnerships

Some types of business organizations mimic the characteristics of partnerships:

- **S corporations:** **S corporations** are corporations that U.S. tax laws treat as partnerships. Unlike normal corporations, S corporations do not pay federal income taxes. They have a limited number of stockholders, who report the income or losses on their investments in the business on their personal tax returns. This avoids the problem of double taxation.
- **Limited liability company (LLC):** In a **limited liability company (LLC)**, the members are partners, and their liability is limited to their investment in the business. LLCs are used frequently by accounting and consultancy firms.
- **Special-purpose entities (SPEs):** **Special-purpose entities (SPEs)**, which gained notoriety because of the **Enron** case, are firms with limited lives that a company creates to achieve a specific objective, such as raising money by selling receivables. By meeting certain conditions, a company that sets up an SPE can legitimately avoid including the debt of the SPE on its balance sheet. Enron used SPEs extensively and fraudulently to hide debt and other commitments.

## APPLY IT!

Identify each of the following statements as either (a) limited partnership, (b) joint venture, (c) S corporation, (d) limited liability company, or (e) special-purpose entity:

1. Entities with limited lives that a company creates to achieve a specific objective.
2. An association of two or more entities for the purpose of achieving a specific goal.
3. Corporations that U.S. tax laws treat as partnerships, and they do not pay income taxes.
4. An entity in which members are partners, and their liability is limited to their investment in the business.
5. A special type of partnership that confines the limited partner's potential loss to the amount of his or her investment.

### SOLUTION

1. e; 2. b; 3. c; 4. d; 5. a

**TRY IT! SE11, E10A, E10B**



## TriLevel Problem



Photo:Alto/Alamy

**Ankin and Kent Partnership**

### Distribution of Income and Admission of a Partner

The beginning of this chapter focused on Patrick Ankin and Eric Kent, who were forming their partnership in 2014. They were faced with a number of important decisions. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*How does the separate entity concept apply to partners' interest in a partnership?*

#### Section 2: Accounting Applications

*How would Patrick Ankin and Eric Kent share the income or losses of their business, and how would they handle any changes in ownership that might occur?*

Patrick and Eric drafted a written partnership agreement that clearly stated the details of the arrangement, including the name, location, and purpose of the business; their names and respective duties; the investments each of them had made; the method of distributing income and losses; and the procedures for the admission and withdrawal of partners, the withdrawal of assets allowed each partner, and the liquidation (termination) of the business. They decided that Patrick, who had contributed \$100,000 to the partnership, was to receive an annual salary of \$6,000 and that Eric was to receive 3 percent interest annually on his original investment of \$150,000. They were to share income and losses after salary and interest in a 2:3 ratio.

1. In 2014, the partnership had an income of \$27,000, and in 2015, it had a loss of \$2,000 (before salaries and interest). Compute Patrick Ankin and Eric William's share of the income and loss for the two years, and prepare the required journal entries.
2. On January 1, 2016, Adele Matiz offers Patrick and Eric \$60,000 for a 15 percent interest in the partnership. They agree to Matiz's offer because they need her resources to expand the business. On January 1, 2016, the balance in Patrick's Capital account is \$113,600, and the balance in Eric's Capital account is \$161,400. Record the admission of Adele Matiz to the partnership, assuming that her investment represents a 15 percent interest in the total partners' capital and that a bonus will be distributed to Patrick and Eric in the ratio of 2:3.

#### Section 3: Business Applications

*As the partnership grows, what alternate forms of partnership-like entities might the partners consider?*

## SOLUTION

#### Section 1: Concepts

A partnership is an association of two or more persons to carry on as co-owners of a business for profit. A partnership is treated in the accounting records and financial statements as a *separate entity* apart from the partners who have an interest in the partnership.



2.

**Capital Balance and Bonus Computation**

$$\text{Matiz, Capital} = (\text{Original Partners' Capital} + \text{New Partner's Investment}) \times 15\%$$

$$= (\$113,600 + \$161,400 + \$60,000) \times 0.15 = \$50,250$$

$$\text{Bonus} = \text{New Partner's Investment} - \text{Matiz, Capital}$$

$$= \$60,000 - \$50,250$$

$$= \$9,750$$

**Distribution of Bonus**

$$\text{Ankin} = \$9,750 \times \frac{2}{5} = \$3,900$$

$$\text{Kent} = \$9,750 \times \frac{3}{5} = 5,850$$

$$\text{Total bonus} \quad \underline{\underline{\$9,750}}$$

**Journal Entry:**

2016		<i>Dr.</i>	<i>Cr.</i>
Jan. 1	Cash	60,000	
	Patrick Ankin, Capital		3,900
	Eric Kent, Capital		5,850
	Adele Matiz, Capital		50,250
	Sale of a 15 percent interest in the partnership to Adele Matiz and the bonus paid to the original partners		

**Section 3: Business Applications**

As the partnership business grows, the partners may want to consider changing the form of organization to a limited partnership, joint venture, or limited liability company. This change would help overcome some of the disadvantages of partnerships, such as the unlimited liability of partners and limited life of the partnership.

## Chapter Review

Define the *partnership* form of business, and identify its principal characteristics. **LO 1**

A partnership is a voluntary association of two or more people who combine their talents and resources to carry on a business. Legally, the partnership is not separate from its partners. Their joint effort should be supported by a partnership agreement that spells out the venture's operating procedures. A partnership is dissolved by a partner's admission, withdrawal, or death and therefore has a limited life. Each partner acts as an agent of the partnership within the scope of normal operations and is personally liable for the partnership's debts. Property invested in the partnership becomes an asset of the partnership, owned jointly by all the partners. Each partner has the right to share in the company's income and the responsibility to share in its losses. For accounting purposes, however, the partnership is treated as a separate entity with its own accounting records and financial statements.

Record partners' investments of cash and other assets when a partnership is formed. **LO 2**

A partnership is formed when the partners contribute cash, other assets, or a combination of both to the business. The details are stated in the partnership agreement. Initial investments are recorded with a debit to Cash or another asset account and a credit to the investing partner's Capital account. The recorded amount of the other assets should

**Compute and record the income or losses that partners share, based on stated ratios, capital balance ratios, and partners' salaries and interest.** **Lo 3**

be their fair market value on the date of transfer to the partnership. In addition, a partnership can assume an investing partner's liabilities. When this occurs, the partner's Capital account is credited with the difference between the assets invested and the liabilities assumed.

The partners must share income and losses in accordance with the partnership agreement. If the agreement says nothing about the distribution of income and losses, the partners share them equally. Common methods used for distributing income and losses include stated ratios, capital balance ratios, and salaries and interest on capital investments.

Stated ratios usually are based on the partners' relative contributions to the partnership. When capital balance ratios are used, income or losses are divided strictly on the basis of each partner's capital balance. The use of salaries and interest on capital investment takes into account both efforts (salary) and capital investment (interest) in dividing income or losses among the partners.

**Record a person's admission to or withdrawal from a partnership.** **Lo 4**

An individual is admitted to a partnership by purchasing a partner's interest or by contributing additional assets. When an interest is purchased, the withdrawing partner's capital is transferred to the new partner. When the new partner contributes assets to the partnership, it may be necessary to recognize a bonus shared or borne by the original partners or by the new partner.

A person can withdraw from a partnership by selling his or her interest in the business to the remaining partners or a new partner or by withdrawing company assets. When assets are withdrawn, the amount can be equal to, less than, or greater than the partner's capital interest. When assets that have a value less than or greater than the partner's interest are withdrawn, a bonus is recognized and distributed among the remaining partners or to the departing partner.

**Compute and record the distribution of assets to partners when they liquidate their partnership.** **Lo 5**

The liquidation of a partnership entails selling the assets necessary to pay the company's liabilities and then distributing any remaining assets to the partners. Any gain or loss on the sale of the assets is shared by the partners according to their stated ratios. When a partner has a deficit balance in a Capital account, that partner must contribute personal assets equal to the deficit. When a partner does not have personal assets to cover a capital deficit, the deficit must be absorbed by the solvent partners according to their stated ratios.

**Identify alternate forms of partnership-type entities.** **Lo 6**

Common alternate forms of association similar to a regular partnership are limited partnerships, joint ventures, and limited liability companies. Each of these forms of business overcomes certain disadvantages of partners.

## Key Terms

**bonus** 463 (LO4)  
**dissolution** 461 (LO4)  
**joint venture** 474 (LO6)  
**limited liability company (LLC)** 475 (LO6)  
**limited life** 452 (LO1)

**limited partnership (LP)** 474 (LO6)  
**liquidation** 467 (LO5)  
**mutual agency** 452 (LO1)  
**partners' equity** 454 (LO2)  
**partnership** 452 (LO1)  
**partnership agreement** 452 (LO1)

**S corporations** 475 (LO6)  
**special-purpose entities (SPEs)** 475 (LO6)  
**unlimited liability** 452 (LO1)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ► Even though, from accounting standpoint, partnerships are separate entities from the partners, why is it important for people to form partnerships with people they can trust?
- LO 2 **DQ2.** When accounts receivable are transferred into a partnership, at what amount should they be recorded?
- LO 3 **DQ3.** What is a disadvantage of receiving a large salary as part of a partner's distribution?
- LO 4 **DQ4.** If the value of a partnership is worth far more than the book value of the assets on the balance sheet, would a new partner entering the partnership be more likely to pay a bonus to the old partners or receive a bonus from the old partners?
- LO 5 **DQ5.** When a partnership is dissolved, what is an alternate approach to selling all the assets and distributing the proceeds, and what decisions will have to be made if this approach is taken?

### SHORT EXERCISES

#### LO 1 Partnership Characteristics

**SE1.** Indicate whether each statement below is a reflection of (a) voluntary association, (b) a partnership agreement, (c) limited life, (d) mutual agency, or (e) unlimited liability.

1. A written contract among partners.
2. Any partner can sign a contract obligating the partnership.
3. A partner may be liable for the debts of the partnership.
4. A partnership ends when a partner is admitted, withdraws, retires, or dies.
5. A partner may leave a partnership if he or she wants to.

#### LO 2 Partnership Formation

**SE2.** Martin contributes cash of \$24,000, and Steven contributes office equipment that cost \$20,000 but is valued at \$16,000 to the formation of a new partnership. Prepare the journal entry to form the partnership.

#### LO 3 Distribution of Partnership Income

**SE3.** During the first year, the Martin and Steven partnership in **SE2** earned an income of \$10,000. Assume the partners agreed to share income and losses in the ratio of the beginning balances of their capital accounts. How much income should be transferred to each Capital account?

#### LO 3 Distribution of Partnership Income

**SE4.** During the first year, the Martin and Steven partnership in **SE2** earned an income of \$10,000. Assume the partners agreed to share income and losses by figuring interest on the beginning capital balances at 10 percent and dividing the remainder equally. How much income should be transferred to each Capital account?

#### LO 3 Distribution of Partnership Income

**SE5.** During the first year, the Martin and Steven partnership in **SE2** earned an income of \$10,000. Assume the partners agreed to share income and losses by figuring interest on the beginning capital balances at 10 percent, allowing a salary of \$12,000 to Martin,

and dividing the remainder equally. How much income (or loss) should be transferred to each Capital account?

**LO 4 Withdrawal of a Partner**

**SE6.** After the partnership has been operating for a year, the Capital accounts of Martin and Steven are \$15,000 and \$10,000, respectively. Steven withdraws from the partnership by selling his interest in the business to Sania for \$8,000. What will be the Capital account balances of the partners in the new Martin and Sania partnership? Prepare the journal entry to record the transfer of ownership on the partnership books.

**LO 4 Admission of a New Partner**

**SE7.** After the partnership has been operating for a year, the Capital accounts of Martin and Steven are \$30,000 and \$20,000, respectively. Sania buys a one-sixth interest in the partnership by investing cash of \$22,000. What will be the Capital account balances of the partners in the new Martin, Steven, and Sania partnership, assuming a bonus to the old partners, who share income and losses equally? Prepare the journal entry to record the transfer of ownership on the partnership books.

**LO 4 Admission of a New Partner**

**SE8.** After the partnership has been operating for a year, the Capital accounts of Martin and Steven are \$15,000 and \$10,000, respectively. Sania buys a one-fourth interest in the partnership by investing cash of \$5,000. What will be the Capital account balances of the partners in the new Martin, Steven, and Sania partnership, assuming that the new partner receives a bonus and that Martin and Steven share income and losses equally? Prepare the journal entry to record the transfer of ownership on the partnership books.

**LO 4 Withdrawal of a Partner**

**SE9.** After the partnership has been operating for several years, the Capital accounts of Martin, Steven, and Sania are \$50,000, \$32,000, and \$18,000, respectively. Sania decides to leave the partnership and is allowed to withdraw \$18,000 in cash. Prepare the journal entry to record the withdrawal on the partnership books.

**LO 5 Liquidation of a Partnership**

**SE10.** After the partnership has been operating for a year, the Capital accounts of Martin and Steven are \$15,000 and \$10,000, respectively. The firm has cash of \$12,000 and office equipment of \$13,000. The partners decide to liquidate the partnership. The office equipment is sold for only \$4,000. Assuming the partners share income and losses in the ratio of one-third to Martin and two-thirds to Steven, how much cash will be distributed to each partner in liquidation?

**LO 6 Types of Partnerships**

**SE11. BUSINESS APPLICATION** ► Indicate whether each statement that follows is a reflection of (a) normal partnership (b) limited partnership, (c) joint venture, or (d) S corporation.

1. A special type of partnership that, like corporations, confines the limited partner's potential loss to the amount of his or her investment.
2. A form of organization that has the disadvantage of unlimited liability.
3. An association formed by two or more entities for the purpose of achieving a specific goal.
4. A form of organization that makes it difficult to raise large amounts of capital.
5. A form of corporation that is treated as a partnership and pays no federal income taxes.



## EXERCISES: SET A

### LO 1 Partnership Characteristics

**E1A.** Indicate whether each action that follows is a reflection of (a) voluntary association, (b) a partnership agreement, (c) limited life, (d) mutual agency, or (e) unlimited liability.

1. A partner signs an contract obligating the partnership.
2. A partner leaves a partnership for personal reasons.
3. A partner has to pay some of the debts of the partnership.
4. The partners write a contract among themselves.
5. A partner leaves the partnership ending the partnership.

### LO 1 Partnership Advantages and Disadvantages

**E2A.** Indicate whether each statement below is a reflection of an (a) advantage or a (b) disadvantage of the partnership form of business.

1. It is easy to form, change, and dissolve.
2. The life of a partnership is limited.
3. It gives the partners a certain amount of freedom and flexibility.
4. It is more difficult for a partnership to raise large amounts of capital and to transfer ownership interests than it is for a corporation.

### LO 2 Partnership Formation

**E3A.** Hanna Hark and Jamie Rice are watch repairmen who want to form a partnership and open a jewelry store. An attorney prepares their partnership agreement, which indicates that assets invested in the partnership will be recorded at their fair market value and that liabilities will be assumed at book value.

The assets contributed by each partner and the liabilities assumed by the partnership follow.

Assets	Hanna Hark	Jamie Rice	Total
Cash	\$ 80,000	\$60,000	\$140,000
Accounts receivable	104,000	40,000	144,000
Allowance for uncollectible accounts	8,000	6,000	14,000
Supplies	2,000	1,000	3,000
Equipment	40,000	20,000	60,000
<b>Liabilities</b>			
Accounts payable	64,000	18,000	82,000

Prepare the journal entries necessary to record the original investments of Hark and Rice in the partnership.

### LO 3 Distribution of Income

**E4A.** Isha Shah and Brian Ruben agreed to form a partnership. Shah contributed \$400,000 in cash, and Ruben contributed assets with a fair market value of \$800,000. The partnership, in its initial year, reported net income of \$240,000. Calculate the distribution of the first year's income to the partners under each of the following conditions:

1. Shah and Ruben failed to include stated ratios in the partnership agreement.
2. Shah and Ruben agreed to share income and losses in a 3:2 ratio.
3. Shah and Ruben agreed to share income and losses in the ratio of their original investments.
4. Shah and Ruben agreed to share income and losses by allowing 10 percent interest on original investments and sharing any remainder equally.

### LO 3 Distribution of Income or Losses: Salaries and Interest

**E5A.** Assume that the partnership agreement of Shah and Ruben in **E4A** states that Shah and Ruben are to receive salaries of \$40,000 and \$48,000, respectively; that Shah is to receive 6 percent interest on his capital balance at the beginning of the year; and that the

remainder of income and losses are to be shared equally. Calculate the distribution of the income or losses under the following conditions:

1. Income totaled \$240,000 before deductions for salaries and interest.
2. Income totaled \$96,000 before deductions for salaries and interest.
3. There was a loss of \$4,000.
4. There was a loss of \$80,000.

**LO 3 Distribution of Income: Average Capital Balance**

**E6A.** Amine and Ankit operate a furniture rental business. Their capital balances on January 1, 2014, were \$320,000 and \$480,000, respectively. Amine withdrew cash of \$64,000 from the business on April 1, 2014. Ankit withdrew \$120,000 cash on October 1, 2014. Amine and Ankit distribute partnership income based on their average capital balances each year. Income for 2014 was \$320,000. Compute the income to be distributed to Amine and Ankit using their average capital balances in 2014. (Round percentages to the nearest tenth of a percent.)

**LO 4 Admission of a New Partner: Recording a Bonus**

**E7A.** Gamine, Ronald, and Fenny have equity in a partnership of \$80,000, \$80,000, and \$120,000, respectively, and they share income and losses in a ratio of 1:1:3. The partners have agreed to admit Amit to the partnership. Prepare journal entries to record the admission of Amit to the partnership under the following conditions:

1. Amit invests \$120,000 for a 20 percent interest in the partnership, and a bonus is recorded for the original partners.
2. Amit invests \$120,000 for a 40 percent interest in the partnership, and a bonus is recorded for Amit.

**LO 4 Withdrawal of a Partner**

**E8A.** Sam, Richard, and Tom are partners. They share income and losses in the ratio of 3:2:1. Tom's Capital account has a \$240,000 balance. Sam and Richard have agreed to let Tom take \$320,000 of the company's cash when he retires from the business. What journal entry must be made on the partnership's books when Tom retires, assuming that a bonus to Tom is recognized and absorbed by the remaining partners?

**LO 5 Partnership Liquidation**

**E9A.** Assume the following assets, liabilities, and partners' equity in the Winner and Perry partnership on December 31, 2014:

Assets	=	Liabilities	+	Winner, Capital	+	Perry, Capital
\$320,000	=	\$20,000	+	\$180,000	+	\$120,000

The partnership has no cash. When the partners agree to liquidate the business, the assets are sold for \$240,000, and the liabilities are paid. Winner and Perry share income and losses in a ratio of 3:1.

1. Prepare a statement of liquidation.
2. Prepare journal entries for the sale of assets, payment of liabilities, distribution of loss from realization, and final distribution of cash to Winner and Perry.

**LO 5 Partnership Liquidation**

**E10A. BUSINESS APPLICATION** ▶ Abby, Anna, and Anita are partners in a tanning salon. The assets, liabilities, and capital balances as of July 1, 2014, follow.

Assets	\$960,000
Liabilities	320,000
Abby, Capital	280,000
Anna, Capital	80,000
Anita, Capital	280,000

(Continued)

Because competition is strong, business is declining, and the partnership has no cash, the partners have decided to sell the business. Abby, Anna, and Anita share income and losses in a ratio of 3:1:1, respectively. The assets were sold for \$520,000, and the liabilities were paid. Anna has no other assets and will not be able to cover any deficits in her Capital account. Prepare a statement of liquidation to show how the ending cash balance will be distributed to the partners.

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

LO 2, 3

- ✓ 2c: Thomas 2013 income: \$67,200;  
Thomas 2014 income: \$32,000
- ✓ 2d: Thomas 2013 income: \$72,000;  
Thomas 2014 income: \$28,000
- ✓ 2f: Thomas 2013 income: \$85,200;  
Thomas 2014 income: \$41,200

### Partnership Formation and Distribution of Income

**P1.** In January 2013, Edi Thomas and George Lopez agreed to produce and sell chocolate candies. Thomas contributed \$480,000 in cash to the business. Lopez contributed the building and equipment, valued at \$440,000 and \$280,000, respectively. The partnership had an income of \$168,000 during 2013 but was less successful during 2014, when income was only \$80,000.

#### REQUIRED

1. Prepare the journal entry to record the investment of both partners in the partnership.
2. Determine the share of income for each partner in 2013 and 2014 under each of the following conditions:
  - a. The partners agreed to share income equally.
  - b. The partners failed to agree on an income-sharing arrangement.
  - c. The partners agreed to share income according to the ratio of their original investments.
  - d. The partners agreed to share income by allowing interest of 10 percent on their original investments and dividing the remainder equally.
  - e. The partners agreed to share income by allowing salaries of \$80,000 for Thomas and \$56,000 for Lopez, and dividing the remainder equally.
  - f. The partners agreed to share income by paying salaries of \$80,000 to Thomas and \$56,000 to Lopez, allowing interest of 9 percent on their original investments, and dividing the remainder equally.
3. **ACCOUNTING CONNECTION** ► What are some of the factors that need to be considered in choosing the plan of partners' income sharing among the options shown in requirement 2?

LO 3

#### SPREADSHEET

- ✓ 1: Chevron income: \$58,400
- ✓ 3: Wilkes income: \$32,160

### Distribution of Income: Salaries and Interest

**P2.** Wilkes and Chevron are partners in a tennis shop. They have agreed that Wilkes will operate the store and receive a salary of \$104,000 per year. Chevron will receive 10 percent interest on his average capital balance during the year of \$500,000. The remaining income or losses are to be shared by Wilkes and Chevron in a 2:3 ratio.

#### REQUIRED

Determine each partner's share of income and losses under each of the following conditions. In each case, the income or loss is stated before the distribution of salary and interest.

1. Income was \$168,000.
2. Income was \$88,000.
3. The loss was \$25,600.

## LO 4

## Admission and Withdrawal of a Partner

## SPREADSHEET

- ✓ 1c: credit Mason, Capital: \$6,000
- ✓ 1d: credit Frank, Capital: \$96,000
- ✓ 1f: debit Mason, Capital: \$90,000

**P3.** Mason, Jiri, and James are partners in Woodware Company. Their capital balances as of July 31, 2014, are as follows.

Mason, Capital		Jiri, Capital		James, Capital	
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.
	90,000		30,000		60,000

Each partner has agreed to admit Frank to the partnership.

## REQUIRED

1. Prepare the journal entries to record Frank's admission to or Mason's withdrawal from the partnership under each of the following conditions:
  - a. Frank pays Mason \$25,000 for 20 percent of Mason's interest in the partnership.
  - b. Frank invests \$40,000 cash in the partnership and receives an interest equal to her investment.
  - c. Frank invests \$60,000 cash in the partnership for a 20 percent interest in the business. A bonus is to be recorded for the original partners on the basis of their capital balances.
  - d. Frank invests \$60,000 cash in the partnership for a 40 percent interest in the business. The original partners give Frank a bonus according to the ratio of their capital balances on July 31, 2014.
  - e. Mason withdraws from the partnership, taking \$105,000. The excess of withdrawn assets over Mason's partnership interest is distributed according to the balances of the Capital accounts.
  - f. Mason withdraws by selling her interest directly to Frank for \$120,000.
2. **ACCOUNTING CONNECTION** ► When a new partner enters a partnership, why would the new partner pay a bonus to the old partners, or why would the old partners pay a bonus to the new partner?

## LO 5

## Partnership Liquidation

- ✓ 1: Cash distributed to Josh: \$336,000

**P4.** Josh, John, and Hassan are partners in a retail lighting store. They share income and losses in the ratio of 2:2:1, respectively. The partners have agreed to liquidate the partnership. The partnership balance sheet before the liquidation follows.

**Josh, John, and Hassan  
Partnership Balance Sheet  
August 31, 2014**

Assets		Liabilities	
Cash	\$ 280,000	Accounts payable	\$ <u>360,000</u>
Other assets	<u>880,000</u>		
		Partners' Equity	
		Josh, capital	\$ 400,000
		John, capital	240,000
		Hassan, capital	<u>160,000</u>
		Total partners' equity	<u>\$ 800,000</u>
Total assets	<u>\$1,160,000</u>	Total liabilities and partners' equity	<u>\$1,160,000</u>

The other assets were sold on September 1, 2014, for \$720,000. Accounts payable were paid on September 4, 2014. The remaining cash was distributed to the partners on September 11, 2014.

*(Continued)*

**REQUIRED**

1. Prepare a statement of liquidation.
2. Prepare the following journal entries:
  - a. The sale of the other assets.
  - b. Payment of the accounts payable.
  - c. The distribution of the loss from realization.
  - d. The distribution to the partners of the remaining cash.

**ALTERNATE PROBLEMS****LO 3****SPREADSHEET**

- ✓ 2: Jan income: \$60,400; Pat income: \$178,640; Misa income: \$72,160
- ✓ 3: Jan loss: \$152,000; Pat income: \$51,200; Misa loss: \$12,800

**Distribution of Income: Salaries and Interest**

**P5.** Jan, Pat, and Misa are partners in South Central Company. The partnership agreement states that Jan is to receive 8 percent interest on his capital balance at the beginning of the year, Pat is to receive a salary of \$200,000 a year, and Misa will be paid interest of 6 percent on his average capital balance during the year. Jan, Pat, and Misa will share any income or loss after salary and interest in a 5:3:2 ratio. Jan's capital balance at the beginning of the year was \$1,200,000, and Misa's average capital balance for the year was \$1,440,000.

**REQUIRED**

Determine each partner's share of income and losses under the following conditions. In each case, the income or loss is stated before the distribution of salary and interest.

1. Income was \$1,090,400.
2. Income was \$311,200.
3. The loss was \$113,600.

**LO 4**

- ✓ 1c: credit Sasha, Capital: \$16,000
- ✓ 1d: credit Rob, Capital: \$188,000
- ✓ 1f: debit Sasha, Capital: \$100,000

**Admission and Withdrawal of a Partner**

**P6.** Sasha, Serge, and Sander are partners in the Image Gallery. As of November 30, 2014, the balance in Sasha's Capital account was \$100,000, the balance in Serge's was \$120,000, and the balance in Sander's was \$180,000. Sasha, Serge, and Sander share income and losses in a ratio of 2:3:5.

**REQUIRED**

1. Prepare journal entries for each of the following independent conditions:
  - a. Rob pays Sander \$200,000 for four-fifths of Sander's interest.
  - b. Rob is to be admitted to the partnership with a one-third interest for a \$200,000 cash investment.
  - c. Rob is to be admitted to the partnership with a one-third interest for a \$320,000 cash investment. A bonus, based on the partners' ratio for income and losses, is to be distributed to the original partners when Rob is admitted.
  - d. Rob is to be admitted to the partnership with a one-third interest for an \$164,000 cash investment. A bonus is to be given to Rob on admission.
  - e. Sasha withdraws from the partnership, taking \$132,000 in cash.
  - f. Sasha withdraws from the partnership by selling his interest directly to Rob for \$140,000.
2. **ACCOUNTING CONNECTION** ► In general, when a new partner enters a partnership, why would the new partner pay a bonus to the old partners, or why would the old partners pay a bonus to the new partner?

## LO 5

## Partnership Liquidation

## SPREADSHEET

- ✓ 1: Cash distributed to  
Tailor: \$208,800

P7. Leverage Partnership's balance sheet as of July 31, 2014, follows.

Assets		Liabilities	
Cash	\$ 12,000	Accounts payable	\$ 960,000
Accounts receivable	240,000		
Inventory	528,000	Partners' Equity	
Equipment (net)	<u>924,000</u>	Gauri, capital	\$ 144,000
		Taylor, capital	360,000
		Pavel, capital	<u>240,000</u>
		Total partners' equity	<u>\$ 744,000</u>
Total assets	<u>\$1,704,000</u>	Total liabilities and partners' equity	<u>\$1,704,000</u>

The partners—Gauri, Taylor, and Pavel—share income and losses in the ratio of 5:3:2. Because of a mutual disagreement, Gauri, Taylor, and Pavel have decided to liquidate the business.

Assume that Gauri cannot contribute any additional personal assets to the company during liquidation and that the following transactions occurred during liquidation: (a) Accounts receivable were sold for 60 percent of their book value. (b) Inventory was sold for \$552,000. (c) Equipment was sold for \$600,000. (d) Accounts payable were paid in full. (e) Gain or loss from realization was distributed to the partners' Capital accounts. (f) Gauri's deficit was transferred to the remaining partners in their new income and loss ratio. (g) The remaining cash was distributed to Taylor and Pavel.

**REQUIRED**

1. Prepare a statement of liquidation.
2. Prepare journal entries to liquidate the partnership and distribute any remaining cash.

## LO 2, 3, 4, 5

- ✓ December 31, 2013 income to Slater: \$88,000  
 ✓ January 1, 2014 debit to Slater, Capital: \$54,000  
 ✓ December 31, 2014 loss to Zadoney: \$13,920  
 ✓ Cash distributed to Nissan: \$509,600

**Comprehensive Partnership Transactions**

P8. The events that follow pertain to a partnership formed by Mercian Zadoney and Michael Slater to operate a floor-cleaning company.

2013

Feb. 14 The partnership was formed. Zadoney transferred to the partnership \$160,000 cash, land worth \$160,000, a building worth \$960,000, and a mortgage on the building of \$480,000. Slater transferred to the partnership \$80,000 cash and equipment worth \$320,000.

Dec. 31 During 2013, the partnership earned income of just \$168,000. The partnership agreement specifies that income and losses are to be divided by paying salaries of \$80,000 to Zadoney and \$120,000 to Slater, allowing 8 percent interest on beginning capital investments, and dividing any remainder equally.

2014

Jan. 1 To improve the prospects for the company, the partners decided to take in a new partner, George Nissan, who had experience in the floor-cleaning business. Nissan invested \$312,000 for a 25 percent interest in the business. A bonus was transferred in equal amounts from the original partners' Capital accounts to Nissan's Capital account.

Dec. 31 During 2014, the company earned income of \$174,400. The new partnership agreement specified that income and losses would be divided by paying salaries of \$120,000 to Slater and \$160,000 to Nissan (no salary to Zadoney), allowing 8 percent interest on beginning capital balances after Nissan's admission, and dividing the remainder equally.

(Continued)



2015

Jan. 1 Because it appeared that the business could not support the three partners, the partners decided to liquidate the partnership. The asset and liability accounts of the partnership were as follows: Cash, \$814,400; Accounts Receivable (net), \$136,000; Land, \$160,000; Building (net), \$896,000; Equipment (net), \$472,000; Accounts Payable, \$176,000; and Mortgage Payable, \$448,000. The equipment was sold for \$400,000. The accounts payable were paid. The loss was distributed equally to the partners' Capital accounts. A statement of liquidation was prepared, and the remaining assets and liabilities were distributed. Zadoney agreed to accept cash plus the land and building at book value and the mortgage payable as payment for his share. Slater accepted cash and the accounts receivable for his share. Nissan was paid in cash.

**REQUIRED**

Prepare journal entries to record all of the facts above. Support your computations with schedules, and prepare a statement of liquidation in connection with the January 1, 2015, entries.

**CASES****LO 3 Conceptual Understanding: Distribution of Partnership Income and Losses**

**C1.** Landow, Donovan, and Hansa, who are forming a partnership to operate an antiques gallery, are discussing how income and losses should be distributed. Among the facts they are considering are the following:

- a. Landow will contribute cash for operations of \$100,000, Donovan will contribute a collection of antiques that is valued at \$300,000, and Hansa will not contribute any assets.
- b. Landow and Hansa will handle day-to-day business operations. Hansa will work full-time, and Landow will devote about half-time to the partnership. Donovan will not devote time to day-to-day operations. A full-time clerk in a retail store would make about \$20,000 in a year, and a full-time manager would receive about \$30,000.
- c. The current interest rate on long-term bonds is 8 percent.

Landow, Donovan, and Hansa have just hired you as the partnership's accountant. Write a memorandum describing an equitable plan for distributing income and losses. Outline the reasons why you believe this plan is equitable. According to your plan, which partner will gain the most if the partnership is very profitable, and which will lose the most if the partnership has large losses?

**LO 1, 2, 3 Conceptual Understanding: Partnership Agreement**

**C2.** Form a partnership with one or two of your classmates. Assume that the two or three of you are forming a small service business. For example, you might form a company that hires college students to paint houses during the summer or to provide landscaping services.

Working together, draft a partnership agreement for your business. The agreement can be a simple one, with just a sentence or two for each provision. However, it should include the name, location, and purpose of the business; the names of the partners and their respective duties; the investments of each partner; methods for distributing profits and losses; and procedures for dealing with the admission or withdrawal of partners, the withdrawal of assets, the death of a partner, and liquidation of the business. Include a title, date, and signature lines.

**LO 1, 3 Interpreting Financial Reports: Effects of a Lawsuit on Partnership**

**C3.** The Springfield Clinic is owned and operated by ten local doctors as a partnership. Recently, a paralyzed patient sued the clinic for malpractice, for a total of \$20 million. The clinic carries malpractice liability insurance in the amount of \$10 million. There is no provision for the possible loss from this type of lawsuit in the partnership's financial statements. The condensed balance sheet for 2014 follows.

<b>Springfield Clinic</b>		
<b>Condensed Balance Sheet</b>		
<b>December 31, 2014</b>		
<b>Assets</b>		
Current assets	\$246,000	
Property, plant, and equipment (net)	<u>750,000</u>	
Total assets		<u>\$996,000</u>
<b>Liabilities and Partners' Equity</b>		
Current liabilities	\$180,000	
Long-term debt	<u>675,000</u>	
Total liabilities		\$855,000
Partners' equity		<u>141,000</u>
Total liabilities and partners' equity		<u>\$996,000</u>

1. How should information about the lawsuit be disclosed in the December 31, 2014, financial statements of the partnership?
2. Assume that the clinic and its insurance company settle out of court by agreeing to pay a total of \$10.1 million, of which \$100,000 must be paid by the partnership. What effect will the payment have on the clinic's December 31, 2014, financial statements? Discuss the effect of the settlement on the Springfield Clinic doctors' personal financial situations.

**LO 6 Conceptual Understanding: International Joint Ventures**

**C4. BUSINESS APPLICATION** ► **Nokia**, the Finnish telecommunications company, has formed an equally owned joint venture with Capital Corporation, a state-owned Chinese company, to develop a center for the manufacture and development of telecommunications equipment in China, the world's fastest-growing market for this kind of equipment. The main aim of the development is to persuade Nokia's suppliers to move close to the company's main plant. The Chinese government looks favorably on companies that involve local suppliers.<sup>1</sup> What advantages does a joint venture have over a single company in entering a new market in another country? What are the potential disadvantages? Divide into groups. One-half of the groups will make a strong argument for the joint venture. The other half will make a strong case against the joint venture. Engage in a class debate over the joint venture.

**LO 5, 6 Ethical Dilemma: Death of a Partner**

**C5.** South Shore Realty was started 20 years ago when T. S. Tyler, R. C. Strong, and A. J. Hibbert established a partnership to sell real estate near Galveston, Texas. The partnership has been extremely successful. In 2014, Tyler, the senior partner, who in recent years had not been very active in the partnership, died. Unfortunately, the partnership agreement is vague about how the partnership interest of a partner who dies should be valued. It simply states that "the estate of a deceased partner shall receive compensation for his or her interest in the partnership in a reasonable time after death." The attorney for Tyler's family believes that the estate should receive one-third of the assets of the partnership based on the fair market value of the net assets (total assets less total liabilities). The total assets of the partnership are \$10 million in the accounting records, but the assets are worth at least \$20 million. Because the firm's total liabilities

*(Continued)*

are \$4 million, the attorney is asking for \$5.3 million (one-third of \$16 million). Strong and Hibbert do not agree, but all parties want to avoid a protracted, expensive lawsuit. They have decided to put the question to an arbitrator, who will make a determination of the settlement.

Here are some other facts that may or may not be relevant. The current balances in the partners' Capital accounts are \$1.5 million for Tyler, \$2.5 million for Strong, and \$2.0 million for Hibbert. Net income in 2014 is to be distributed to the Capital accounts in the ratio of 1:4:3. Before Tyler's semiretirement, the distribution ratio was 3:3:2. Assume you or your group is the arbitrator, and develop what you would consider a fair distribution of assets to Tyler's estate. Defend your solution.

LO 1, 6 **Conceptual Understanding: Comparison of Career Opportunities in Partnerships and Corporations**

**C6.** Accounting firms are among the world's largest partnerships and provide a wide range of attractive careers for business and accounting majors. You can explore careers in public accounting by linking to the website of one of the Big Four accounting firms: **Deloitte & Touche**, **Ernst & Young**, **KPMG International**, and **PricewaterhouseCoopers**. Each firm's home page has a career opportunity section. For the firm you choose, compile a list of facts about the firm—size, locations, services, and career opportunities. Do you have the interest and background for a career in public accounting? Why or why not? How do you think working for a large partnership would differ from or be the same as working for a large corporation? Be prepared to discuss your findings in class.

# CHAPTER 13

## Accounting for Corporations

### BUSINESS INSIGHT

#### Vietecha, Inc.

In 2014, a group of investors in Wisconsin formed a corporation called Vietecha, Inc. The corporation's state charter authorized it to issue 2 million shares of \$1 par value common stock and 50,000 shares of 4 percent, \$20 par value cumulative and convertible preferred stock. Vietecha's **initial public offering (IPO)** (i.e., its first sale of stock to the public) occurred on February 1, 2014, when it issued 200,000 shares of common stock for \$250,000 and, thereby, realized its first influx of contributed capital.

During its first year of operations, Vietecha engaged in a number of other transactions involving common stock, as well as transactions involving preferred stock, treasury stock, and dividends. In this chapter, you will learn how to account for these transactions. You will also learn why corporations are the dominant form of business in the U.S. economy and how a corporation's owners—its stockholders—can evaluate the return on their investments.

- 1. CONCEPT** ► How does the separate entity concept apply to the stockholders in a corporation?
- 2. ACCOUNTING APPLICATION** ► How should a corporation account for its stock transactions and dividends?
- 3. BUSINESS APPLICATION** ► What measures should stockholders use to evaluate the return on their investments?

### LEARNING OBJECTIVES

- LO 1** Define the *corporate* form of business and its characteristics.
- LO 2** Identify the components of stockholders' equity and their characteristics.
- LO 3** Account for the issuance of stock for cash and other assets.
- LO 4** Account for treasury stock.
- LO 5** Account for cash dividends.
- LO 6** Account for stock dividends and stock splits.
- LO 7** Describe the statement of stockholders' equity, and compute book value per share.
- LO 8** Calculate dividend yield and return on equity, and define stock options.



## SECTION 1

## CONCEPTS

## CONCEPT

- Separate entity

RELEVANT  
LEARNING OBJECTIVE

- Lo 1** Define the *corporate* form of business and its characteristics.

## Lo 1 Concepts Underlying the Corporate Form of Business

In Chapter 1, we defined a *corporation* as a *separate entity* chartered by the state and *legally separate* from its owners—that is, its stockholders. **Contributed capital**, which refers to stockholders' investments in a corporation, is a major means of financing a corporation. Managing contributed capital requires an understanding of the advantages and disadvantages of the corporate form of business and of the issues involved in equity financing. It also requires familiarity with dividend policies, with how to use return on equity to evaluate performance, and with stock option plans.

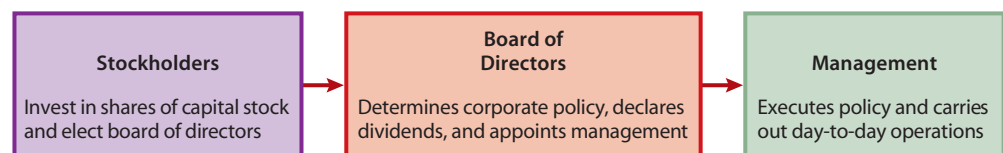
### The Corporate Form of Business

The corporate form of business is well suited to today's trends toward large organizations, international trade, and professional management. Although fewer in number than sole proprietorships and partnerships, corporations dominate the U.S. economy, in part because of their ability to raise large amounts of capital. In 2007, the peak market year, the amount of new capital that corporations raised was \$2.7 trillion. Even though the following years were not the best for markets, the amount of new capital raised by corporations was \$1.4 trillion.<sup>1</sup>

To form a corporation, most states require individuals, called *incorporators*, to sign an application and file it with the proper state official. This application contains the **articles of incorporation**. If approved by the state, these articles, which form the company charter, become a contract between the state and the incorporators. The company is then authorized to do business as a corporation.

The authority to manage a corporation is delegated by its stockholders to a board of directors and by the board of directors to the corporation's officers. That is, the stockholders elect a board of directors, which sets corporate policies and chooses the corporation's officers, who in turn carry out the corporate policies in their management of the business, as shown in Exhibit 1.

**Exhibit 1**  
The Corporate Organization



**Stockholders** A unit of ownership in a corporation is called a **share of stock**. The articles of incorporation state the maximum number of shares that a corporation is authorized to issue. The number of shares held by stockholders is the outstanding stock, which may be less than the number authorized in the articles of incorporation. To invest in a corporation, a stockholder transfers cash or other resources to the corporation. In return, the stockholder receives shares of stock representing a proportionate share of ownership.

**Board of Directors** A corporation's **board of directors** decides on major business policies. Among the board's specific duties are authorizing contracts, setting executive



salaries, and arranging major loans with banks. The declaration of dividends is another important function of the board of directors. **Dividends** are distributions, among the stockholders, of the assets that a corporation's earnings have generated. Only the board of directors has the authority to declare dividends.

The composition of the board of directors varies from company to company, but generally it includes several officers of the corporation and several outsiders. The outsiders are called *independent directors* because they do not directly participate in managing the business.

**Management** Management, appointed by the board of directors to carry out corporate policies and run day-to-day operations, consists of the operating officers—generally the president, or chief executive officer; vice presidents; chief financial officer; and chief operating officer. Besides being responsible for running the business, management has the duty of reporting the financial results of its administration to the board of directors and the stockholders. Though management must, at a minimum, make a comprehensive annual report, it generally reports more often. The annual reports of public corporations are available to the public.

## Advantages and Disadvantages of Incorporation

As noted, managers of a corporation must be familiar with the advantages and disadvantages of this form of business.

**Advantages of Incorporation** Some of the advantages of the corporate form of business follow.

- **Separate legal entity:** As a *separate legal entity*, a corporation can buy and sell property, sue other parties, enter into contracts, hire and fire employees, and be taxed.
- **Limited liability:** Because a corporation is a *legal entity, separate* from its owners, its creditors can satisfy their claims only against the assets of the corporation, not against the personal property of the corporation's owners. Because the owners are not responsible for the corporation's debts, their liability is limited to the amount of their investment. In contrast, the personal property of sole proprietors and partners generally is available to creditors.
- **Ease of capital generation:** It is fairly easy for a corporation to raise capital because shares of ownership in the business are available to a great number of potential investors for a small amount of money. As a result, a single corporation can have many owners.
- **Ease of transfer of ownership:** A stockholder can normally buy and sell shares of stock without affecting the corporation's activities or needing the approval of other owners.
- **Lack of mutual agency:** If a stockholder tries to enter into a contract for a corporation, the corporation is not bound by the contract. In a partnership, because of what is called *mutual agency*, all the partners can be bound by one partner's actions.
- **Continuous existence:** Because a corporation is a *separate legal entity*, an owner's death, incapacity, or withdrawal does not affect the life of the corporation. A corporation's life is set by its charter and regulated by state laws.
- **Centralized authority and responsibility:** The board of directors represents the stockholders and delegates the responsibility and authority for day-to-day operation to a single person, usually the president. Operating power is centralized rather than divided among the multiple owners of the business. The president may delegate authority over certain segments of the business to others, but he or she is held accountable to the board of directors. If the board is dissatisfied with the performance of the president, it can replace that person.
- **Professional management:** Large corporations have many owners, most of whom are not able to make timely decisions about business operations. Thus, management and ownership are usually separate. This allows management to hire the best talent available to run the business.



**Disadvantages of Incorporation** Some of the disadvantages of corporations follow.

- **Government regulation:** As “creatures of the state,” corporations are subject to greater control and regulation than are other forms of business. They must file many reports with the state in which they are chartered. Publicly held corporations must also file reports with the Securities and Exchange Commission and with the stock exchanges on which they are listed. They must also maintain internal controls and have audits conducted in compliance with regulations set by the Public Company Accounting Oversight Board (PCAOB). Meeting these requirements is very costly.
- **Double taxation:** A major disadvantage of the corporate form of business is **double taxation**. Because a corporation is a *separate legal entity*, its earnings are subject to federal and state income taxes, which may be as much as 35 percent of corporate earnings. If any of a corporation’s after-tax earnings are paid out as dividends, the earnings are taxed again as income to the stockholders. In contrast, the earnings of sole proprietorships and partnerships are taxed only once, as income to the owners.
- **Limited liability:** Limited liability restricts the ability of a small corporation to borrow money. Because creditors can lay claim only to the assets of a corporation, they may limit their loans to the level secured by those assets or require stockholders to guarantee the loans personally.
- **Separation of ownership and control:** Just as limited liability can be a drawback of incorporation, so can the separation of ownership and control. Management sometimes makes decisions that are not good for the corporation. Poor communication can also make it hard for stockholders to exercise control over the corporation or even to recognize that management’s decisions are harmful.

**STUDY NOTE:** Lenders to a small corporation may require the corporation’s officers to sign a promissory note, which makes them personally liable for the debt.

## Equity Financing

Equity financing is accomplished by issuing stock to investors in exchange for assets, usually cash. Once the stock has been issued to them, the stockholders can transfer their ownership at will. Large corporations can have millions of shares of stock, thousands of which change ownership every day. They, therefore, often appoint independent **registrars** and **transfer agents** (usually banks and trust companies) to help perform the transfer duties. The outside agents are responsible for transferring the corporation’s stock, maintaining stockholders’ records, preparing a list of stockholders for stockholders’ meetings, and paying dividends.

Two important terms in equity financing are par value and legal capital:

- **Par value** is an arbitrary amount assigned to each share of stock. It must be recorded in the capital stock accounts. Par value usually bears little, if any, relationship to the market value of the shares. For example, although **Google**’s stock initially sold for \$85 per share and the market value is now much higher, its par value per share is only \$0.001.
- **Legal capital** is the number of shares issued multiplied by the par value. It is the minimum amount that a corporation can report as contributed capital. For example, even though the total market value of **Google**’s shares now exceeds \$200 billion, Google’s legal capital is only about \$325,140 (325.14 million shares × \$0.001).

To help with its initial public offering (IPO), a corporation often uses an **underwriter**—an intermediary between the corporation and the investing public. For a fee—usually less than 1 percent of the selling price—the underwriter guarantees the sale of the stock. The corporation records the amount of the net proceeds of the offering in its Capital Stock and Additional Paid-in Capital accounts. The net proceeds are what the public paid less the underwriter’s fees, legal expenses, and any other direct costs of the offering.

The costs of forming a corporation are called **start-up and organization costs**. These costs include:

- State incorporation fees
- Attorneys' fees for drawing up the articles of incorporation
- The cost of printing stock certificates
- Accountants' fees for registering the firm's initial stock
- Other expenditures necessary for the formation of the corporation

**STUDY NOTE:** Start-up and organization costs are expensed as they are incurred.

Theoretically, start-up and organization costs benefit the entire life of a corporation. For that reason, a case can be made for recording them as intangible assets and amortizing them over the life of the corporation. However, a corporation's life normally is not known, so accountants expense start-up and organization costs as they are incurred.

**Advantages of Equity Financing** Financing a business by issuing common stock has several advantages.

- **Decreased financial risk:** Issuing common stock is less risky than financing with long-term debt because a company does not pay dividends on common stock unless the board of directors decides to pay them. In contrast, if a company does not pay interest on long-term debt, it can be forced into bankruptcy.
- **Increased cash for operations:** When a company does not pay a cash dividend, it can shift the cash generated by profitable operations back into the company's operations. **Google**, for instance, does not currently pay any dividends, and its issuance of common stock provides it with funds for expansion.
- **Better debt to equity ratio:** A company can use the proceeds of a common stock issue to maintain or improve its debt to equity ratio.

**Disadvantages of Equity Financing** Issuing common stock also has certain disadvantages.

- **Increased tax liability:** Whereas the interest on debt is tax-deductible, the dividends paid on stock are not tax-deductible.
- **Decreased stockholder control:** When a corporation issues more stock, it dilutes its ownership. Thus, the current stockholders must yield some control to the new stockholders.

## APPLY IT!

Match each item that follows with the topic to which it pertains.

- |   |   |
|---|---|
| <ul style="list-style-type: none"> <li>a. Advantage of the corporate form of business</li> <li>b. Disadvantage of the corporate form of business</li> <li>c. Dividend policies</li> </ul> | <ul style="list-style-type: none"> <li>1. U.S. tax policies</li> <li>2. Separate legal entity</li> <li>3. Ease of ownership transfer</li> <li>4. Distributing cash to stockholders</li> <li>5. Need to deal with government regulation</li> </ul> |
|---|---|

### SOLUTION

1. b; 2. a; 3. a; 4. c; 5. b

### TRY IT! SE1, SE2, E1A, E1B

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Prepare the statement of stockholders' equity
- Record the issuance of stock for cash and other assets
- Record the purchase, sale, and retirement of treasury stock
- Account for cash dividends
- Account for stock dividends and stock splits

## RELEVANT LEARNING OBJECTIVES

**LO 2** Identify the components of stockholders' equity and their characteristics.

**LO 3** Account for the issuance of stock for cash and other assets.

**LO 4** Account for treasury stock.

**LO 5** Account for cash dividends.

**LO 6** Account for stock dividends and stock splits.

**LO 7** Describe the statement of stockholders' equity, and compute book value per share.

## LO 2 Components of Stockholders' Equity

In a corporation's balance sheet, the owners' claims to the business are called **stockholders' equity**. As shown in Exhibit 2, this section of a corporate balance sheet usually has at least three components.

- **Contributed capital:** The stockholders' investments in the corporation.
- **Retained earnings:** The earnings of the corporation since its inception, less any losses, dividends, or transfers to contributed capital. **Retained earnings** are reinvested in the business. They are not a pool of funds to be distributed to the stockholders; instead, they represent the stockholders' claim to assets resulting from profitable operations.
- **Treasury stock:** Shares of the corporation's own stock that it has bought back on the open market are called **treasury stock**. The cost of these shares is treated as a reduction in stockholders' equity. By buying back the shares, the corporation reduces the ownership of the business.

### Exhibit 2 Stockholders' Equity Section of a Balance Sheet

Stockholders' Equity		
<b>Contributed capital:</b>		
Preferred stock, \$50 par value, 2,000 shares authorized, issued, and outstanding	\$100,000	
Common stock, \$5 par value, 60,000 shares authorized, 40,000 shares issued, 36,000 shares outstanding	\$200,000	
Additional paid-in capital	100,000	300,000
Total contributed capital		\$400,000
<b>Retained earnings</b>		
Total contributed capital and retained earnings		\$520,000
<b>Less: Treasury stock, common</b> (4,000 shares at cost)		40,000
Total stockholders' equity		\$480,000

© Cengage Learning 2014

In keeping with the convention of *full disclosure*, the stockholders' equity section of a balance sheet gives a great deal of information about the corporation's stock. Under contributed capital, it lists the kinds of stock, their par values, and the number of shares authorized, issued, and outstanding. Corporations may disclose more detail in a **statement of stockholders' equity** (or *statement of changes in stockholders' equity*). This



## International Perspective

IFRS

### How Does a Stock Become a Debt Under IFRS?

A significant difference between International Financial Reporting Standards (IFRS) and U.S. GAAP is the issue of what constitutes stockholders' equity. This issue is important because it affects financial ratios such as return on assets, requirements under loan agreements, and the capital requirements of banks. Under U.S. GAAP, most preferred stocks are *classified* as stockholders' equity. In contrast, under IFRS, most preferred stocks are *classified* as liabilities because they resemble debt in that they have fixed dividends rates and are often cumulative.

The FASB is considering a proposal that would require these special preferred stocks to be classified as a liability on the balance sheet, which would be more in line with IFRS.<sup>2</sup>

© loops7 / iStockphoto.com

statement summarizes changes in the components of the stockholders' equity section of the balance sheet.

A corporation can issue two types of stock:

- **Common stock** is the basic form of stock. If a corporation issues only one type of stock, it is common stock. Because shares of common stock carry voting rights, they generally provide their owners with the means of controlling the corporation. Common stock is also called *residual equity*, which means that if the corporation is liquidated, the claims of all creditors and usually those of preferred stockholders rank ahead of the claims of common stockholders.
- **Preferred stock** is stock that a corporation may issue to attract investors whose goals differ from those of common stockholders. Preferred stock gives its owners preference over common stockholders, usually in terms of receiving dividends and in terms of claims to assets if the corporation is liquidated.

In addition to identifying the kind of stock and its par value, the description of contributed capital in Exhibit 2 specifies the number of shares authorized, issued, and outstanding.

- **Authorized shares** are the maximum number of shares that a corporation's state charter allows it to issue. Most corporations are authorized to issue more shares than they need to issue at the time they are formed. Thus, they are able to raise more capital in the future by issuing additional shares. When a corporation issues all of its authorized shares, it cannot issue more without a change in its state charter.
- **Issued shares** are those that a corporation sells or otherwise transfers to stockholders. The owners of a corporation's issued shares own 100 percent of the business. Unissued shares have no rights or privileges until they are issued.
- **Outstanding shares** are shares that a corporation has issued and that are still in circulation. Treasury stock is not outstanding because it consists of shares that a corporation has issued but has bought back and thereby put out of circulation. Thus, a corporation can have more shares issued than are currently outstanding.

Exhibit 3 shows the relationship of authorized shares to issued, unissued, outstanding, and treasury shares. For example, **Google** has 9 billion authorized shares of stock and only about 325 million shares issued. With its excess of authorized shares, Google has plenty of flexibility for future stock transactions.



## Business Perspective

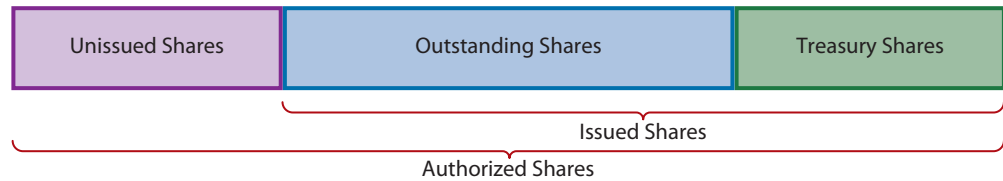
### Are You a First-Class or Second-Class Stockholder?

When companies go public, the founders of the company or top management often get first-class shares with extra votes, while outsiders get second-class shares with fewer votes. The class A and class B shares of **Adolph Coors Company**, the large brewing firm, are an extreme example. The company's class B shares, owned by the public, have no votes except in the case of a merger. Its class A shares, held by the Coors family trust, have all the votes on all other issues.

**Google** also has two classes of identical common shares, except that each class B share is entitled to ten votes and each class A share is entitled to only one vote. Class A shares are the ones that Google offered to the public in its IPO. As a result, Class B holders control 70 percent of the company.<sup>3</sup>

Shareholder advocates maintain that this practice gives a privileged few shareholders all or most of the control of a company and that it denies other shareholders voting power consistent with the risk they are taking. Defenders of the practice argue that it shields top executives from the market's obsession with short-term results and allows them to make better long-term decisions. They also point out that many investors don't care about voting rights as long as the stock performs well.

**Exhibit 3**  
**Relationship of**  
**Authorized Shares**  
**to Unissued, Issued,**  
**Outstanding, and**  
**Treasury Shares**



© Cengage Learning 2014

**STUDY NOTE:** Preferred stock has many different characteristics. They are rarely exactly the same from company to company.

## Characteristics of Preferred Stock

Most preferred stock has one or more of the following characteristics: preference as to dividends, preference as to assets if a corporation is liquidated, convertibility, and a callable option. A corporation may offer several different classes of preferred stock, each with distinctive characteristics to attract different investors.

**Preference as to Dividends** Preferred stockholders ordinarily must receive a certain amount of dividends before common stockholders receive anything. The amount that preferred stockholders must be paid before common stockholders can be paid is usually stated in dollars per share or as a percentage of the par value of the preferred shares. For example, a company might pay an annual dividend of \$4 per share on preferred stock, or it might issue preferred stock at \$50 par value and pay an annual dividend of 8 percent of par value, which would also be \$4 per share.

Preferred stockholders have no guarantee of receiving dividends. A company's board of directors must declare dividends on preferred stock before any liability arises. The consequences of not granting an annual dividend on preferred stock vary according to whether the stock is noncumulative or cumulative.

- If the stock is **noncumulative preferred stock** and the board of directors fails to declare a dividend on it in any given year, the company is under no obligation to make up the missed dividend in future years.
- If the stock is **cumulative preferred stock**, the dividend amount per share accumulates from year to year, and the company must pay the whole amount before it pays any dividends on common stock.

Dividends not paid in the year they are due are called **dividends in arrears**. If a corporation has dividends in arrears, it should report the amount either in the body of its financial statements or in a note to its financial statements. The following note is typical of one that might appear in a corporation's annual report:

*On December 31, 2014, the company was in arrears by \$37,851,000 (\$1.25 per share) on dividends to its preferred stockholders. The company must pay all dividends in arrears to preferred stockholders before paying any dividends to common stockholders.*



## Business Perspective

### How Does a Stock Become a Debt?

Some companies have used the flexibility of preferred stocks to create a type of stock that is similar to debt. Usually, stocks do not have maturity dates, and companies do not buy them back except at the option of management. However, **CMS Energy, Time Warner, Xerox**, and other companies have issued preferred stock that is "mandatorily redeemable." This means that the issuing companies are required to buy back the stock at fixed future dates or under predetermined conditions. Thus, these special preferred stocks are similar to long-term debt in that they have a fixed maturity date. In addition, in much the same way as long-term debt requires periodic interest payments at a fixed rate, these stocks require an annual dividend payment, also at a fixed rate. Even though companies list these stocks in the stockholders' equity section of their balance sheets, the astute analyst will treat them as debt when calculating a company's debt to equity ratio.<sup>4</sup>

### Dividends in Arrears

**Transaction** Harbach Corporation has 20,000 outstanding shares of \$10 par value, 6 percent cumulative preferred stock. Operations in 2015 produced income of only \$8,000. However, the board of directors declared a \$6,000 cash dividend to the preferred stockholders.

**Computation** Dividends in arrears are calculated as follows.

2015 dividends due preferred stockholders $[(20,000 \times \$10) \times 0.06]$	\$12,000
Less 2015 dividends declared to preferred stockholders	<u>6,000</u>
2015 preferred stock dividends in arrears	<u>\$ 6,000</u>

**Comment** Before the corporation can pay a dividend in 2016 to common stockholders, it must pay the preferred stockholders the \$6,000 in arrears from 2015, plus \$12,000 for 2016 for a total of \$18,000.

### Dividend Distribution

**Transaction** In 2016, Harbach Corporation earns income of \$60,000 and wants to pay dividends to both preferred and common stockholders. The board of directors declares a \$24,000 dividend.

**Computation** The dividend would be distributed as follows.

2016 declaration of dividends	\$24,000
Less 2015 preferred stock dividends in arrears	<u>6,000</u>
Amount available for 2016 dividends	\$18,000
Less 2016 dividends due preferred stockholders $[(20,000 \times \$10) \times 0.06]$	<u>12,000</u>
Remainder available to common stockholders	<u>\$ 6,000</u>

**Preference as to Assets** Preferred stockholders often have preference in terms of their claims to a corporation's assets if the corporation goes out of business. If a corporation is liquidated, these preferred stockholders have a right to receive the par value of their stock or a larger stated liquidation value per share before the common stockholders receive any share of the assets. This preference can also extend to any dividends in arrears owed to the preferred stockholders.

**Convertible Preferred Stock** Owners of **convertible preferred stock** can exchange their shares of preferred stock for shares of common stock at a ratio stated in the preferred stock contract. If the market value of the common stock increases, the conversion feature allows these stockholders to share in the increase by converting their stock to common stock.

Suppose that a company issues 1,000 shares of 8 percent, \$100 par value convertible preferred stock for \$100 per share. Each share of stock can be converted to five shares of the company's common stock at any time. The market value of the common stock when the company issues the convertible preferred stock is \$15 per share. The owner of one share of preferred stock purchased for \$100, therefore, has an investment if converted into common stock with a market value of about \$75. The investor would not convert at this point, preferring to receive the 8 percent dividend.

Now suppose that in the next few years, the market value of a share of the common stock increases from \$15 to \$30. By converting each of their shares to five common shares, preferred stockholders can realize \$150 (5 shares  $\times$  \$30 per share) or a gain of \$50 above the \$100 they paid per share of preferred stock.

**Callable Preferred Stock** Most preferred stock is **callable preferred stock**—that is, the issuing corporation can redeem it at a price stated in the preferred stock contract. An

**STUDY NOTE:** When preferred stockholders convert their shares to common stock, they gain voting rights but lose the dividend and liquidation preference. Conversion back to preferred stock is not an option.



owner of callable preferred stock that is not convertible must surrender it to the issuing corporation when asked to do so. If the preferred stock is convertible, the stockholder can either surrender the stock to the corporation or convert it to common stock when the corporation calls the stock. The *call price*, or *redemption price*, is usually higher than the stock's par value. For example, preferred stock that has a \$100 par value might be callable at \$103 per share.

When preferred stock is called and surrendered, the stockholder is entitled to the following:

- The par value of the stock
- The call premium
- Any dividends in arrears
- The current period's dividend prorated by the proportion of the year to the call date

A corporation may decide to call its preferred stock for any of the following reasons:

- It may want to force conversion of the preferred stock to common stock because the dividend that it pays on preferred shares is higher than the dividend that it pays on the equivalent number of common shares.
- It may be able to replace the outstanding preferred stock with a preferred stock at a lower dividend rate or with long-term debt, which can have a lower after-tax cost.
- It may simply be profitable enough to retire the preferred stock.

## APPLY IT!

Romeo Corporation has 2,000 shares of \$100 par value, 7 percent cumulative preferred stock outstanding and 200,000 shares of \$1 par value common stock outstanding. In the corporation's first three years of operation, its board of directors declared cash dividends as follows:

2014: None  
 2015: \$20,000  
 2016: \$30,000

Determine the total cash dividends paid to the preferred and common stockholders during each of the three years.

### SOLUTION

2014:	None	
2015:	Preferred dividends in arrears (2,000 shares × \$100 × 0.07)	\$14,000
	Current year remainder to preferred (\$20,000 – \$14,000)	6,000
	Total to preferred stockholders	<u>\$20,000</u>
2016:	Preferred dividends in arrears (\$14,000 – \$6,000)	\$ 8,000
	Current year to preferred (2,000 shares × \$100 × 0.07)	14,000
	Total to preferred stockholders	\$22,000
	Total to common stockholders (\$30,000 – \$22,000)	8,000
	Total dividends in 2016	<u>\$30,000</u>

**TRY IT! SE4, SE5, E2A, E3A, E4A, E5A, E2B, E3B, E4B, E5B**

## LO 3 Issuance of Common Stock

A share of capital stock may be either par or no-par. The value of par stock is stated in the corporate charter and on each stock certificate. It can be \$0.01, \$1, \$5, \$100, or any other amount established by the organizers of the corporation. The par values of common stocks tend to be lower than those of preferred stocks.

A corporation cannot declare a dividend that would cause stockholders' equity to fall below the legal capital. Par value is thus a minimum cushion of capital that protects a corporation's creditors.

**No-par stock** does not have a par value. A corporation may issue stock without a par value for several reasons. For one thing, rather than recognizing par value as an arbitrary figure, investors may confuse it with the stock’s market value. For another, most states do not allow a stock issue below par value, and this limits a corporation’s flexibility in obtaining capital.

To illustrate accounting for the issuance of stock, we will use Rexio Corporation.

## Accounting for Par Value Stock

When a corporation issues par value stock, the appropriate Capital Stock account (usually Common Stock or Preferred Stock) is credited for the par value regardless of whether the proceeds are more or less than the par value. When a corporation issues stock at a price greater than par value, as is usually the case, the proceeds in excess of par are credited to an account called Additional Paid-in Capital.

### Issuing Stock Above Par Value

**Transaction** Rexio Corporation is authorized to issue 10,000 shares of \$10 par value common stock. On January 1, 2014, it issues 5,000 shares at \$12 each.

**Analysis** The journal entry to record the issuance of the stock above par value

- ▲ *increases Cash* with a debit for the proceeds of \$60,000 (5,000 shares × \$12)
- ▲ *increases Common Stock* with a credit for the total par value of \$50,000 (5,000 shares × \$10)
- ▲ *increases Additional Paid-in Capital* with a credit for the difference of \$10,000 (5,000 shares × \$2)

### Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
Cash						Common Stock	
Dr.	Cr.					Dr.	Cr.
Jan. 1	60,000						Jan. 1 50,000
							<b>Additional Paid-in Capital</b>
						Dr.	Cr.
							Jan. 1 10,000

### Journal Entry

$$\begin{array}{r}
 \mathbf{A} \\
 +60,000
 \end{array}
 =
 \begin{array}{r}
 \mathbf{L} \\
 +50,000 \\
 +10,000
 \end{array}
 +
 \begin{array}{r}
 \mathbf{SE} \\
 +50,000 \\
 +10,000
 \end{array}$$

		Dr.	Cr.
Jan. 1	Cash	60,000	
	Common Stock		50,000
	Additional Paid-in Capital		10,000
	Issued 5,000 shares of \$10 par value common stock for \$12 per share		

**STUDY NOTE:** If a corporation issues stock for less than par value, an account called *Discount on Capital Stock* is debited for the difference. The issuance of stock at a discount rarely occurs. It is illegal in many states.

**Comment** The amount in excess of par value is part of Rexio’s contributed capital and will be included in the stockholders’ equity section of its balance sheet. Immediately after the stock issue, this section of Rexio’s balance sheet would appear as follows.

Contributed capital:	
Common stock, \$10 par value, 10,000 shares authorized, 5,000 shares issued and outstanding	\$50,000
Additional paid-in capital	10,000
Total contributed capital	\$60,000
Retained earnings	—
Total stockholders’ equity	\$60,000

**STUDY NOTE:** When no-par stock has a stated value, the stated value serves the same purpose as par value in that it represents the minimum legal capital.

## No-Par Stock

Most states require that all or part of the proceeds from a corporation's issuance of no-par stock be designated as legal capital, which cannot be used unless the corporation is liquidated. The purpose of this requirement is to protect the corporation's assets for creditors. State laws often require corporations to place a **stated value** on each share of stock that they issue, but even when this is not required, a corporation's board of directors may do so as a matter of convenience. The stated value can be any value set by the board unless the state specifies a minimum amount, which is sometimes the case. The stated value can be set before or after the shares are issued if the state law is not specific.

### Issuing No-Par Stock with No Stated Value

**Transaction** On January 1, 2014, Rexio issues 5,000 shares of no-par common stock at \$15 per share.

**Analysis** The journal entry to record this no-par stock with no stated value

- ▲ increases *Cash* with a debit of \$75,000 (5,000 shares × \$15)
- ▲ increases *Common Stock* with a credit of \$75,000

### Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
Cash						Common Stock	
Dr.	Cr.					Dr.	Cr.
Jan. 1	75,000					Jan. 1	75,000

A		=	L		+	SE		
+75,000						+75,000		
Jan. 1	Cash		Dr.			Cr.		
	Common Stock		75,000			75,000		
	Issued 5,000 shares of no-par common stock for \$15 per share							

**Comment** Because the stock does not have a stated or par value, all proceeds (\$75,000) of the issue are *credited* to Common Stock and are part of the company's legal capital.

As noted earlier, state laws may require corporations to put a stated value on each share of stock that they issue.

### Issuing No-Par Stock with a Stated Value

**Event** Assume the same facts as were provided previously, except that Rexio puts a \$10 stated value on each share of its no-par stock.

**Analysis** The journal entry to record this no-par stock with a stated value

- ▲ increases *Cash* with a debit of \$75,000 (5,000 shares × \$15)
- ▲ increases *Common Stock* with a credit of \$50,000 (the stated value decided by Rexio's board of directors)
- ▲ increases *Additional Paid-in Capital* with a credit of \$25,000, which is the difference between the proceeds (\$75,000) and the total stated value (\$50,000)

**Application of Double Entry**

Assets		=	Liabilities	+	Stockholders' Equity	
Cash					Common Stock	
Dr.	Cr.				Dr.	Cr.
Jan. 1	75,000				Jan. 1	50,000
					Additional Paid-in Capital	
					Dr.	Cr.
						Jan. 1 25,000

**Journal Entry**

Jan. 1	Cash	Dr.	75,000	
	Common Stock			Cr. 50,000
	Additional Paid-in Capital			Cr. 25,000
	Issued 5,000 shares of no-par common stock with \$10 stated value for \$15 per share			

$$\begin{array}{r}
 \mathbf{A} = \mathbf{L} + \mathbf{SE} \\
 +75,000 \qquad \qquad +50,000 \\
 \qquad \qquad \qquad \qquad +25,000
 \end{array}$$

**STUDY NOTE:** In establishing the fair market value of property that a corporation exchanges for stock, a board of directors cannot be arbitrary. It must use all the information at its disposal.

Start-up companies commonly exchange services or intellectual property for stock in the company because they have very little money and need people with a wealth of expertise in specific areas. For example, Mark Zuckerberg and Adam D'Angelo, the founders of Facebook, essentially traded the intellectual property involved in creating programming language and their time investment for stock in the company.



Ian Dagnall/Alamy

**Comment** In this case, the company's legal capital is \$50,000 because the no-par common stock has a stated value.

**Issuance of Stock for Noncash Assets**

A corporation may issue stock in return for assets or services other than cash. Transactions of this kind usually involve a corporation's exchange of stock for land or buildings or for the services of attorneys and others who help organize the corporation. Generally, this kind of transaction is recorded at the *fair market value* of the stock given up by the corporation. If the stock's fair market value cannot be determined, the fair market value of the assets or services received can be used.

**Issuing Stock for Noncash Assets When No Market Value for the Stock Exists**

**Transaction** When Rexion was formed on January 1, 2014, its attorney agreed to accept 200 shares of its \$10 par value common stock for services rendered. At that time, the market value of the stock could not be determined. However, for similar services, the attorney would have charged Rexion \$3,000.

**Analysis** The journal entry to record stock exchanged for non-cash assets when no market value for the stock exists

- ▲ increases *Legal Expenses* with a debit of \$3,000 (estimated cost for attorney services)
- ▲ increases *Common Stock* with a credit for the total par value of \$2,000 (200 shares × \$10)
- ▲ increases *Additional Paid-in Capital* with a credit for the difference of the proceeds (\$3,000) and the total stated value (\$2,000)

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
						<b>Legal Expenses</b>	
						<i>Dr.</i>	<i>Cr.</i>
						Jan. 1	3,000
						<b>Common Stock</b>	
						<i>Dr.</i>	<i>Cr.</i>
							Jan. 1 2,000
						<b>Additional Paid-in Capital</b>	
						<i>Dr.</i>	<i>Cr.</i>
							Jan. 1 1,000

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
				-3,000
				+2,000
				+1,000

		<i>Dr.</i>	<i>Cr.</i>
Jan. 1	Legal Expenses	3,000	
	Common Stock		2,000
	Additional Paid-in Capital		1,000
Issued 200 shares of \$10 par value common stock for attorney's services			

**Comment** As a stockholder, the attorney becomes a part-owner of the business. Even though the corporation is a *separate entity* from its owners for accounting purposes, the owners have the right vote on corporate board members and, at times, other important issues.

**Issuance of Stock for Noncash Assets When Market Value for the Stock Exists**

**Transaction** Two years later, Rexio exchanged 500 shares of its \$10 par value common stock for a piece of land. At the time of the exchange, Rexio's stock was selling on the market for \$16 per share.

**Analysis** In this case, the market value of the land is irrelevant because the value of the stock is known. The journal entry to record stock exchanged for noncash assets when a market value for the stock exists

- ▲ increases *Land* with a debit of \$8,000 (500 shares × \$16)
- ▲ increases *Common Stock* with a credit of \$5,000 (500 shares × \$10)
- ▲ increases *Additional Paid-in Capital* with a credit for \$3,000 (\$8,000 – \$5,000)

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Land</b>						<b>Common Stock</b>	
						<i>Dr.</i>	<i>Cr.</i>
							Jan. 1 5,000
						<b>Additional Paid-in Capital</b>	
						<i>Dr.</i>	<i>Cr.</i>
							Jan. 1 3,000

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+8,000				+5,000
				+3,000

		<i>Dr.</i>	<i>Cr.</i>
Jan. 1	Land	8,000	
	Common Stock		5,000
	Additional Paid-in Capital		3,000
Issued 500 shares of \$10 par value common stock with a market value of \$16 per share for a piece of land			

**APPLY IT!**

Norma Company is authorized to issue 10,000 shares of common stock. The company sold 1,000 shares at \$10 per share. Prepare the journal entries to record the sale of stock for cash under each of the following independent alternatives: (1) The stock has a par value of \$2, and (2) the stock has no par value but a stated value of \$1 per share.

**SOLUTION**

1.		<b>Dr.</b>	<b>Cr.</b>
	Cash	10,000	
	Common Stock		2,000
	Additional Paid-in Capital		8,000
	Issued 1,000 shares of \$2 par value common stock at \$10 per share		
2.			
	Cash	10,000	
	Common Stock		1,000
	Additional Paid-in Capital		9,000
	Issued 1,000 shares of no-par value common stock with a stated value of \$1 at \$10 per share		

**TRY IT! SE6, SE7, E6A, E7A, E8A, E6B, E7B, E8B**

## **LO 4** Accounting for Treasury Stock

As noted earlier, treasury stock is stock that the issuing company has reacquired, usually by purchasing shares on the open market. Although repurchasing its own stock can be a drain on a corporation's cash, it is common practice. In a recent year, 323, or 65 percent, of 500 large companies held treasury stock.<sup>5</sup>

A company may want to buy back its own stock for any of the following reasons:

- To distribute to employees through stock option plans.
- To maintain a favorable market for its stock.
- To increase its earnings per share or stock price per share.
- To have additional shares of stock available for purchasing other companies.
- To prevent a hostile takeover.

Treasury stock is not considered a purchase of assets but is a reduction in stockholders' equity. A company can hold treasury shares for an indefinite period or reissue or retire them. Treasury shares have no rights until they are reissued. Like unissued shares, they do not have voting rights, rights to dividends, or rights to assets during liquidation of the company. However, there is one major difference between unissued shares and treasury shares. A share of stock issued at par value or greater and that was reacquired as treasury stock can be reissued at less than par value.

### **Purchase of Treasury Stock**

When a firm purchases treasury stock, it is recorded at cost. The par value, stated value, or original issue price of the stock is ignored. To illustrate accounting for treasury stock, we will use Kobak Corporation.

**STUDY NOTE:** Treasury stock is not the same as unissued stock. Treasury stock represents shares that have been issued but are no longer outstanding. Unissued shares, on the other hand, have never been in circulation.



### Purchase of Treasury Stock

**Transaction** On September 15, Kobak Corporation purchases 2,000 shares of its common stock on the market at a price of \$50 per share.

**Analysis** The entry to record this purchase of treasury stock

- ▲ *increases Treasury Stock, Common* with a debit of \$100,000 (2,000 shares × \$50)
- ▼ *decreases Cash* with a credit of \$100,000 (2,000 shares × \$50)

### Application of Double Entry

Assets		=	Liabilities	+	Stockholders' Equity	
<b>Cash</b>					<b>Treasury Stock, Common</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
	Sept. 15 100,000				Sept. 15 100,000	

Journal Entry					
Sept. 15	Treasury Stock, Common	<i>Dr.</i>	100,000	<i>Cr.</i>	
	Cash				100,000
	Acquired 2,000 shares of the company's common stock for \$50 per share				

A	=	L	+	SE
-100,000				-100,000

**Comment** In the stockholders' equity section of Kobak's balance sheet, \$100,000 would be deducted from total contributed capital and retained earnings, as shown below.

Contributed capital:

Common stock, \$5 par value, 200,000 shares authorized, 60,000 shares issued, 58,000 shares outstanding	\$ 300,000
Additional paid-in capital	60,000
Total contributed capital	<u>\$ 360,000</u>
Retained earnings	1,800,000
Total contributed capital and retained earnings	<u>\$2,160,000</u>
Less: Treasury stock, common (2,000 shares at cost)	100,000
Total stockholders' equity	<u><u>\$2,060,000</u></u>

Note that the number of shares issued, and therefore the legal capital, has not changed. However, the number of shares outstanding has *decreased* as a result of the transaction.

## Sale of Treasury Stock

Treasury shares can be sold at cost, above cost, or below cost.

### Sale of Treasury Shares at Cost

**Transaction** On November 15, Kobak sold 2,000 shares of its \$5 par value common stock on the market at a price of \$50 per share.

**Analysis** When treasury shares are sold at cost, the entry is the reverse of the previous transaction for the purchase of the shares. The journal entry to record this sale of treasury stock at cost

- ▲ *increases Cash* with a debit for the sales amount
- ▼ *decreases Treasury Stock, Common* with a credit for the same amount

**Application of Double Entry**

Assets		=	Liabilities	+	Stockholders' Equity	
<b>Cash</b>					<b>Treasury Stock, Common</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
Nov. 15	100,000					Nov. 15 100,000

**Journal Entry**

$$A = L + SE$$

$$+100,000 = +100,000$$

		<i>Dr.</i>	<i>Cr.</i>
Nov. 15	Cash	100,000	
	Treasury Stock, Common		100,000
	Reissued 2,000 shares of treasury stock for \$50 per share		

**Sale of Treasury Shares Above Cost**

**Transaction** On November 15, Kobak sold for \$60 per share 1,000 of the treasury shares that it repurchased at \$50 per share.

**Analysis** Even though the treasury stock was sold above cost, no gain is recorded. The journal entry to record this sale of treasury stock above cost

- ▲ *increases Cash* with a debit of \$60,000 (1,000 shares × \$60)
- ▼ *decreases Treasury Stock, Common* with a credit of \$50,000 (1,000 shares × \$50)
- ▲ *increases Paid-in Capital, Treasury Stock* with a credit of \$10,000 (\$60,000 – \$50,000)

**Application of Double Entry**

Assets		=	Liabilities	+	Stockholders' Equity	
<b>Cash</b>					<b>Treasury Stock, Common</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>
Nov. 15	60,000					Nov. 15 50,000
					<b>Paid-in Capital, Treasury Stock</b>	
					<i>Dr.</i>	<i>Cr.</i>
						Nov. 15 10,000

**Journal Entry**

$$A = L + SE$$

$$+60,000 = +50,000 + 10,000$$

		<i>Dr.</i>	<i>Cr.</i>
Nov. 15	Cash	60,000	
	Treasury Stock, Common		50,000
	Paid-in Capital, Treasury Stock		10,000
	Sold 1,000 shares of treasury stock for \$60 per share; cost was \$50 per share		

**Comment** When treasury shares are sold for an amount greater than their cost, the excess of the sales price over the cost is not considered a gain but is credited to Paid-in Capital, Treasury Stock.

### Sale of Treasury Shares Below Cost

**Transaction** On December 15, Kobak sells its remaining 1,000 treasury shares for \$38 per share.

**Analysis** When treasury shares are sold below their cost, the difference is deducted from Paid-in Capital, Treasury Stock. If this account does not exist or if its balance is insufficient to cover the excess of cost over the reissue price, Retained Earnings absorbs the excess. The journal entry to record the sale of treasury stock below cost

- ▲ *increases Cash* with a debit of \$38,000 (1,000 shares × \$38)
- ▼ *decreases Paid-in Capital, Treasury Stock* with a debit of \$10,000
- ▼ *decreases Retained Earnings* with a debit for the remaining \$2,000 by which the shares were sold below their cost (\$50,000 – \$38,000 – \$10,000)
- ▼ *decreases Treasury Stock, Common* with a credit of \$50,000 (\$38,000 + \$10,000 + \$2,000)

### Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>						<b>Paid-in Capital, Treasury Stock</b>	
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
Dec. 15	38,000		Dec. 15	10,000			
						<b>Retained Earnings</b>	
			<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
			Dec. 15	2,000			
						<b>Treasury Stock, Common</b>	
			<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
							Dec. 15 50,000

### Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+38,000				
		-10,000		
		-2,000		
				+50,000

	<i>Dr.</i>	<i>Cr.</i>
Dec. 15	Cash	
	38,000	
	Paid-in Capital, Treasury Stock	
	10,000	
	Retained Earnings	
	2,000	
	Treasury Stock, Common	
		50,000
	Sold 1,000 shares of treasury stock for \$38 per share; cost was \$50 per share	

**Comment** Note that the *decrease* in Treasury Stock, Common *increases* stockholders' equity. Also, note that no loss is recorded. Further, Retained Earnings is debited only when the Paid-in Capital, Treasury Stock account does not exist or has been depleted. For Kobak, the Paid-in Capital, Treasury Stock had a balance of \$10,000 so the remaining \$2,000 had to come from Retained Earnings.

## Retirement of Treasury Stock

If a company decides not to reissue treasury stock, it can retire the stock. All items related to those shares are then removed from the associated capital accounts. If the cost of buying back the treasury stock is less than the company received when it issued the stock, the difference is recorded in Paid-in Capital, Retirement of Stock. If the cost is more than was received when the stock was first issued, the difference is a reduction in stockholders' equity and is debited to Retained Earnings.

### Retiring Treasury Stock

**Transaction** On November 15, Kobak decides to retire the 2,000 shares of stock that it bought back for \$100,000.

**Analysis** If the \$5 par value common stock was originally issued at \$6 per share, the journal entry to record this retirement of treasury stock

- ▼ decreases *Common Stock* with a debit of \$10,000 (2,000 shares × \$5)
- ▼ decreases *Additional Paid-in Capital* with a debit of \$2,000 [2,000 shares × (\$6 – \$5)]
- ▼ decreases *Retained Earnings* with a debit of \$88,000 (\$100,000 – \$10,000 – \$2,000)
- ▼ decreases *Treasury Stock, Common* with a credit of \$100,000 (2,000 shares × \$50)

### Application of Double Entry

Assets	=	Liabilities	+	Stockholders' Equity	
				<b>Common Stock</b>	
				<i>Dr.</i>	<i>Cr.</i>
				Nov. 15 10,000	
				<b>Additional Paid-in Capital</b>	
				<i>Dr.</i>	<i>Cr.</i>
				Nov. 15 2,000	
				<b>Retained Earnings</b>	
				<i>Dr.</i>	<i>Cr.</i>
				Nov. 15 88,000	
				<b>Treasury Stock, Common</b>	
				<i>Dr.</i>	<i>Cr.</i>
					Nov. 15 100,000

### Journal Entry

<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>SE</b>
				-10,000
				-2,000
				-88,000
				+100,000

	<i>Dr.</i>	<i>Cr.</i>
Nov. 15	Common Stock 10,000	
	Additional Paid-in Capital 2,000	
	Retained Earnings 88,000	
		Treasury Stock, Common 100,000
	Retired 2,000 shares that cost \$50 per share and were issued originally at \$6 per share	

**Comment** The Additional Paid-in Capital was reduced by \$2,000 because this is how much was in that account since the stock had a \$5 par value and was sold at \$6 share [2,000 shares × (\$6 – \$5)]. Note that this transaction does not change the total stockholders' equity because all accounts are in stockholders' equity.

## APPLY IT!

Prepare journal entries to record the following stock transactions for Junior Company during 2015:

- May 1 Purchased 5,000 shares of its own \$1 par value common stock for \$10 per share, the current market price.
- 17 Sold 1,000 shares of treasury stock purchased on May 1 for \$11 per share.

**SOLUTION**

	<i>Dr.</i>	<i>Cr.</i>
May 1		
Treasury Stock, Common	50,000	
Cash		50,000
Purchased 5,000 shares of Junior Company's common stock at \$10 per share		
May 17		
Cash	11,000	
Treasury Stock, Common		10,000
Paid-in Capital, Treasury Stock		1,000
Sold 1,000 shares of treasury stock for \$11 per share		

**TRY IT! SE8, SE9, E9A, E10A, E9B, E10B**

## **LO 5** Accounting for Cash Dividends

A corporation's board of directors has sole authority to declare dividends; but senior managers, who usually serve as members of the board, influence dividend policies. Receiving dividends is one of two ways in which stockholders can earn a return on their investment in a corporation. The other way is to sell their shares for more than they paid for them.

Although a corporation may have sufficient cash and retained earnings to pay a dividend, its board of directors may not declare dividends for several reasons:

- The corporation may need the cash for expansion.
- It may want to improve its overall financial position by liquidating debt.
- It may be facing major uncertainties, such as a pending lawsuit, strike, or a projected decline in the economy.

A corporation pays dividends quarterly, semiannually, annually, or at other times. Most states do not allow a corporation to declare a dividend that exceeds its retained earnings. When a corporation does declare a dividend that exceeds retained earnings, it is, in essence, returning to the stockholders part of their contributed capital. This is called a **liquidating dividend**. A corporation usually pays a liquidating dividend only when it is going out of business or reducing its operations.

Having sufficient retained earnings in itself does not justify the declaration of a dividend. If a corporation does not have cash or other assets readily available for distribution, it might have to borrow money to pay the dividend—an action most boards of directors want to avoid.

Companies usually pay dividends only when they have had profitable operations. For example, **Apple** began paying dividends in 1987, but it stopped those payments in 1996 to conserve cash after it suffered large operating losses in 1995. Factors other than earnings also affect the decision to pay dividends. Among them are the following:

- **Industry policies:** A company may change its dividend policy to bring it into line with the prevailing policy in its industry. For example, despite positive earnings, **AT&T Corporation** slashed its dividends by 83 percent in 2002. This action put AT&T's policy more in line with the policies of its peers in the telecommunications industry, most of which do not pay dividends.
- **Volatility of earnings:** If a company has years of good earnings followed by years of poor earnings, it may want to keep dividends low to avoid giving a false impression of sustained high earnings. For example, for many years, **General Motors** paid a fairly low but stable dividend but declared a bonus dividend in especially good years.



- **Effect on cash flows:** A company may not pay dividends because its operations do not generate enough cash to do so or because it wants to invest cash in future operations. **Abbott Laboratories** increases its dividends per share each year to reward its stockholders but also keeps back a portion of its earnings to spend for other purposes, such as researching and developing new drugs. In a recent year, for example, the company with earnings per share of \$3.03 paid a \$1.92 per share dividend.<sup>6</sup>

In recent years, because of a 15 percent reduction in the tax rate on dividends, attitudes toward dividends have changed. Many firms have either increased their dividends or started to pay dividends for the first time.

**Dividend Dates** Three important dates are associated with dividends: the declaration date, the record date, and the payment date.

- The **declaration date** is the date on which the board of directors formally declares that the corporation is going to pay a dividend. Because the legal obligation to pay the dividend arises at this time, a liability for Dividends Payable is recorded and the Dividends account is debited. In the accounting process, Retained Earnings will be reduced by the total dividends declared.
- The **record date** is the date on which ownership of stock, and therefore the right to receive a dividend, is determined. Persons who own the stock on the record date will receive the dividend. No entry is made on this date. Between the record date and the date of payment, the stock is said to be **ex-dividend**. If the owner on the date of record sells the shares of stock before the date of payment, the right to the dividend remains with that person; it does not transfer with the shares to the second owner.
- The **payment date** is the date on which the dividend is paid to the stockholders of record. On this date, the Dividends Payable account is eliminated, and the Cash account is reduced.

**Dividend Transactions** Assume a board of directors declares a cash dividend of \$28,000 on December 21. The record date is December 31, which is also the end of the company's accounting period. The dividend payment date is January 11.

### Declaration Date

**Transaction** On December 21, the company declared a cash dividend of \$28,000.

**Analysis** The journal entry to record the dividend on the declaration date (December 21)

- ▲ *increases* the equity account *Dividends* with a debit on the declaration date
- ▲ *increases* the liability account *Dividends Payable* with a credit in the amount of the total dividends declared

### Journal Entry

$$\begin{array}{r} \mathbf{A} \\ +28,000 \end{array} = \begin{array}{r} \mathbf{L} \\ -28,000 \end{array} + \begin{array}{r} \mathbf{SE} \\ -28,000 \end{array}$$

		<i>Dr.</i>	<i>Cr.</i>
Dec. 21	Dividends	28,000	
	Dividends Payable		28,000
	Declaration of dividends		

**Comment** The Dividends account reduces equity by appearing as a deduction from retained earnings on the statement of stockholders' equity, and Dividends Payable appears as a liability on the balance sheet.



**Record Date**

**Event** December 31, the record date for the dividends declared on December 21.

**Analysis** As noted, no journal entry is made on the record date (December 31).

**Comment** Journal entries for dividends are made only on the declaration date and the payment date.

**Payment Date**

**Transaction** On January 11, the company made the dividend payment.

**Analysis** The journal entry to record the dividend on the payment date (January 11)

- ▼ *decreases* the liability account *Dividends Payable* with a debit in the amount of the total dividends declared
- ▼ *decreases* the asset account *Cash* with a credit

**Journal Entry**

$$\begin{array}{r} \mathbf{A} \\ -28,000 \end{array} = \begin{array}{r} \mathbf{L} \\ -28,000 \end{array} + \begin{array}{r} \mathbf{SE} \end{array}$$

		<i>Dr.</i>	<i>Cr.</i>
Jan. 11	Dividends Payable	28,000	
	Cash		28,000
	Payment of dividends		

**Comment** When the date of declaration and the payment date occur in the same period, the amount of dividends shown on the statement of stockholders' equity and on the statement of cash flows will be equal. In this example, however, the accounting period ended between the dates of declaration and payment. Thus, dividends declared during the period ending December 31 exceed the amount paid for dividends. As a result,

- The statement of stockholders' equity for the accounting period will show a *decrease* of \$28,000 in the amount of the dividends declared.
- The statement of cash flows will not show the dividends because the cash has not yet been paid out.

**APPLY IT!**

Jask Corporation has authorized 100,000 shares of \$1 par value common stock, of which 80,000 are issued and 70,000 are outstanding. On March 15, the board of directors declared a cash dividend of \$0.10 per share, payable on April 15 to stockholders of record on May 1. Prepare the journal entries, as necessary, for each of the three dates.

**SOLUTION****Journal Entry:**

Mar. 15	Dividends	7,000	
	Dividends Payable		7,000
	Declaration of dividends		

April 15: no entry

**Journal Entry:**

May 1	Dividends Payable	7,000	
	Cash		7,000
	Payment of dividends		

**TRY IT! SE10, E11A, E12A, E11B, E12B**

## LO 6 Stock Dividends and Stock Splits

Two transactions that commonly modify the content of stockholders' equity are stock dividends and stock splits.

### Stock Dividends

A **stock dividend** is a proportional distribution of shares among a corporation's stockholders. Unlike a cash dividend, a stock dividend involves no distribution of assets, and so it has no effect on assets or liabilities. A board of directors may declare a stock dividend for the following reasons:

- To give stockholders some evidence of the company's success without affecting working capital (which would be the case if it paid a cash dividend).
- To reduce the stock's market price by increasing the number of shares outstanding (a goal, however, more often met by a stock split).
- To make a nontaxable distribution to stockholders (because stock dividends that meet certain conditions are not considered income and are thus not taxed).
- To increase the company's permanent capital by transferring an amount from retained earnings to contributed capital.

**STUDY NOTE:** The declaration of a stock dividend results in a reshuffling of stockholders' equity—that is, a portion of retained earnings is converted to contributed capital (by closing the Stock Dividends account). Total stockholders' equity is not affected.

A stock dividend does not affect total stockholders' equity. Basically, it transfers a dollar amount from retained earnings to contributed capital. The amount transferred is the fair market value (usually, the market price) of the additional shares. When stock distributions are small—less than 20 to 25 percent of a company's outstanding common stock—generally accepted accounting principles require that the market price be used to account for the stock dividends.<sup>7</sup>

**Stock Dividend Transactions** To illustrate accounting for stock dividends, we will use Wing Corporation. Stockholders' equity in Wing is as follows.

Contributed capital:	
Common stock, \$5 par value, 50,000 shares authorized, 15,000 shares issued and outstanding	\$ 75,000
Additional paid-in capital	15,000
Total contributed capital	\$ 90,000
Retained earnings	450,000
Total stockholders' equity	<u>\$540,000</u>

### Declaration Date

**Transaction** On February 24, when the market price of Wing's \$5 par value common stock is \$20 per share, the board of directors declares a 10 percent stock dividend to be distributed on March 31 to stockholders of record on March 15.

**Analysis** The journal entry to record this stock dividend on the declaration date (February 24)

- ▲ *increases* the *Stock Dividends* account with a debit of \$30,000 ( $0.10 \times 15,000$  shares  $\times$  \$20), the total market value of the stock dividend
- ▲ *increases* *Common Stock Distributable* (a temporary account until the 1,500 shares are distributed on March 31) with a credit at total par value of \$7,500 (1,500 shares  $\times$  \$5)
- ▲ *increases* *Additional Paid-in Capital* with a credit of \$22,500 ( $\$30,000 - \$7,500$ ), the amount by which the total market value of the stock to be issued exceeds its total par value

**STUDY NOTE:** For a small stock dividend, the portion of retained earnings transferred is determined by multiplying the number of shares to be distributed by the stock's market price on the declaration date.

**Journal Entry**

<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>SE</b>
				-30,000
				+7,500
				+22,500

		<i>Dr.</i>	<i>Cr.</i>
Feb. 24	Stock Dividends	30,000	
	Common Stock Distributable		7,500
	Additional Paid-in Capital		22,500
	Declared a 10 percent stock dividend on common stock, distributable on March 31 to stockholders of record on March 15:		
	15,000 shares × 0.10 = 1,500 shares		
	1,500 shares × \$20 per share = \$30,000		
	1,500 shares × \$5 per share = \$7,500		

**Comment** Because Common Stock Distributable represents an obligation to distribute additional shares of capital stock, it is a stockholders' equity account, not a liability account, as Cash Dividends Payable is. Also, the Stock Dividends account appears as a deduction from retained earnings on the statement of stockholders' equity.

**Record Date**

**Analysis** No entry is needed on the date of record (March 15).

**Payment Date**

**Analysis** The journal entry to record the stock dividend on the distribution, or payment, date (March 31)

▼ *decreases Common Stock Distributable* to zero with debit of \$7,500 (1,500 shares × \$5)

▲ *increases Common Stock* with a credit of \$7,500 (1,500 shares × \$5)

**Journal Entry**

<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>SE</b>
				-7,500
				+7,500

		<i>Dr.</i>	<i>Cr.</i>
Mar. 31	Common Stock Distributable	7,500	
	Common Stock		7,500
	Distributed a stock dividend of 1,500 shares of common stock		

**Effect of a Stock Dividend on Stockholders' Equity** If financial statements are prepared between the declaration date and the date of distribution, Common Stock Distributable should be reported as part of contributed capital.

Contributed capital:

Common stock, \$5 par value, 50,000 shares authorized, 15,000 shares issued and outstanding	\$ 75,000
Common stock distributable, 1,500 shares	7,500
Additional paid-in capital	<u>37,500</u>
Total contributed capital	\$120,000
Retained earnings	420,000
Total stockholders' equity	<u>\$540,000</u>

Note that after the stock dividend has been distributed:

- Total stockholders' equity is the same before and after the stock dividend.
- The assets of the corporation are not reduced, as they would be by a cash dividend.
- The proportionate ownership in the corporation of any individual stockholder is the same before and after the stock dividend.

**Large Stock Dividends** All stock dividends have some effect on the market price of a company's stock, but some are so large that they have a material effect. For example, a 50 percent stock dividend would cause the market price of a stock to drop about 33 percent because the increase would be one-third of the shares outstanding. The AICPA has ruled that large stock dividends—those greater than 20 to 25 percent—should be accounted for by transferring the par or stated value of the stock on the declaration date from retained earnings to contributed capital.<sup>8</sup>

## Stock Splits

**STUDY NOTE:** Stock dividends and stock splits reduce earnings per share because they increase the number of shares issued and outstanding. Cash dividends have no effect on earnings per share.

A **stock split** occurs when a corporation increases the number of shares of stock issued and outstanding and reduces the par or stated value proportionally. A company may plan a stock split for the following reasons:

- To lower its stock's market price per share and, thereby, increase the demand and volume of trading for its stock at this lower price.
- To signal to the market its success in achieving its operating goals.

**Business Application Nike** achieved these strategic objectives in 2007 by increasing its cash dividend and declaring a 2-for-1 stock split.<sup>9</sup> After the stock split, the number of the company's outstanding shares doubled, thereby cutting the share price from about \$80 per share to \$40 per share. The stock split left each stockholder's total wealth unchanged but increased the income stockholders received from dividends. Although there is no fundamental reason why a stock should go up because of a stock split, the stock split was a sign that Nike has continued to do well. In fact, Nike's stock continued to rise during the difficult years for the economy that followed to over \$100 per share in 2012.<sup>10</sup>

### Stock Split

**Transaction** Wing has 15,000 shares of \$5 par value stock outstanding and the market value is \$70 per share. The corporation plans a 2-for-1 split.

**Analysis** The journal entry to record this split

▼ *decreases* the par value to \$2.50 per share ( $\$5.00 \div 2$ )

▲ *increases* the number of shares outstanding to 30,000 ( $15,000 \text{ shares} \times 2$ )

After the split, a stockholder who previously owned 200 shares of the \$5 par value stock will own:

- 400 shares of the \$2.50 par value stock in outstanding shares of stock
- the same proportionate share of the company as before the split
- approximately the same total market value of stock because the 2-for-1 stock split will cause the price of the stock to drop by approximately 50 percent, to about \$35

**Journal Entry** A stock split does not increase the number of shares authorized, nor does it change the balances in the stockholders' equity section of the balance sheet. It simply changes the par value and the number of shares issued for both shares outstanding and treasury stock. Thus, a journal entry is unnecessary. However, it is appropriate to document the change with a memorandum entry in the general journal.



## Business Perspective

### Do Stock Splits Help Increase a Company's Market Price?

When **General Mills**, the cereal company, completed a 2-for-1 split in May 2010, its stock dropped from about \$70 per share to about \$35 per share. Since then, the price has trended upward.<sup>11</sup>

July 15 The 15,000 shares of \$5 par value common stock issued and outstanding were split 2 for 1, resulting in 30,000 shares of \$2.50 par value common stock issued and outstanding.

The stockholders' equity before and after the stock split follows.

Before Stock Split		After Stock Split	
Contributed capital:		Contributed capital:	
Common stock, \$5 par value, 50,000 shares authorized; 15,000 shares issued and outstanding	\$ 75,000	Common stock, \$2.50 par value, 50,000 shares authorized, 30,000 shares issued and outstanding	\$ 75,000
Additional paid-in capital	15,000	Additional paid-in capital	15,000
Total contributed capital	\$ 90,000	Total contributed capital	\$ 90,000
Retained earnings	450,000	Retained earnings	450,000
Total stockholders' equity	<u>\$540,000</u>	Total stockholders' equity	<u>\$540,000</u>

**Comment** The balances of all accounts remain the same. Only the par value and number of shares issued and outstanding change. If the number of split shares exceeds the number of authorized shares, the corporation's board of directors must secure state and stockholders' approval before it can issue the additional shares.

## APPLY IT!

Kelly Corporation's board of directors declared a 2 percent stock dividend applicable to the outstanding shares of its \$10 par value common stock, of which 1,000,000 shares are authorized, 300,000 are issued, and 100,000 are held in the treasury. Then, the board declared a 2-for-1 stock split on issued shares. How many authorized, issued, and treasury shares existed after each of these transactions? What is the par value per share?

### SOLUTION

Stock dividend applies to outstanding shares:

$$(300,000 \text{ shares} - 100,000 \text{ shares}) \times 0.02 = 4,000 \text{ shares}$$

Stock split applies to all issued shares:

$$304,000 \text{ shares} \times 2 = 608,000 \text{ shares}$$

Authorized shares are unchanged (1,000,000, but par value is now \$5 per share); issued shares are 608,000; and outstanding shares are 408,000 (608,000 – 200,000 treasury shares).

**TRY IT! SE11, SE12, SE13, E13A, E14A, E15A, E13B, E14B, E15B**

## LO 7 The Statement of Stockholders' Equity and Book Value per Share

The following sections describe the statement of stockholders' equity and show how to calculate book value per share.

### Statement of Stockholders' Equity

The statement of stockholders' equity (or *statement of changes in stockholders' equity*) summarizes changes in the components of the stockholders' equity section of the balance sheet. Most companies use this statement in place of the statement of retained earnings because it reveals much more about the stockholders' equity transactions that took place during the period. For example, in the statement of stockholders' equity in Exhibit 4, the first line shows the beginning balance of each account in the stockholders' equity section of Snow Corporation's balance sheet. Each subsequent line *discloses* the effects of transactions on those accounts.

**STUDY NOTE:** The statement of stockholders' equity is a labeled calculation of the change in each stockholder's equity account over an accounting period.

**Exhibit 4**  
Statement of Stockholders' Equity

**Snow Corporation**  
**Statement of Stockholders' Equity**  
**For the Year Ended December 31, 2015**

	<b>Preferred Stock \$100 Par Value 8% Convertible</b>	<b>Common Stock \$10 Par Value</b>	<b>Additional Paid-in Capital</b>	<b>Retained Earnings</b>	<b>Treasury Stock</b>	<b>Total</b>
Balance, December 31, 2014	\$ 800,000	\$600,000	\$ 600,000	\$1,200,000		\$3,200,000
Net income				540,000		540,000
Issuance of 10,000 shares of common stock		100,000	400,000			500,000
Conversion of 2,000 shares of preferred stock to 6,000 shares of common stock	(200,000)	60,000	140,000			—
10 percent stock dividend on common stock, 7,600 shares		76,000	304,000	(380,000)		—
Purchase of 1,000 shares of treasury stock					\$(48,000)	(48,000)
Cash dividends:						
Preferred stock				(48,000)		(48,000)
Common stock				(95,200)		(95,200)
Balance, December 31, 2015	<u>\$ 600,000</u>	<u>\$836,000</u>	<u>\$1,444,000</u>	<u>\$1,216,800</u>	<u>\$(48,000)</u>	<u>\$4,048,800</u>

© Cengage Learning 2014

As shown in Exhibit 4, Snow had the following:

- Net income of \$540,000
- 10,000 shares of common stock issued for \$500,000
- Conversion of \$200,000 of preferred stock to common stock
- A 10 percent stock dividend on common stock
- Treasury stock purchases of \$48,000
- Cash dividends on both preferred and common stock

The ending balances of the accounts appear at the bottom of the statement. Those accounts and balances make up the stockholders' equity section of Snow's balance sheet on December 31, 2015, as shown in Exhibit 5.

**STUDY NOTE:** The ending balances on the statement of stockholders' equity appear in the stockholders' equity section of the balance sheet.

**Exhibit 5**  
Stockholders' Equity  
Section of a Balance Sheet

**Snow Corporation**  
**Balance Sheet**  
**December 31, 2015**  
**Stockholders' Equity**

Contributed capital:		
Preferred stock, \$100 par value, 8 percent convertible, 20,000 shares authorized. 6,000 shares issued and outstanding		\$ 600,000
Common stock, \$10 par value, 200,000 shares authorized, 83,600 shares issued. 82,600 shares outstanding	\$ 836,000	
Additional paid-in capital	1,444,000	2,280,000
Total contributed capital		\$2,880,000
Retained earnings		1,216,800
Total contributed capital and retained earnings		\$4,096,800
Less: Treasury stock, common (1,000 shares, at cost)		48,000
Total stockholders' equity		<u>\$4,048,800</u>

© Cengage Learning 2014



## Book Value per Share

The word *value* is associated with shares of stock in several ways. Par value or stated value is set when the stock is authorized, and it establishes a company's legal capital. Neither par value nor stated value has any relationship to a stock's book value or market value. The **book value** of stock represents a company's total assets less its liabilities. It is simply the stockholders' equity in a company or, to put it another way, it represents a company's net assets. The **book value per share** is, therefore, the equity of the owner of one share of stock in the net assets of a company. That value generally does not equal the amount a stockholder receives if the company is sold or liquidated because, in most cases, assets are recorded at historical cost, not at their current market value.

**Book Value per Share of Common Stock** If a company has only common stock outstanding, book value per share is calculated as follows.

$$\text{Stockholders' Equity} \div \text{Common Shares Outstanding} = \text{Book Value per Share}$$

Common stock distributable is included in the number of shares outstanding, but treasury stock is not. For example, if a firm has total stockholders' equity of \$2,060,000 and 58,000 shares outstanding, the book value per share of its common stock would be \$35.52 (\$2,060,000 ÷ 58,000 shares, rounded).

**Book Value for Common and Preferred Stock** If a company has both preferred and common stock, determining the book value per share is not so simple. Generally, the preferred stock's call value (or par value, if a call value is not specified) and any dividends in arrears are subtracted from stockholders' equity to determine the equity pertaining to common stock. Refer to the stockholders' equity section of Snow's balance sheet in Exhibit 5. If Snow has no dividends in arrears and its preferred stock is callable at \$105, the equity pertaining to its common stock would be calculated as follows.

Total stockholders' equity	\$4,048,800
Less equity allocated to preferred stockholders (6,000 shares × \$105)	630,000
Equity pertaining to common stockholders	<u>\$3,418,800</u>

As indicated in Exhibit 5, Snow has 82,600 shares of common stock outstanding (83,600 shares issued less 1,000 shares of treasury stock). Its book values per share are computed as follows.

$$\begin{aligned} \text{Preferred stock: } & \$630,000 \div 6,000 \text{ shares} = \$105 \text{ per share} \\ \text{Common stock: } & \$3,418,800 \div 82,600 \text{ shares} = \$41.39 \text{ per share (rounded)} \end{aligned}$$

**Book Value for Dividends in Arrears** Assume the same facts except that Snow's preferred stock is 8 percent cumulative and that one year of dividends is in arrears. The stockholders' equity would be allocated as follows.

Total stockholders' equity	\$4,048,800
Less call value of outstanding preferred shares	\$630,000
Dividends in arrears (\$600,000 × 0.08)	<u>48,000</u>
Equity allocated to preferred stockholders	678,000
Equity pertaining to common stockholders	<u>\$3,370,800</u>

The book values per share would then be as follows.

$$\begin{aligned} \text{Preferred stock: } & \$678,000 \div 6,000 \text{ shares} = \$113 \text{ per share} \\ \text{Common stock: } & \$3,370,800 \div 82,600 \text{ shares} = \$40.81 \text{ per share (rounded)} \end{aligned}$$

## Stockholders' Equity and the Financial Statements

The stockholders' equity of a corporation, as shown on the balance sheet in Exhibit 6, is separated into contributed capital, retained earnings, and treasury stock.

**Exhibit 6**  
**Stockholders' Equity**  
**on the Balance Sheet**

© Cengage Learning 2014

<b>Balance Sheet</b>	
December 31, 2014	
<b>Assets</b>	<b>Liabilities</b>
Current assets	Current liabilities
Investments	Long-term liabilities
Property, plant, and equipment	Total liabilities
Intangible assets	
	<b>Stockholders' Equity</b>
	Preferred stock, par value
	Common stock, par value
	Paid in capital in excess of par value, common
	Paid in capital in excess of par value, treasury
	Total contributed capital
	Retained earnings
	Less treasury stock
	Total stockholders' equity
<b>Total Assets = Total Liabilities + Stockholders' Equity</b>	

## APPLY IT!

Using the data from the stockholders' equity section of Puskin Corporation's balance sheet that follows, compute the book value per share for both the preferred and common stock.

Contributed capital:

Preferred stock, \$100 par value, 6 percent cumulative, 20,000 shares authorized, 2,000 shares issued and outstanding*	\$ 200,000
Common stock, \$5 par value, 200,000 shares authorized. 100,000 shares issued and outstanding	500,000
Additional paid-in capital	300,000
<b>Total contributed capital</b>	<b>\$1,000,000</b>
Retained earnings	500,000
<b>Total stockholders' equity</b>	<b>\$1,500,000</b>

\*The preferred stock is callable at \$104 per share, and one year's dividends are in arrears.

### SOLUTION

Total stockholders' equity	\$1,500,000
Less call value of outstanding preferred shares	\$208,000
Dividends in arrears ( $\$200,000 \times 0.06$ )	12,000
Equity allocated to preferred stockholders	220,000
Equity pertaining to common stockholders	<u>\$1,280,000</u>

Preferred stock book value per share:  $\$220,000 \div 2,000 \text{ shares} = \$110$ , or  $\$104 + \$6 = \$110$  per share

Common stock book value per share:  $(\$1,500,000 - \$220,000) \div 100,000 \text{ common shares} = \$12.80$  per share

**TRY IT! SE14, SE15, E16A, E17A, E16B, E17B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Evaluate dividend policies
  - Dividend yield
- Evaluate profitability
  - Return on equity
- Evaluate investors' confidence in a company's future
  - Price/earnings ratio
- Evaluate stock options

## RELEVANT LEARNING OBJECTIVE

- LO 8** Calculate dividend yield and return on equity, and define stock options.

## LO 8 Evaluating Dividend Policies, Company Performance, and Stock Options

Investors use the dividend yield ratio to evaluate the amount of dividends they receive. In addition to evaluating dividends, investors will also want to evaluate a firm's past and future performance, using return on equity, the price-earnings ratio, and cash flow information. Both employees and investors evaluate stock options to determine their effects on compensation (employees) and the financial performance of the company (investors).

### Dividend Yield

**Dividend yield** is computed by dividing the dividends per share by the market price per share. To illustrate, **Microsoft** built up a large cash balance through its years of profitable operations, with no dividends paid. In 2005, it paid a large dividend of \$3.40 per share and began paying regular dividends thereafter (\$0.35 per share in 2006). By 2011, Microsoft's annual dividend increased to \$5.4 billion (\$0.64 per share).<sup>12</sup> Microsoft's dividend yield is computed as follows.

## RATIO

#### Dividend Yield: What Is the Return from Dividends on Each Share of Stock?

$$\text{Dividend Yield} = \frac{\text{Dividends per Share}}{\text{Market Price per Share}} = \frac{\$0.64}{\$26} = 2.5\%^*$$

\*Rounded

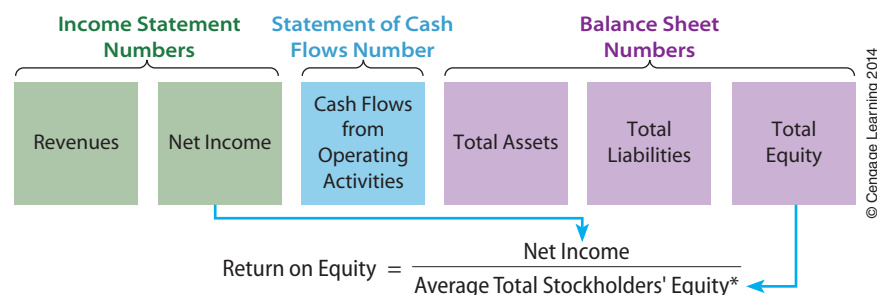
Because the yield is relatively low, Microsoft shareholders must expect some of their return to come from increases in the price of the shares.

### Return on Equity

**Return on equity** is the most important ratio associated with stockholders' equity. It is also a common measure of management's performance. For instance, when *Business Week* and *Forbes* rate companies on their success, return on equity is the major basis of their evaluations. In addition, the compensation of top executives is often tied to return on equity benchmarks. Return on equity is the ratio of net income to average total stockholders' equity. **Microsoft's** return on equity in 2011 is computed as follows.

## RATIO

#### Return on Equity: How Much Does the Company Earn on the Stockholders' Investment in the Company?



\*For a corporation, total equity is the same as stockholders' equity.

$$\begin{aligned}
 &= \frac{\$23,150}{(\$57,083 + \$46,175) \div 2} \\
 &= \frac{\$23,150}{\$51,629} \\
 &= 44.8\%^{**}
 \end{aligned}$$

\*\*Rounded

Microsoft's healthy 44.8 percent return on equity depends, of course, on the amount of net income the company earns. However, it also depends on the level of stockholders' equity, which in turn depends on management decisions about the amount of stock the company sells to the public. As a company sells more shares,

- ▲ stockholders' equity *increases*
- ▼ return on equity *decreases*

Management can keep stockholders' equity at a minimum, thereby increasing return on equity, by financing the business with cash flows from operations and by issuing long-term debt instead of stock. However, issuing long-term debt increases a company's financial risk because the interest and principal of the debt must be paid in a timely manner.

Management can also reduce stockholders' equity, thereby increasing return on equity, by buying back the company's shares on the open market. The cost of treasury stock has the following effect:

- ▼ Stockholders' equity *decreases*
- ▲ Return on equity *increases*

Many companies buy back their own stock instead of paying or increasing dividends. Their reason for doing so is that it puts money into the hands of stockholders in the form of market price appreciation without creating a commitment to higher dividends in the future. For instance, in 2011, **Microsoft** purchased \$11.6 billion of its common stock on the open market.<sup>13</sup> Microsoft's stock repurchases will improve the company's return on equity, increase its earnings per share, and lower its price/earnings ratio.

## Price-Earnings Ratio

The **price/earnings (P/E) ratio** is a measure of investors' confidence in a company's future. It is calculated by dividing the market price per share by the earnings per share. The price/earnings ratio will vary as market price per share fluctuates daily and the amount of earnings per share changes. Using the annual earnings per share from **Microsoft's** 2011 income statement, its P/E ratio can be calculated as follows.

### RATIO

#### Price/Earnings Ratio: What Value Does the Market Place on the Company's Earnings?

$$\text{Price/Earnings (P/E) Ratio} = \frac{\text{Market Price per Share}}{\text{Earnings per Share}} = \frac{\$26}{\$2.69} = 9.7 \text{ times}^*$$

\*Rounded

Because the market price is 9.7 times earnings, investors are paying a moderately high price in relation to earnings. They do so expecting that Microsoft will continue to be successful.



## Cash Flow Information

The best source of information concerning cash flows related to stock transactions and dividends is the financing activities section of the statement of cash flows. For instance, **Microsoft's** cash flows from these activities are clearly revealed in this partial section of the company's statement of cash flows (in millions):

	2011	2010
Financing Activities		
Common stock issued	\$ 2,422	\$ 2,311
Common stock repurchased	(11,555)	(11,269)
<b>Common stock cash dividend</b>	<b>(5,180)</b>	<b>(4,578)</b>

Note the increasing amounts of common stock repurchased (treasury stock) and the small amount of new common stock issued in 2011. Both actions are a reflection of the company's success.

## Stock Options as Compensation

More than 98 percent of public companies encourage employees to invest in their common stock through **stock option plans**.<sup>14</sup> Most such plans give employees the right to purchase stock in the future at a fixed price. Investors evaluate these plans to determine their effect on current and future financial statements and the value of their investment.

Some companies offer stock option plans only to management personnel, but others, including **Google**, make them available to all employees. Because the market value of a company's stock is tied to a company's performance, these plans are a means of both motivating and compensating employees. As the market value of the stock goes up, the difference between the option price and the market price grows, which increases the amount of compensation. Another key benefit of stock option plans is that compensation expense is tax-deductible.

In one example of how firms value stock options, **Google** recognized \$1.97 billion of stock-based compensation expense in 2011. This amount represented about 7.6 percent of the company's total expenses and 20.3 percent of the net income.<sup>15</sup>



## Business Perspective

### Politics and Accounting Don't Mix

The FASB has long held that stock options should be treated as an expense, because they are a form of compensation. However, technology industry leaders have maintained that expensing stock options would hurt their companies' profits and growth. The U.S. Congress pressured the FASB to back down, using the companies' reasoning that stock options essentially have no value and, thus, are not an expense on the income statement, although they should be mentioned in a note to the financial statements. Many stock options were being granted, and the companies granting them were very loose in how they accounted for them. Many of the stock transactions were back-dated so that the exercise price would be most advantageous to the executives who were benefiting. By 2010, the SEC had settled more than 60 criminal investigations related to stock options, usually resulting in settlements and significant fines.<sup>16</sup>

**APPLY IT!**

In 2014, Chalet Corporation earned \$2.20 per share and paid a dividend of \$0.88 per share. At year-end, the price of its stock was \$44 per share. Calculate the dividend yield and the price/earnings ratio.

**SOLUTION**

$$\begin{aligned} \text{Dividend Yield} &= \frac{\text{Dividends per Share}}{\text{Market Price per Share}} \\ &= \frac{\$0.88}{\$44.00} = 2.0\% \end{aligned}$$

$$\begin{aligned} \text{Price/Earnings (P/E) Ratio} &= \frac{\text{Market Price per Share}}{\text{Earnings per Share}} \\ &= \frac{\$44.00}{\$2.20} = 20.0 \text{ times} \end{aligned}$$

**TRY IT! SE3, SE16, E18A, E18B****TriLevel Problem**

Dmitriy Shironosov/Alamy Limited

**Vietecha, Inc.**

The beginning of this chapter focused on Vietecha, Inc., a company that had engaged in several transactions involving stock, including the initial public offering of common stock, the issuance of preferred stock, as well as treasury stock and dividends. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

**Section 1: Concepts**

*How does the separate entity concept apply to the stockholders in a corporation?*

**Section 2: Accounting Applications**

*How should a corporation account for its stock transactions and dividends?*

As noted earlier, Vietecha's state charter authorized it to issue 2 million shares of \$1 par value common stock and 50,000 shares of 4 percent, \$20 par value cumulative and convertible preferred stock. Vietecha engaged in the following transactions involving stock and dividends during 2014:

- Feb. 1 Issued 200,000 shares of common stock for \$250,000.
- 15 Issued 6,000 shares of common stock for accounting and legal services. The bills for these services totaled \$7,200.
- Mar. 15 Issued 240,000 shares of common stock to Jesus Miko in exchange for a building and land appraised at \$200,000 and \$50,000, respectively.
- Apr. 2 Purchased 40,000 shares of its own common stock at \$1.25 per share from a person who changed her mind about investing in the company.
- July 1 Issued 50,000 shares of preferred stock for \$1,000,000.
- Sept. 30 Sold 20,000 of the shares in the treasury for \$1.50 per share.
- Dec. 31 Vietecha's board of directors declared dividends of \$49,820 payable on January 15, 2015, to stockholders of record on January 7. Dividends included preferred dividends of \$20,000 for one-half year.



For the period ended December 31, 2014, Vietecha reported net income of \$80,000 and earnings per common share of \$0.14. At December 31, the market price per common share was \$1.60.

1. Record Vietecha's stock transactions using T accounts.
2. Prepare the stockholders' equity section of Vietecha's balance sheet as of December 31, 2014. (*Hint: Use net income and dividends to calculate retained earnings.*)



**Section 3: Business Applications**

*What measures should stockholders use to evaluate the return on their investments?*

To better answer this question, calculate Vietecha's dividend yield on common stock, price/earnings ratio, and return on equity.

**SOLUTION**

**Section 1: Concepts**

A corporation is an *entity*, chartered by the state, that is *separate* from its owners both legally and from an accounting standpoint. Vietecha's founders chose the corporate form of business rather than a partnership because it is relatively easy for a corporation to raise capital by issuing stock. Moreover, this approach to financing does not burden a company with debt and interest payments. Among the several other advantages that corporations have over partnerships are limited liability, ease of transfer of ownership, and continuous existence.

**Section 2: Accounting Applications**

- 1.

1	Assets			=	Liabilities			+	Stockholders' Equity			
2	Cash				Dividends Payable				Preferred Stock			
3	Feb.	1	250,000	Apr.	2	50,000				July	1	1,000,000
4	July	1	1,000,000				Dec.	31	49,820			
5	Sept.	30	30,000							Common Stock		
6	Bal.		1,230,000							Feb.	1	200,000
7	Building										15	6,000
8	Mar.	15	200,000							Mar.	15	240,000
9										Bal.		446,000
10	Land											
11	Mar.	15	50,000							Additional Paid-in Capital		
12										Feb.	1	50,000
13											15	1,200
14										Mar.	15	10,000
15										Bal.		61,200
16										Paid-in Capital, Treasury Stock		
17										Sept.	30	5,000
18												
19	Assets			=	Liabilities			+	Stockholders' Equity			
20										Dividends		
21										Dec.	31	49,820
22												
23	Treasury Stock											
24	Apr.	2	50,000	Sept.	30	25,000						
25	Bal.		25,000									
26										Start-up and Organization Costs		
27										Feb.	15	7,200
28												
29												
30												
31												
32												



Identify the components of stockholders' equity and their characteristics. **LO 2**

Most states require corporations to issue stock at a minimum value called legal capital. Legal capital is represented by the stock's par or stated value.

The stockholders' equity section of a corporate balance sheet usually has at least three components: contributed capital, retained earnings, and treasury stock. Contributed capital consists of money raised through stock issues. A corporation can issue two types of stock: common stock and preferred stock. Common stockholders have voting rights; they also share in the earnings of the corporation. Preferred stockholders usually have preference over common stockholders in one or more areas. Retained earnings are reinvested in the corporation. They represent stockholders' claims to assets resulting from profitable operations. Treasury stock is stock that the issuing corporation has reacquired. It is treated as a deduction from stockholders' equity.

Preferred stock generally gives its owners first right to dividend payments. Only after these stockholders have been paid can common stockholders receive any portion of a dividend. If the preferred stock is cumulative and dividends are in arrears, a corporation must pay the amount in arrears to preferred stockholders before it pays any dividends to common stockholders. Preferred stockholders also usually have preference over common stockholders in terms of their claims to assets if the corporation is liquidated. In addition, preferred stock may be convertible to common stock, and it is often callable at the option of the corporation.

Account for the issuance of stock for cash and other assets. **LO 3**

Corporations normally issue their stock in exchange for cash or other assets. When stock is issued for cash at par or stated value, Cash is debited and Common Stock or Preferred Stock is credited. When stock is sold at an amount greater than par or stated value, the excess is recorded in Additional Paid-in Capital.

When stock is issued for noncash assets, the general rule is to record the stock at its market value. If this value cannot be determined, the fair market value of the asset received is used to record the transaction.

Account for treasury stock. **LO 4**

Treasury stock is stock that the issuing company has reacquired. A company may buy back its own stock for several reasons, including a desire to create stock option plans, maintain a favorable market for the stock, increase earnings per share, or purchase other companies. The purchase of treasury stock is recorded at cost and is deducted from stockholders' equity. Treasury stock can be reissued or retired. It is similar to unissued stock in that it does not have rights until it is reissued.

Account for cash dividends. **LO 5**

The liability for payment of dividends arises on the date the board of directors declares a dividend. The declaration is recorded with a debit to Dividends and a credit to Dividends Payable. The record date—the date on which ownership of the stock, and thus of the right to receive a dividend, is determined—requires no entry. On the payment date, the Dividends Payable account is eliminated, and the Cash account is reduced.

Account for stock dividends and stock splits. **LO 6**

A stock dividend is a proportional distribution of shares among a corporation's stockholders. The following is a summary of the key dates and accounting treatments of stock dividends:

Key Date	Stock Dividend
Declaration date	Debit Stock Dividends for the market value of the stock to be distributed (if the stock dividend is small) and credit Common Stock Distributable for the stock's par value and Additional Paid-in Capital for the excess of the market value over the stock's par value.
Record date	No entry is needed.
Date of distribution	Debit Common Stock Distributable and credit Common Stock for the par value of the stock

A company usually declares a stock split to reduce the market value of its stock and thereby increase the demand for the stock. Because the par value of the stock normally decreases in proportion to the number of additional shares issued, a stock split has no effect on the dollar amount in stockholders' equity. A stock split does not require a journal entry, but a memorandum entry in the general journal is appropriate.

**Describe the statement of stockholders' equity, and compute book value per share.** **LO 7**

The statement of stockholders' equity summarizes changes during a period in each component of the stockholders' equity section of the balance sheet.

Book value per share is calculated by dividing stockholders' equity by the number of common shares outstanding. If a company has both preferred and common stock, the call or par value of the preferred stock and any dividends in arrears are deducted from stockholders' equity before dividing by the common shares outstanding.

**Calculate dividend yield and return on equity, and define stock options.** **LO 8**

Investors evaluate dividend policies and company performance by determining the dividend yield, return on equity, and the price/earnings ratio. Another issue involved in managing contributed capital is using stock options as compensation.

## Key Terms and Ratios

**articles of incorporation** 492 (LO1)  
**authorized shares** 497 (LO2)  
**board of directors** 492 (LO1)  
**book value** 518 (LO7)  
**book value per share** 518 (LO7)  
**callable preferred stock** 499 (LO2)  
**common stock** 497 (LO2)  
**contributed capital** 492 (LO1)  
**convertible preferred stock** 499 (LO2)  
**cumulative preferred stock** 498 (LO2)  
**declaration date** 511 (LO5)  
**dividends** 493 (LO1)  
**dividends in arrears** 498 (LO2)  
**double taxation** 494 (LO1)

**ex-dividend** 511 (LO5)  
**initial public offering (IPO)** 491  
**issued shares** 497 (LO2)  
**legal capital** 494 (LO1)  
**liquidating dividend** 510 (LO5)  
**noncumulative preferred stock** 498 (LO2)  
**no-par stock** 501 (LO3)  
**outstanding shares** 497 (LO2)  
**par value** 494 (LO1)  
**payment date** 511 (LO5)  
**preferred stock** 497 (LO2)  
**record date** 511 (LO5)  
**registrars** 494 (LO1)  
**retained earnings** 496 (LO2)  
**share of stock** 492 (LO1)

**start-up and organization costs** 495 (LO1)  
**statement of stockholders' equity** 496 (LO2)  
**stock dividend** 513 (LO6)  
**stock option plans** 522 (LO8)  
**stock split** 515 (LO6)  
**stockholders' equity** 496 (LO2)  
**transfer agents** 494 (LO1)  
**treasury stock** 496 (LO2)  
**underwriter** 494 (LO1)

### RATIOS

**dividend yield** 520 (LO8)  
**price/earnings (P/E) ratio** 521 (LO8)  
**return on equity** 520 (LO8)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 DQ1.** Why are most large companies established as corporations rather than as partnerships?
- LO 2 DQ2.** Why does a company usually not want to issue all its authorized shares?
- LO 2 DQ3.** Why would a company want to issue callable preferred stock?
- LO 2 DQ4.** What arguments can you give for treating preferred stock as debt rather than equity when carrying out financial analysis?
- LO 4 DQ5.** Why is treasury stock not considered an investment or an asset?
- LO 5 DQ6.** If an investor sells shares after the declaration date but before the date of record, does the seller still receive the dividend?

- LO 6 **DQ7.** Upon receiving shares of stock from a stock dividend, why should the stockholder not consider the value of the stock as income?
- LO 6, 7 **DQ8.** What is the effect of a stock dividend or a stock split on book value per share?
- LO 8 **DQ9. BUSINESS APPLICATION** ► Why do many companies like to give stock options as compensation?
- LO 8 **DQ10. BUSINESS APPLICATION** ► What relevance does par value or stated value have to a financial ratio, such as return on equity or debt to equity?

## SHORT EXERCISES

### LO 1 Advantages and Disadvantages of a Corporation

**SE1. CONCEPT** ► Identify whether each of the following characteristics is an advantage or a disadvantage of the corporate form of business:

1. Ease of transfer of ownership
2. Taxation
3. Separate legal entity
4. Lack of mutual agency
5. Government regulation
6. Continuous existence

### LO 1 Effect of Start-up and Organization Costs

**SE2.** At the beginning of 2014, Salinas Company incurred the following start-up and organization costs: (1) attorneys' fees with a market value of \$10,000, paid with 6,000 shares of \$1 par value common stock, and (2) incorporation fees of \$6,000 cash. Calculate total start-up and organization costs. What will be the effect of these costs on the income statement and balance sheet?

### LO 1, 5, 8 Management Issues

**SE3. BUSINESS APPLICATION** ► Indicate whether each of the following actions is related to (a) managing under the corporate form of business, (b) using equity financing, (c) determining dividend policies, (d) evaluating performance using return on equity, or (e) issuing stock options:

1. Considering whether to make a distribution to stockholders.
2. Controlling day-to-day operations.
3. Determining whether to issue preferred or common stock.
4. Compensating management based on the company's meeting or exceeding the targeted return on equity.
5. Compensating employees by giving them the right to purchase shares at a given price.
6. Transferring shares without the approval of other owners.

### LO 2 Stockholders' Equity

**SE4.** Prepare the stockholders' equity section of Waldemar Corporation's balance sheet from the following accounts and balances on December 31, 2014:

Common Stock, \$10 par value, 30,000 shares authorized, 20,000 shares issued, and 19,500 shares outstanding	\$200,000
Additional Paid-in Capital	100,000
Retained Earnings	15,000
Treasury Stock, Common (500 shares, at cost)	7,500

**LO 2 Preferred Stock Dividends with Dividends in Arrears**

**SE5.** Mazurka Corporation has 2,000 shares of \$100, 8 percent cumulative preferred stock outstanding and 40,000 shares of \$1 par value common stock outstanding. In the company's first three years of operation, its board of directors paid the following cash dividends: 2013, none; 2014, \$40,000; and 2015, \$80,000. Determine the total cash dividends and dividends per share paid to the preferred and common stockholders during each of the three years.

**LO 3 Issuance of Stock**

**SE6.** Sigma Company is authorized to issue 100,000 shares of common stock. The company sold 5,000 shares at \$12 per share. Prepare journal entries to record the sale of stock for cash under each of the following independent alternatives: (1) The stock has a par value of \$5, and (2) the stock has no par value but a stated value of \$1 per share.

**LO 3 Issuance of Stock for Noncash Assets**

**SE7.** Tulip Corporation issued 16,000 shares of its \$1 par value common stock in exchange for land that had a fair market value of \$100,000. Prepare the journal entries necessary to record the issuance of the stock for the land under each of these conditions: (1) The stock was selling for \$7 per share on the day of the transaction; (2) management attempted to place a value on the common stock but could not do so.

**LO 4 Treasury Stock Transactions**

**SE8.** Prepare the journal entries necessary to record Dao Company's following stock transactions during 2014:

- Oct. 1 Purchased 2,000 shares of its own \$2 par value common stock for \$20 per share, the current market price.  
17 Sold 500 shares of treasury stock purchased on October 1 for \$25 per share.  
21 Sold 800 shares of treasury stock purchased on October 1 for \$18 per share.

**LO 4 Retirement of Treasury Stock**

**SE9.** Refer to the information for Dao Company in **SE8**. On October 28, 2014, Dao retired the remaining 700 shares of treasury stock. The shares were originally issued at \$5 per share. Prepare the necessary journal entry.

**LO 5 Cash Dividends**

**SE10.** Leon Corporation has authorized 400,000 shares of \$1 par value common stock, of which 320,000 are issued and 280,000 are outstanding. On May 15, the board of directors declared a cash dividend of \$0.20 per share, payable on June 15 to stockholders of record on June 1. Prepare the entries using T accounts, as necessary, for each of the three dates.

**LO 6 Stock Dividends**

**SE11.** On February 15, Mite Corporation's board of directors declared a 2 percent stock dividend applicable to the outstanding shares of its \$10 par value common stock, of which 400,000 shares are authorized, 260,000 are issued, and 40,000 are held in the treasury. The stock dividend was distributed on March 15 to stockholders of record on March 1. On February 15, the market value of the common stock was \$15 per share. On March 30, the board of directors declared a \$0.50 per share cash dividend. No other stock transactions have occurred. Prepare journal entries to record, as necessary, the transactions of February 15, March 1, March 15, and March 30.



**LO 6 Stock Split**

**SE12.** On August 10, 2014, Geller, Inc.'s board of directors declared a 3-for-1 stock split of its \$9 par value common stock, of which 400,000 shares were authorized and 125,000 were issued and outstanding. The market value on that date was \$60 per share. On the same date, the balance of additional paid-in capital was \$3,000,000, and the balance of retained earnings was \$3,250,000. Prepare the stockholders' equity section of the company's balance sheet after the stock split. What entry, if any, is needed to record the stock split?

**LO 6,7 Effects of Stockholders' Equity Actions**

**SE13.** Tell whether each of the following actions will increase, decrease, or have no effect on total assets, total liabilities, and total stockholders' equity:

1. Declaration of a stock dividend
2. Declaration of a cash dividend
3. Stock split
4. Purchase of treasury stock

**LO 7 Statement of Stockholders' Equity**

**SE14.** Refer to Snow Corporation's statement of stockholders' equity in Exhibit 4 to answer the following questions: (1) At what price per share were the 10,000 shares of common stock sold? (2) What was the conversion price per share of the common stock? (Round to the nearest cent.) (3) At what price was the common stock selling on the date of the stock dividend? (4) At what price per share was the treasury stock purchased?

**LO 7 Book Value for Preferred and Common Stock**

**SE15.** Using data from the stockholders' equity section of Tramot Corporation's balance sheet that follows, and assuming one year's dividend in arrears, compute the book value per share for both the preferred and the common stock. (Round to the nearest cent.)

Contributed capital:

Preferred stock, \$100 par value, 8 percent cumulative, 20,000 shares authorized, 1,000 shares issued and outstanding	\$ 100,000
Common stock, \$10 par value, 200,000 shares authorized, 80,000 shares issued and outstanding	800,000
Additional paid-in capital	<u>1,032,000</u>
Total contributed capital	\$1,932,000
Retained earnings	<u>550,000</u>
Total stockholders' equity	<u><u>\$2,482,000</u></u>

**LO 8 Dividend Yield and Price/Earnings Ratio**

**SE16. BUSINESS APPLICATION** ▶ In 2014, Konstan Corporation earned \$3.30 per share and paid a dividend of \$1.65 per share. At year-end, the price of its stock was \$33 per share. Calculate the dividend yield and the price/earnings ratio.

**EXERCISES: SET A****LO 1 Advantages and Disadvantages of a Corporation**

**E1A. CONCEPT** ▶ Identify whether each of the following characteristics is an advantage (A) or a disadvantage (D) of the corporate form of business:

1. Continuous existence
2. Government regulation
3. Separate legal entity
4. Double taxation
5. Professional management

**LO 2 Stockholders' Equity**

**E2A.** The accounts and balances that follow are from Hastings Corporation's records on December 31, 2014.

Preferred Stock, \$100 par value, 9 percent cumulative, 10,000 shares authorized, 6,000 shares issued and outstanding	\$600,000
Common Stock, \$12 par value, 45,000 shares authorized, 30,000 shares issued, and 28,500 shares outstanding	360,000
Additional Paid-in Capital	194,000
Retained Earnings	23,000
Treasury Stock, Common (1,500 shares, at cost)	30,000

Prepare the stockholders' equity section of Hastings' balance sheet as of December 31, 2014.

**LO 2 Characteristics of Common and Preferred Stock**

**E3A.** Indicate whether each of the following characteristics is more closely associated with common stock (C) or preferred stock (P):

1. Can be callable
2. Generally receives dividends before other classes of stock
3. Often receives dividends at a set rate
4. Is considered the residual equity of a company
5. Can be convertible
6. More likely to have dividends that vary in amount from year to year
7. Can be entitled to receive dividends not paid in past years
8. Likely to have full voting rights
9. Receives assets first in liquidation

**LO 2 Cash Dividends with Dividends in Arrears**

**E4A.** Rutherford Corporation has 20,000 shares of its \$100 par value, 7 percent cumulative preferred stock outstanding and 100,000 shares of its \$1 par value common stock outstanding. In Rutherford's first four years of operation, its board of directors paid the following cash dividends: 2011, none; 2012, \$240,000; 2013, \$280,000; 2014, \$280,000. Determine the dividends per share and total cash dividends paid to the preferred and common stockholders during each of the four years.

**LO 2 Cash Dividends on Preferred and Common Stock**

**E5A.** Ex-Act Corporation pays dividends at the end of each year. The dividends that it paid for 2012, 2013, and 2014 were \$160,000, \$120,000, and \$360,000, respectively. Calculate the total amount of dividends Ex-Act paid in each of these years to its common and preferred stockholders under both of the following capital structures: (1) 40,000 shares of \$100 par, 6 percent noncumulative preferred stock and 120,000 shares of \$10 par common stock; (2) 20,000 shares of \$100 par, 7 percent cumulative preferred stock and 120,000 shares of \$10 par common stock. Ex-Act had no dividends in arrears at the beginning of 2012.

**LO 2, 3 Stock Entries Using T Accounts; Stockholders' Equity**

**E6A.** Gormanus Corporation was organized in 2014. It was authorized to issue 400,000 shares of no-par common stock with a stated value of \$5 per share, and 80,000 shares of \$100 par value, 6 percent noncumulative preferred stock. On March 1, the company issued 120,000 shares of its common stock for \$15 per share and 16,000 shares of its preferred stock for \$100 per share.

1. Record the issuance of the stock using T accounts.
2. Prepare the stockholders' equity section of Gormanus' balance sheet as it would appear immediately after the company issued the common and preferred stock.

**LO 3 Issuance of Stock**

**E7A.** Sussex Company is authorized to issue 100,000 shares of common stock. On August 1, the company issued 5,000 shares at \$25 per share. Prepare journal entries to record the issuance of stock for cash under each of the following alternatives: (1) the stock has a par value of \$25; (2) the stock has a par value of \$10; (3) the stock has no par value; and (4) the stock has a stated value of \$1 per share.

**LO 3 Issuance of Stock for Noncash Assets**

**E8A.** On July 1, 2014, Jones Corporation, a new corporation, issued 40,000 shares of its common stock to finance a corporate headquarters building. The building has a fair market value of \$1,200,000 and a book value of \$800,000. Because Jones is a new corporation, it is not possible to establish a market value for its common stock. Prepare journal entries to record the issuance of stock for the building, assuming the following conditions: (1) the par value of the stock is \$10 per share; (2) the stock is no-par stock; and (3) the stock has a stated value of \$4 per share.

**LO 4 Treasury Stock Transactions**

**E9A.** Record DeMeo Corporation's following stock transactions, which represent all the company's treasury stock transactions during 2014, using T accounts:

- May 5 Purchased 800 shares of its own \$2 par value common stock for \$20 per share, the current market price.
- 17 Sold 300 shares of treasury stock purchased on May 5 for \$22 per share.
- 21 Sold 200 shares of treasury stock purchased on May 5 for \$20 per share.
- 28 Sold the remaining 300 shares of treasury stock purchased on May 5 for \$19 per share.

**LO 4 Treasury Stock Transactions Including Retirement**

**E10A.** Record Carmel Corporation's following stock transactions, which represent all its treasury stock transactions for the year, using T accounts:

- June 1 Purchased 1,000 shares of its own \$30 par value common stock for \$70 per share, the current market price.
- 10 Sold 250 shares of treasury stock purchased on June 1 for \$80 per share.
- 20 Sold 350 shares of treasury stock purchased on June 1 for \$58 per share.
- 30 Retired the remaining shares purchased on June 1. The original issue price was \$42 per share.

**LO 5 Cash Dividends**

**E11A.** Nogel Corporation secured authorization from the state for 200,000 shares of \$10 par value common stock. It has 80,000 shares issued and 70,000 shares outstanding. On June 5, the board of directors declared a \$0.25 per share cash dividend to be paid on June 25 to stockholders of record on June 15. Record these events using T accounts.

**LO 5 Cash Dividends**

**E12A.** Bennett Corporation has 500,000 authorized shares of \$1 par value common stock, of which 200,000 are issued, including 20,000 shares of treasury stock. On October 15, the corporation's board of directors declared a cash dividend of \$0.50 per share payable on November 15 to stockholders of record on November 1. Record these events using T accounts.

**LO 6 Journal Entries: Stock Dividends**

**E13A.** Panza Corporation has 60,000 shares of its \$1 par value common stock outstanding. Prepare journal entries to record the following transactions as they relate to the company's common stock:

- July 17 Declared a 10 percent stock dividend on common stock to be distributed on August 10 to stockholders of record on July 31. Market value of the stock was \$5 per share on this date.
- 31 Date of record.
- Aug. 10 Distributed the stock dividend declared on July 17.
- Sept. 1 Declared a \$0.50 per share cash dividend on common stock to be paid on September 16 to stockholders of record on September 10.

**LO 6 Stock Split**

**E14A.** Charles Corporation currently has 250,000 shares of \$1 par value common stock authorized with 100,000 shares outstanding. The board of directors declared a 2-for-1 split on May 15, 2014, when the market value of the common stock was \$2.50 per share. The retained earnings balance on May 15 was \$350,000. Additional paid-in capital on this date was \$10,000. Prepare the stockholders' equity section of the company's balance sheet before and after the stock split. What entry, if any, would be necessary to record the stock split?

**LO 6 Stock Split**

**E15A.** On January 15, 2014, Agard International's board of directors declared a 3-for-1 stock split of its \$12 per value common stock, of which 1,600,000 shares were authorized and 400,000 were issued and outstanding. The market value on that date was \$45 per share. On the same date, the balance of additional paid-in capital was \$8,000,000, and the balance of retained earnings was \$16,000,000. Prepare the stockholders' equity section of Agard's balance sheet before and after the stock split. What entry, if any, is needed to record the stock split?

**LO 7 Statement of Stockholders' Equity**

**E16A.** The stockholders' equity section of Manco Corporation's balance sheet on December 31, 2014, follows.

Contributed capital:

Common stock, \$2 par value, 250,000 shares authorized, 200,000 shares issued and outstanding	\$ 400,000
Additional paid-in capital	600,000
Total contributed capital	\$1,000,000
Retained earnings	2,100,000
Total stockholders' equity	\$3,100,000

Prepare a statement of stockholders' equity for the year ended December 31, 2015, assuming these transactions occurred in sequence in 2015:

- a. Issued 5,000 shares of \$100 par value, 9 percent cumulative preferred stock at par after obtaining authorization from the state.
- b. Issued 20,000 shares of common stock in connection with the conversion of bonds having a carrying value of \$300,000.
- c. Declared and issued a 2 percent common stock dividend. The market value on the date of declaration was \$14 per share.
- d. Purchased 5,000 shares of common stock for the treasury at a cost of \$16 per share.
- e. Earned net income of \$230,000.
- f. Declared and paid the full-year's dividend on preferred stock and a dividend of \$0.40 per share on common stock outstanding at the end of the year.

**LO 7 Book Value for Preferred and Common Stock**

**E17A.** The stockholders' equity section of Plaka Corporation's balance sheet follows. Assuming one year's dividend in arrears, determine the book value per share for both the preferred and the common stock. (Round to the nearest cent.)

Contributed capital:	
Preferred stock, \$100 par value, callable at \$105 per share, 6 percent cumulative, 5,000 shares authorized, 100 shares issued and outstanding	\$10,000
Common stock, \$5 par value, 50,000 shares authorized, 5,000 shares issued, 4,500 shares outstanding	25,000
Additional paid-in capital	14,000
Total contributed capital	<u>\$49,000</u>
Retained earnings	47,500
Total contributed capital and retained earnings	<u>\$96,500</u>
Less treasury stock, common (500 shares at cost)	7,500
Total stockholders' equity	<u><u>\$89,000</u></u>

**LO 8 Dividend Yield and Price/Earnings Ratio****RATIO**

**E18A. BUSINESS APPLICATION** ▶ In 2014, Konstan Corporation earned \$4.40 per share and paid a dividend of \$2.00 per share. At year-end, the price of its stock was \$66 per share. Calculate the dividend yield and the price/earnings ratio. (Round the dividend yield to the nearest tenth of a percent.)

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS****LO 1, 2, 3, 4, 5****CASH FLOW****GENERAL LEDGER**

✓ 2: Total stockholders' equity: \$302,400

**Common Stock Transactions and Stockholders' Equity**

**P1.** On March 1, 2014, Kissell Corporation began operations with a charter from the state that authorized 100,000 shares of \$4 par value common stock. Over the next quarter, the company engaged in the transactions that follow.

- Mar. 1 Issued 30,000 shares of common stock, \$200,000.  
 2 Paid fees associated with obtaining the charter and starting up and organizing the corporation, \$24,000.
- Apr. 10 Issued 13,000 shares of common stock, \$130,000.  
 15 Purchased 5,000 shares of common stock, \$50,000
- May 31 The board of directors declared a \$0.20 per share cash dividend to be paid on June 15 to shareholders of record on June 10.

**REQUIRED**

- Record the above transactions using T accounts.
- Prepare the stockholders' equity section of Kissell's balance sheet on May 31, 2014. Net income earned during the first quarter was \$30,000.
- ACCOUNTING CONNECTION** ▶ What effect, if any, will the cash dividend declaration on May 31 have on Kissell's net income, retained earnings, and cash flows?

**LO 2, 8****RATIO****SPREADSHEET**

✓ 1: Total dividends in 2014: preferred, \$40,000; common, \$90,000

**Preferred and Common Stock Dividends and Dividend Yield**

**P2.** Avaya Corporation had the following stock outstanding from 2011 through 2014:  
*Preferred stock:* \$100 par value, 8 percent cumulative, 5,000 shares authorized, issued, and outstanding  
*Common stock:* \$10 par value, 100,000 shares authorized, issued, and outstanding

The company paid \$30,000, \$30,000, \$94,000, and \$130,000 in dividends during 2011, 2012, 2013, and 2014, respectively. The market price per common share was \$7.25 and \$8.00 per share at the end of years 2013 and 2014, respectively.

**REQUIRED**

1. Determine the dividends per share and the total dividends paid to common stockholders and preferred stockholders in 2011, 2012, 2013, and 2014.
2. Perform the same computations, with the assumption that the preferred stock was noncumulative.
3. **BUSINESS APPLICATION** ► Calculate the 2013 and 2014 dividend yield for common stock, using the dividends per share computed in requirement 2. (Round to the nearest tenth of a percent.)
4. **ACCOUNTING CONNECTION** ► How are cumulative preferred stock and noncumulative preferred stock similar to long-term bonds? How do they differ from long-term bonds?

LO 1, 2, 3, 4, 5

GENERAL LEDGER

SPREADSHEET

**Comprehensive Stockholders' Equity Transactions**

**P3.** In January 2014, Vanowski Corporation was organized and authorized to issue 2,000,000 shares of no-par common stock and 50,000 shares of 5 percent, \$50 par value, noncumulative preferred stock. The stock-related transactions for the first year's operations follow.

		Account			
		Debited		Credited	
		Account Number	Dollar Amount	Account Number	Dollar Amount
Jan.	19			310	\$15,000
		110	\$31,500	312	\$16,500
	21				
Feb.	7				
Mar.	22				
July	15				
Aug.	1				
Sept.	1				

*(Continued)*



Sept.	15	Date of record for cash dividends.	—	—	—	—
	25	Paid cash dividends to stockholders of record on September 15.	—	—	—	—
Oct.	30	Issued 4,000 shares of common stock for a piece of land. The stock was selling for \$3 per share, and the land had a fair market value of \$12,000.	—	—	—	—
Dec.	15	Issued 2,200 shares of preferred stock for \$50 per share.	—	—	—	—

**REQUIRED**

- For each of these transactions, indicate the account numbers and dollar amounts (as shown in the example) for the account(s) debited and credited, using the account numbers that follow.

110 Cash	312 Additional Paid-in Capital
120 Land	313 Paid-in Capital, Treasury Stock
121 Building	340 Retained Earnings
220 Dividends Payable	341 Dividends
305 Preferred Stock	350 Treasury Stock, Common
310 Common Stock	510 Start-up and Organization Costs

- BUSINESS APPLICATION** ► Why is the stockholders' equity section of the balance sheet an important consideration in analyzing the performance of a company?

LO 2, 3, 4, 5, 8

RATIO

GENERAL LEDGER

✓ 2: Total stockholders' equity: \$236,520

**Comprehensive Stockholders' Equity Transactions and Stockholders' Equity**

**P4.** Kraft Unlimited, Inc., was organized and authorized to issue 5,000 shares of \$100 par value, 9 percent preferred stock and 50,000 shares of no par, \$5 stated value common stock on July 1, 2014. Stock-related transactions for Kraft Unlimited follow.

July	1	Issued 10,000 shares of common stock at \$11 per share.
	1	Issued 500 shares of common stock at \$11 per share for services rendered in connection with the organization of the company.
	2	Issued 1,000 shares of preferred stock at par value for cash.
	10	Issued 2,500 shares of common stock for land on which the asking price was \$35,000. Market value of the stock was \$12. Management wishes to record the land at the market value of the stock.
Aug.	2	Purchased 1,500 shares of its common stock at \$13 per share.
	10	Declared a cash dividend for one month on the outstanding preferred stock and \$0.02 per share on common stock outstanding, payable on August 22 to stockholders of record on August 12.
	12	Date of record for cash dividends.
	22	Paid cash dividends.

**REQUIRED**

- Prepare journal entries to record these transactions.
- Prepare the stockholders' equity section of Kraft's balance sheet as it would appear on August 31, 2014. Net income for July was zero and August was \$11,500.
- BUSINESS APPLICATION** ► Calculate dividend yield, price/earnings ratio, and return on equity. Assume earnings per common share are \$1.00 and market price per common share is \$20. For beginning stockholders' equity, use the balance after the July transactions. (Round to the nearest tenth of a percent.)

4. **BUSINESS APPLICATION** ► Discuss the results in requirement 3, including the effect on investors' returns and the company's profitability as it relates to stockholders' equity.

LO 4

**Treasury Stock**

GENERAL LEDGER

SPREADSHEET

✓ 1: Balance in Retained Earnings:  
\$17,200 debit

**P5.** Rolex Company was involved in the following treasury stock transactions during 2014:

- Purchased 80,000 shares of its \$1 par value common stock on the market for \$2.50 per share.
- Purchased 16,000 shares of its \$1 par value common stock on the market for \$2.80 per share.
- Sold 44,000 shares purchased in (a) for \$131,000.
- Sold the other 36,000 shares purchased in (a) for \$72,000.
- Sold 6,000 of the remaining shares of treasury stock for \$1.60 per share.
- Retired all the remaining shares of treasury stock. All shares originally were issued at \$1.50 per share.

**REQUIRED**

- Record the treasury stock transactions using T accounts.
- ACCOUNTING CONNECTION** ► What is the reasoning behind treating the purchase of treasury stock as a reduction in stockholders' equity as opposed to treating it as an investment asset?

LO 6, 7

**Dividends, Stock Splits, and Stockholders' Equity**

GENERAL LEDGER

SPREADSHEET

✓ 2: Total retained earnings: \$423,200  
✓ 2: Total stockholders' equity: \$1,049,000

**P6.** The stockholders' equity section of Minh, Inc.'s balance sheet as of December 31, 2013, follows.

Contributed capital:	
Common stock, \$3 par value, 1,000,000 shares authorized, 80,000 shares issued and outstanding	\$240,000
Additional paid-in capital	<u>75,000</u>
Total contributed capital	\$315,000
Retained earnings	<u>240,000</u>
Total stockholders' equity	<u>\$555,000</u>

A review of Minh's stockholders' equity records disclosed the following transactions during 2014:

- Mar. 25 The board of directors declared a 5 percent stock dividend to stockholders of record on April 20 to be distributed on May 1. The market value of the common stock was \$21 per share.
- Apr. 20 Date of record for stock dividend.
- May 1 Issued stock dividend.
- Sept. 10 Declared a 3-for-1 stock split.
- Dec. 15 Declared a 10 percent stock dividend to stockholders of record on January 15 to be distributed on February 15. The market price on this date is \$9 per share.

**REQUIRED**

- Record the stockholders' equity components of these transactions using T accounts.
- Prepare the stockholders' equity section of Minh's balance sheet as of December 31, 2014. Assume net income for 2014 is \$494,000.
- ACCOUNTING CONNECTION** ► If you owned 2,000 shares of Minh stock on March 1, 2014, how many shares would you own on February 15, 2015? Would your proportionate share of the ownership of the company be different on the latter date from what it was on the former date? Explain your answer.

LO 3, 4, 5, 6, 7

RATIO

GENERAL LEDGER

✓ 2: Total stockholders' equity: \$5,605,600

**Comprehensive Stockholders' Equity Transactions**

**P7.** On December 31, 2014, the stockholders' equity section of Delux Corporation's balance sheet appeared as follows:

Contributed capital:		
Common stock, \$8 par value, 400,000 shares authorized, 120,000 shares issued and outstanding		\$ 960,000
Additional paid-in capital		2,560,000
Total contributed capital		<u>\$3,520,000</u>
Retained earnings		1,648,000
Total stockholders' equity		<u>\$5,168,000</u>

Selected transactions involving stockholders' equity in 2015 follow.

- Jan. 4 The board of directors obtained authorization for 40,000 shares of \$40 par value noncumulative preferred stock that carried an indicated dividend rate of \$4 per share and was callable at \$42 per share.
- 14 The company sold 24,000 shares of the preferred stock at \$40 per share and issued another 4,000 in exchange for a building valued at \$160,000.
- Mar. 8 The board of directors declared a 2-for-1 stock split on the common stock.
- Apr. 20 After the stock split, the company purchased 6,000 shares of common stock for the treasury at a price of \$12 per share.
- May 4 The company sold 2,000 of the shares purchased on April 20, at an average price of \$16 per share.
- July 15 The board of directors declared a cash dividend of \$4 per share on the preferred stock and \$0.40 per share on the common stock.
- 25 Date of record.
- Aug. 15 Paid the cash dividend.
- Nov. 28 The board of directors declared a 15 percent stock dividend when the common stock was selling for \$20 per share to be distributed on January 5 to stockholders of record on December 15.
- Dec. 15 Date of record for the stock dividend.

**REQUIRED**

1. Prepare journal entries to record these transactions.
2. Prepare the stockholders' equity section of Delux's balance sheet as of December 31, 2015. Net loss for 2015 was \$436,000. (*Hint:* Use T accounts to keep track of transactions.)
3. **ACCOUNTING CONNECTION** ► Compute the book value per share for preferred and common stock (including common stock distributable) on December 31, 2014 and 2015, using end-of-year shares outstanding. (Round to the nearest cent.) What effect would you expect the change in book value to have on the market price per share of the company's stock?

**ALTERNATE PROBLEMS**

LO 1, 2, 3, 4, 5

CASH FLOW

GENERAL LEDGER

✓ 2: Total retained earnings: \$32,000  
 ✓ 2: Total stockholders' equity: \$1,342,000

**Common Stock Transactions and Stockholders' Equity**

**P8.** Canterbury Corporation began operations on September 1, 2014. The corporation's charter authorized 300,000 shares of \$8 par value common stock. Canterbury engaged in the transactions that follow during its first quarter.

- Sept. 1 Issued 50,000 shares of common stock, \$500,000.
- 1 Paid an attorney \$32,000 to help start up and organize the corporation and obtain a corporate charter from the state.

- Oct. 2 Issued 80,000 shares of common stock, \$960,000.  
 15 Purchased 10,000 shares of common stock for \$150,000.  
 Nov. 30 Declared a cash dividend of \$0.40 per share to be paid on December 15 to stockholders of record on December 10.

**REQUIRED**

1. Prepare entries using T accounts to record the above transactions.
2. Prepare the stockholders' equity section of Canterbury's balance sheet on November 30, 2014. Net income for the quarter was \$80,000.
3. **ACCOUNTING CONNECTION** ► What effect, if any, will the cash dividend declaration on November 30 have on net income, retained earnings, and cash flows?

LO 2, 8

RATIO

✓ 1: Total dividends in 2014: preferred, \$280,000; common, \$820,000

**Preferred and Common Stock Dividends and Dividend Yield**

**P9.** Rhinehart Corporation had both common stock and preferred stock outstanding from 2012 through 2014. Information about each stock for the three years follows.

Type	Par Value	Shares Outstanding	Other
Preferred	\$100	40,000	7% cumulative
Common	20	600,000	

The company paid \$140,000, \$800,000, and \$1,100,000 in dividends for 2012 through 2014, respectively. The market price per common share was \$15 and \$17 per share at the end of years 2013 and 2014, respectively.

**REQUIRED**

1. Determine the dividends per share and total dividends paid to the common and preferred stockholders each year. (Round to the nearest cent.)
2. Assuming that the preferred stock was noncumulative, repeat the computations performed in requirement 1. (Round to the nearest cent.)
3. **BUSINESS APPLICATION** ► Calculate the 2013 and 2014 dividend yield for common stock using dividends per share computed in requirement 2. (Round to the nearest tenth of a percent.)
4. **ACCOUNTING CONNECTION** ► How are cumulative preferred stock and noncumulative preferred stock similar to long-term bonds? How do they differ from long-term bonds?

LO 2, 3, 4, 5, 8

RATIO

GENERAL LEDGER

✓ 2: Total stockholders' equity: \$1,765,900

**Comprehensive Stockholders' Equity Transactions and Financial Ratios**

**P10.** Gorlin Corporation was chartered in the Commonwealth of Massachusetts. The company was authorized to issue 20,000 shares of \$100 par value, 6 percent preferred stock and 100,000 shares of no-par common stock. The common stock has a \$2 stated value. The stock-related transactions for the quarter ended October 31, 2014, follow.

- Aug. 3 Issued 20,000 shares of common stock at \$22 per share.  
 15 Issued 16,000 shares of common stock for land. Asking price for the land was \$200,000. Common stock's market value was \$12 per share. Management wishes to record the land at the market value of the stock.  
 22 Issued 10,000 shares of preferred stock for \$1,000,000.  
 Oct. 4 Issued 10,000 shares of common stock for \$120,000.  
 10 Purchased 5,000 shares of common stock for the treasury for \$13,000.  
 15 Declared a quarterly cash dividend on the outstanding preferred stock and \$0.10 per share on common stock outstanding, payable on October 31 to stockholders of record on October 25.  
 25 Date of record for cash dividends.  
 31 Paid the cash dividends declared on October 15.

(Continued)

**REQUIRED**

- Record transactions for the quarter ended October 31, 2014, using T accounts.
- Prepare the stockholders' equity section of Gorlin's balance sheet as of October 31, 2014. Net income for the quarter was \$46,000.
- BUSINESS APPLICATION** ► Calculate dividend yield, price/earnings ratio, and return on equity. (Round the dividend yield and return on equity to the nearest tenth of a percent. Round the price/earnings ratio to the nearest tenth.) Assume earnings per common share are \$1.97 and market price per common share is \$25. For beginning stockholders' equity, use the balance after the August transactions.
- BUSINESS APPLICATION** ► Discuss the results in requirement 3, including the effect on investors' returns and the firm's profitability as it relates to stockholders' equity.

LO 1, 2, 3, 4, 5

GENERAL LEDGER

**Comprehensive Stockholders' Equity Transactions**

**P11.** In January 2014, Imperial Corporation was organized and authorized to issue 4,000,000 shares of no-par common stock and 100,000 shares of 5 percent, \$50 par value, noncumulative preferred stock. The stock-related transactions for the first year's operations follow.

		Account			
		Debited		Credited	
		Account Number	Dollar Amount	Account Number	Dollar Amount
Jan.	19				
				310	\$30,000
		110	\$63,000	312	\$33,000
	21				
Feb.	7				
Mar.	22				
July	15				
Aug.	1				
Sept.	1				
	15				

Sept. 25	Paid cash dividends to stockholders of record on September 15.	—	—	—	—
Oct. 30	Issued 8,000 shares of common stock for a piece of land. The stock was selling for \$3 per share, and the land had a fair market value of \$24,000.	—	—	—	—
Dec. 15	Issued 4,400 shares of preferred stock for \$50 per share.	—	—	—	—

**REQUIRED**

- For each of these transactions, provided the account numbers and dollar amounts (as shown in the example) for the account(s) debited and credited using the account numbers that follow.

110 Cash	312 Additional Paid-in Capital
120 Land	313 Paid-in Capital, Treasury Stock
121 Building	340 Retained Earnings
220 Dividends Payable	341 Dividends
305 Preferred Stock	350 Treasury Stock, Common
310 Common Stock	510 Start-up and Organization Costs

- BUSINESS APPLICATION** ► Why is the stockholders' equity section of the balance sheet an important consideration in analyzing the performance of a company?

**LO 4****Treasury Stock**

- ✓ 1: Balance in Retained Earnings: \$34,400 debit

**P12.** Khandi Company was involved in the following treasury stock transactions during 2014:

- Purchased 160,000 shares of its \$1 par value common stock on the market for \$2.50 per share.
- Purchased 32,000 shares of its \$1 par value common stock on the market for \$2.80 per share.
- Sold 88,000 shares purchased in (a) for \$262,000.
- Sold the other 72,000 shares purchased in (a) for \$144,000.
- Sold 12,000 of the remaining shares of treasury stock for \$1.60 per share.
- Retired all the remaining shares of treasury stock. All shares originally were issued at \$1.50 per share.

**REQUIRED**

- Record the treasury stock transactions using T accounts.
- ACCOUNTING CONNECTION** ► What is the reasoning behind treating the purchase of treasury stock as a reduction in stockholders' equity as opposed to treating it as an investment asset?

**LO 6, 7****Dividends, Stock Splits, and Stockholders' Equity****GENERAL LEDGER**

- ✓ 2: Total retained earnings: \$798,100;  
2: Total stockholders' equity: \$2,964,000

**P13.** The stockholders' equity section of Villa Corporation's balance sheet as of December 31, 2013, follows.

Contributed capital:	
Common stock, \$4 par value, 500,000 shares authorized, 200,000 shares issued and outstanding	\$ 800,000
Additional paid-in capital	1,000,000
Total contributed capital	<u>\$1,800,000</u>
Retained earnings	1,200,000
Total stockholders' equity	<u><u>\$3,000,000</u></u>

(Continued)



Villa had the following transactions in 2014:

- Feb. 28 The board of directors declared a 10 percent stock dividend to stockholders of record on March 25 to be distributed on April 5. The market value on this date is \$16.
- Mar. 25 Date of record for stock dividend.
- Apr. 5 Issued stock dividend.
- Aug. 3 Declared a 2-for-1 stock split.
- Nov. 20 Purchased 18,000 shares of the company's common stock at \$8 per share for the treasury.
- Dec. 31 Declared a 5 percent stock dividend to stockholders of record on January 25 to be distributed on February 5. The market value per share was \$9.

#### REQUIRED

- Record the stockholders' equity components of these transactions using T accounts.
- Prepare the stockholders' equity section of Villa's balance sheet as of December 31, 2014. Assume net income for 2014 is \$108,000.
- ACCOUNTING CONNECTION** ► If you owned 1,000 shares of Villa stock on February 1, 2014, how many shares would you own on February 5, 2015? Would your proportionate share of the ownership of the company be different on the latter date from what it was on the former date? Explain your answer.

LO 3, 4, 5, 6, 7

RATIO

GENERAL LEDGER

- ✓ 2. Total stockholders' equity:  
\$11,211,200

#### Comprehensive Stockholders' Equity Transactions

**P14.** On December 31, 2014, the stockholders' equity section of Torez Corporation's balance sheet appeared as follows.

Contributed capital:

Common stock, \$8 par value, 800,000 shares authorized, 240,000 shares issued and outstanding	\$ 1,920,000
Additional paid-in capital	5,120,000
Total contributed capital	<u>\$ 7,040,000</u>
Retained earnings	3,296,000
Total stockholders' equity	<u>\$10,336,000</u>

The following are selected transactions involving stockholders' equity in 2015. On January 4, the board of directors obtained authorization for 80,000 shares of \$40 par value noncumulative preferred stock that carried an indicated dividend rate of \$4 per share and was callable at \$42 per share. On January 14, the company sold 48,000 shares of the preferred stock at \$40 per share and issued another 8,000 in exchange for a building valued at \$320,000. On March 8, the board of directors declared a 2-for-1 stock split on the common stock. On April 20, after the stock split, the company purchased 12,000 shares of common stock for the treasury at a price of \$12 per share; 4,000 of these shares subsequently were sold on May 4 at an average price of \$16 per share. On July 15, the board of directors declared a cash dividend of \$4 per share on the preferred stock and \$0.40 per share on the common stock. The date of record was July 25. The dividends were paid on August 15. The board of directors declared a 15 percent stock dividend on November 28, when the common stock was selling for \$20. The date of record for the stock dividend was December 15, and the dividend was to be distributed on January 5.

#### REQUIRED

- Prepare journal entries to record these transactions.
- Prepare the stockholders' equity section of Torez's balance sheet as of December 31, 2015. Net loss for 2015 was \$872,000. (*Hint:* Use T accounts to keep track of transactions.)

3. **BUSINESS APPLICATION** ► Compute the book value per share for preferred and common stock (including common stock distributable) on December 31, 2014 and 2015, using end-of-year shares outstanding. (Round to the nearest cent.) What effect would you expect the change in book value to have on the market price per share of the company's stock?

## CASES

### LO 1 Conceptual Understanding: Reasons for Issuing Common Stock

**C1. DreamWorks Animation**, led by billionaire **Microsoft** founder Paul Allen, went public in a recent year with its class A common stock at \$28 per share, raising \$650 million. By the end of the first day, it was up 27 percent to \$38 per share, giving the company a value of almost \$1 billion. This initial enthusiasm did not last. By the end of 2007, the price was only around \$25 per share.<sup>17</sup> As a growing company that has produced such animated hits as Shrek, DreamWorks could have borrowed significant funds by issuing long-term debt. What are some advantages of issuing common stock as opposed to long-term debt? What are some disadvantages?

### LO 4 Conceptual Understanding: Purposes of Treasury Stock

**RATIO**

**C2. BUSINESS APPLICATION** ► Many companies in recent years have bought back their common stock. For example, **IBM**, with large cash holdings, spent almost \$35 billion over three years repurchasing its stock.<sup>18</sup> What are the reasons companies buy back their own shares? What is the effect of common stock buybacks on earnings per share, return on equity, return on assets, debt to equity, and the current ratio?

### LO 2, 3 Interpreting Financial Reports: Effect of Stock Issue

**C3.** When **Google, Inc.** went public with an IPO, it used an auction system that allowed everyone to participate rather than allocating shares of stock to a few insiders. The company's IPO drew widespread attention. Announcements of the IPO would have been similar to the following:

22,500,000 Shares  
GOOGLE, INC.  
\$0.001 Par Value Common Stock  
Price \$85 a share

The gross proceeds of the IPO before issue costs were \$1.9 billion.

A portion of the stockholders' equity section of the balance sheet adapted from Google's annual report, which was issued prior to this stock offering, follows.

#### Stockholders' Equity (Dollar amounts in thousands)

Common stock, \$0.001 par value, 700,000,000 shares authorized; 161,000,000 shares issued and outstanding	\$ 161
Additional paid-in capital	725,219
Retained earnings	191,352

1. Assume that the net proceeds to Google after issue costs were \$1.8 billion. Prepare the journal entry to record the stock issuance on Google's accounting.
2. Prepare the stockholders' equity section portion of Google's balance sheet shown above after the issue of the common stock, based on the information given. (Round all answers to the nearest thousand.)
3. Based on your answer in 2, did Google have to increase its authorized shares to undertake this stock issue?
4. What amount per share did Google receive and how much did Google's underwriters receive to help in issuing the stock? What do underwriters do to earn their fee?

LO 6 **Conceptual Understanding: Stock Split**

**C4.** When **Crocs**, the shoe company, reported in early 2007 that its first-quarter earnings had increased from the previous year, its stock price jumped to over \$80 per share. At the same time, the company announced a 2-for-1 stock split.<sup>19</sup> What is a stock split and what effect does it have on the company's stockholders' equity? What effect will it likely have on the market value of the company's stock? In light of your answers, do you think the stock split is positive for the company and for its stockholders?

LO 2, 8 **Interpreting Financial Reports: Stockholders' Equity**

**RATIO**

**C5.** Refer to the **CVS Corporation** annual report in the Supplement to Chapter 16 to answer the following questions:

1. What type of capital stock does CVS have? What is the par value? How many shares were authorized, issued, and outstanding at the end of fiscal 2011?
2. **BUSINESS APPLICATION** ► What is the dividend yield (use average price of stock in last quarter) for CVS and its relationship to the investors' total return? (Round the average price to the nearest cent; round the dividend yield to the nearest tenth of a percent.) Does the company rely mostly on stock or on earnings for its stockholders' equity? (CVS's fourth quarter of 2011 high and low market prices were \$41.35 and \$32.28, respectively.)
3. **BUSINESS APPLICATION** ► Does the company have a stock option plan? To whom do the stock options apply? Do employees have significant stock options? Given the market price of the stock shown in the report, do these options represent significant value to the employees?

LO 3, 4, 5, 8 **Interpreting Financial Reports: Return on Equity, Treasury Stock, and Dividends Policy**

**RATIO**

**C6.** Refer to the annual report of **CVS Corporation** and the financial statements of **Southwest Airlines Co.** in the Supplement to Chapter 16.

1. **BUSINESS APPLICATION** ► Compute the return on equity for both companies for fiscal 2011 and 2010. Total stockholders' equity for CVS and Southwest in 2009 was \$35,768 million and \$5,454 million, respectively.
2. **BUSINESS APPLICATION** ► Did either company purchase treasury stock during these years? How will the purchase of treasury stock affect return on equity and earnings per share?
3. Did either company issue stock during these years? What are the details?
4. Compare the dividend policy of the two companies.

**Continuing Case: Annual Report Project**

**RATIO**

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the balance sheet and accompanying notes of your company. Answer the following questions:

1. What percentage of total liabilities and stockholders' equity is stockholders' equity? What kinds of stock does the company have?
2. Is retained earnings a significant component of stockholders' equity?
3. Does the company have treasury stock? What effect does it have on total stockholders' equity?
4. **BUSINESS APPLICATION** ► Compute return on equity for your company.

# CHAPTER 14

## Long-Term Liabilities

### BUSINESS INSIGHT

### Swan Manufacturing Company

Swan Manufacturing Company wants to expand its metal window division, but it does not have enough long-term capital to finance the project. As indicated in the data from Swan's balance sheets that follow, the company has, until now, been able to rely on the issuance of capital stock to take care of its financing needs. (Note the increase in stockholders' equity between 2013 and 2014.) Not included in the balance sheets are annual payments of \$100,000 that Swan makes on long-term leases of various properties.

	2014	2013
Total current liabilities	\$1,000,000	\$ 800,000
Long-term debt	0	0
Total stockholders' equity	3,200,000	3,000,000
Total liabilities and stockholders' equity	<u>\$4,200,000</u>	<u>\$3,800,000</u>

Swan's management is now considering several options, including the issuance of long-term bonds, for financing expansion of the metal window division. In making its decision, management will have to assess how much debt the company should carry and how much risk it is undertaking by assuming long-term debt.

- 1. CONCEPT** ► How do the concepts of recognition, valuation, classification, and disclosure apply to long-term liabilities?
- 2. ACCOUNTING APPLICATION** ► How are long-term bonds accounted for in Swan's records?
- 3. BUSINESS APPLICATION** ► What should Swan consider in deciding to issue long-term debt?

### LEARNING OBJECTIVES

- LO 1** Explain the concepts underlying long-term liabilities, and identify the types of long-term liabilities.
- LO 2** Describe the features of a bond issue and the major characteristics of bonds.
- LO 3** Record bonds issued at face value and at a discount or premium.
- LO 4** Use present values to determine the value of bonds.
- LO 5** Amortize bond discounts and bond premiums using the straight-line and effective interest methods.
- LO 6** Account for the retirement of bonds and the conversion of bonds into stock.
- LO 7** Record bonds issued between interest dates, and record year-end adjustments.
- LO 8** Explain and demonstrate the accounting issues related to leases and pensions.
- LO 9** Evaluate the decision to issue long-term debt, including analyzing long-term debt.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Recognition
- Valuation
- Classification
- Disclosure

RELEVANT  
LEARNING OBJECTIVE

- LO 1** Explain the concepts underlying long-term liabilities, and identify the types of long-term liabilities.

## LO 1 Concepts Underlying Long-Term Liabilities

Profitable operations and short-term credit seldom provide sufficient funds for a growing business. Growth usually requires investments in long-term assets, research and development, and other activities to expand the business. To finance these assets and activities, the company needs funds that will be available for longer periods. Contributed capital by owners is one source of long-term funds. Long-term liabilities are another source. **Long-term liabilities** are debts and obligations that a company expects to satisfy in more than one year or beyond its normal operating cycle, whichever is longer. Managers must understand how long-term liabilities should be *recognized*, *valued*, *classified*, and *disclosed*.

### Recognition

Generally accepted accounting principles require that long-term liabilities be *recognized* and recorded when an obligation occurs even though the obligation may not be due for many years. Some long-term liabilities, such as a note payable due in five years, are easy to identify, but others, such as promises to pay employees pensions after they retire, are more difficult. Nevertheless, recognition of long-term liabilities is important because managers and stockholders need to know how much a company is obligated to pay in the future.

### Valuation

On the balance sheet, long-term liabilities are generally *valued* at the amount of money needed to pay the debt or at the fair market value of the goods or services to be delivered. The amount of most liabilities is definitely known (as with notes payable). Other long-term liabilities require judgment and estimates about conditions in the future (as with pension obligations).

### Classification

In contrast to current liabilities, a liability is *classified* as long-term when it is due beyond one year or beyond the normal operating cycle. The distinction between current and long-term liabilities affects the evaluation of a company's liquidity. For example, when a portion of a long-term liability becomes due in the next year and will be paid out of current assets, it should be classified as a current liability. The investor or creditor can then see what current obligations will need to be paid soon.

### Disclosure

Because of the complex nature of many long-term liabilities, extensive *disclosures* in the notes to the financial statements are often required. For example, the disclosures for long-term notes should include the balances, maturity dates, interest rates, and other features of the debts. Any special credit arrangements should also be disclosed. When estimates and judgments are involved, as with pension liabilities, these should also be disclosed.

### Types of Long-Term Debt

To structure long-term financing to the best advantage of their companies, managers must know the characteristics of the various types of long-term debt. Long-term debt includes bonds payable, notes payable, mortgages, and other more complex obligations.

**Bonds Payable** Long-term **bonds payable** are the most common type of long-term debt. They can have many different characteristics, including the amount of interest,



whether the company can elect to repay them before their maturity date, and whether they can be converted to common stock. We cover bonds in detail in later sections of this chapter.

**Notes Payable** Long-term **notes payable**, those that come due in more than one year, are also very common. They differ from bonds mainly in the way the contract with the creditor is structured. A long-term note is a promissory note that represents a loan from a bank or other creditor, whereas a bond is a more complex financial instrument that usually involves debt to many creditors. Analysts often do not distinguish between long-term notes and bonds because they have similar effects on the financial statements.

**Mortgages Payable** A **mortgage** is a long-term debt secured by real property. It is usually paid in equal monthly installments. Each monthly payment includes interest on the debt and a reduction in the debt. Exhibit 1 shows the first three monthly payments on a \$100,000, 9 percent mortgage.

**Exhibit 1**  
Monthly Payment Schedule on a \$100,000, 9 Percent Mortgage

	A	B	C	D	E
Payment Date	Unpaid Balance at Beginning of Period	Monthly Payment	Interest for 1 Month at ¾% on Unpaid Balance* (¾% × A)	Reduction in Debt (B – C)	Unpaid Balance at End of Period (A – D)
June 1					\$100,000
July 1	\$100,000	\$1,200	\$750	\$450	99,550
August 1	99,550	1,200	747	453	99,097
September 1	99,097	1,200	743	457	98,640

\*Rounded

© Cengage Learning 2014

**Mortgages Payable**

**Transaction** The mortgage was obtained on June 1, and the monthly payments are \$1,200.

**Analysis** The journal entry to record the July 1 mortgage payment

- ▼ decreases the *Mortgage Payable* account with a debit of \$450
- ▲ increases the *Mortgage Interest Expense* account with a debit of \$750
- ▼ decreases the *Cash* account with a credit of \$1,200

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
Cash			Mortgage Payable			Mortgage Interest Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	July 1 1,200		July 1 450			July 1 750	

**Journal Entry**

	Dr.	Cr.
July 1	Mortgage Payable	450
	Mortgage Interest Expense	750
	Cash	1,200
	Made monthly mortgage payment	

$$A = L + SE$$

$$-1,200 = -450 + -750$$

**Comment** Notice from the entry and from Exhibit 1 that the July 1 payment represents the following:

- Interest expense:  $\$100,000 \times 0.09 \times 1/12 = \$750$
- Reduction in debt:  $\$1,200 - \$750 = \$450$

Therefore, the July payment reduces the unpaid balance to \$99,550. August's interest expense is slightly less than July's because of the decrease in the debt.





Monkey Business Images/Shutterstock.com

A mortgage is a type of long-term debt that is secured by real property. Most mortgages are paid in equal monthly installments.

**Other Long-Term Obligations** Other common long-term obligations consist of the following:

- **Long-term leases:** When a long-term lease has a term that corresponds closely to the life of the asset and, thus, is more like a purchase of an asset than a shorter-term lease, it is called a **capital lease**. In this case, a long-term asset with a corresponding long-term liability is *recognized* on the balance sheet. Long-term leases are covered in more detail later in the chapter.
- **Pension liabilities:** A liability arises from a contract that requires a company to make payments to its employees after they retire. Pension obligations are covered in more detail later in the chapter.
- **Other post-retirement benefits:** A liability arises from a contract that requires a company to provide medical and other benefits to its employees after they retire. *Recognition* and *valuation* of the liability requires estimates and assumptions about retirement age, mortality, and, most significantly, future trends in health care benefits.
- **Deferred income taxes:** A common long-term liability on the balance sheets of many companies, **deferred income taxes** are the result of using different accounting methods to calculate income taxes on the income statement and income tax liability on the income tax return. For instance, companies often use straight-line depreciation for financial reporting and an accelerated method to calculate income tax liability. Because straight-line depreciation is less than accelerated depreciation in the early years of an asset's life, the assumption is that the income taxes will eventually have to be paid. Thus, the difference is listed as deferred income taxes. Because companies try to manage their affairs to minimize income taxes paid, deferred income taxes can become quite large. For example, **Southwest Airlines** has deferred income taxes of about \$2.6 billion or almost 23 percent of its total liabilities.<sup>1</sup>



## Business Perspective

### Post-Retirement Liabilities Affect Everyone

© Allia / iStockphoto.com

The rule requiring *recognition* of unfunded pension plans as liabilities impacts even government entities. Most government entities have defined benefit pension plans and provide post-retirement medical benefits. As a result, states, school districts, and municipalities are all encountering previously ignored pension and health care liabilities. For example, the state of New Jersey actually stopped setting aside funds to pay for health care in order to give a tax cut. No one added up the cost until the new accounting rule required it. The estimated cost to provide the health care promised to New Jersey's current and future retirees was \$58 billion, or twice the state's annual budget.<sup>2</sup> These cases, while extreme, are not unusual, especially in light of the decrease in government tax collections during the recent recession. Citizens across the country will face tax increases to pay for these liabilities.

## APPLY IT!

Match each type of long-term liability that follows with the statement to which it applies.

- |                                   |  |
|-----------------------------------|--|
| a. Bonds payable                  | 1. Cost of health care after employees' retirement                         |
| b. Long-term notes payable        | 2. The most common type of long-term debt                                  |
| c. Mortgage payable               | 3. The result of differences between accounting income and taxable income  |
| d. Long-term lease                | 4. Debt that is secured by real estate                                     |
| e. Pension liabilities            | 5. Promissory note that is due in more than one year                       |
| f. Other post-retirement benefits | 6. Company requirement to make payments to its employees after they retire |
| g. Deferred income taxes          | 7. Often similar in form to purchasing a long-term asset                   |

### SOLUTION

1. f, 2. a, 3. g, 4. c, 5. b, 6. e, 7. d

**TRY IT! SE1, SE2, E1A, E1B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Record bonds issued at face value, at a discount, and at a premium
- Value bonds
- Amortize bond discounts and bond premiums
- Record the retirement of bonds
- Record the conversion of bonds into stock
- Record bonds issued between interest dates
- Record year-end adjustments
- Account for leases
- Account for pensions

## RELEVANT LEARNING OBJECTIVES

**LO 2** Describe the features of a bond issue and the major characteristics of bonds.

**LO 3** Record bonds issued at face value and at a discount or premium.

**LO 4** Use present values to determine the value of bonds.

**LO 5** Amortize bond discounts and bond premiums using the straight-line and effective interest methods.

**LO 6** Account for the retirement of bonds and the conversion of bonds into stock.

**LO 7** Record bonds issued between interest dates, and record year-end adjustments.

**LO 8** Explain and demonstrate the accounting issues related to leases and pensions.

**LO 2** The Nature of Bonds

A **bond** is a security, usually long term, representing money that a corporation borrows from the investing public. (The federal, state, and local governments also issue bonds to raise money, as do foreign countries.) A bond entails a promise to repay the amount borrowed, called the *principal*, on a specified date and to pay interest at a specified rate at specified times—usually semiannually. In contrast to stockholders, who are the owners of a corporation, bondholders are a corporation's creditors.

When a public corporation decides to issue bonds, it must submit the appropriate legal documents to the Securities and Exchange Commission (SEC) for permission to borrow the funds. The SEC reviews the corporation's financial health and the specific terms of the **bond indenture**, which is a contract that defines the rights, privileges, and limitations of the bondholders. The bond indenture generally describes such things as:

- the maturity date of the bonds
- interest payment dates
- the interest rate

It may also cover repayment plans and restrictions.

Once the bond issue is approved, the corporation has a limited time in which to issue the authorized bonds. As evidence of its debt to the bondholders, the corporation provides each of them with a **bond certificate**.

**Bond Issue: Prices and Interest Rates**

A **bond issue** is the total value of bonds issued at one time. For example, a \$1,000,000 bond issue could consist of one thousand \$1,000 bonds. The prices of bonds are stated in terms of a percentage of the face value, or principal, of the bonds. A bond issue quoted at 103½ means that a \$1,000 bond costs \$1,035 ( $\$1,000 \times 1.035$ ). When a bond sells at exactly 100, it is said to sell at **face value** (or *par value*). When it sells below 100, it is said to sell at a *discount*; above 100, at a *premium*. For instance, a \$1,000 bond quoted at 87.62 would be selling at a discount and would cost the buyer \$876.20.

**Face Interest Rate and Market Interest Rate** Two interest rates relevant to bond prices are the face interest rate and the market interest rate.

- The **face interest rate** is the fixed rate of interest paid to bondholders based on the face value of the bonds. To allow time to file with the SEC, publicize the bond issue, and print the bond certificates, a company must decide in advance what the face interest rate will be. Most companies try to set the face interest rate as close as possible to the market interest rate.
- The **market interest rate** (or *effective interest rate*) is the rate of interest paid in the market on bonds of similar risk.\* The market interest rate fluctuates daily. Because a company has no control over it, the market interest rate often differs from the face interest rate on the issue date.

**Discounts and Premiums** If the market interest rate fluctuates from the face interest rate before the issue date, the issue price will not equal the bonds' face value.

\* At the time this chapter was written, the market interest rates on corporate bonds were volatile. Therefore, we use a variety of interest rates in our examples.

**STUDY NOTE:** A bond sells at face value when the face interest rate of the bond is identical to the market interest rate for similar bonds on the date of issue. When the face interest and the market interest rates are different, a discount or premium arises.

This fluctuation in market interest rate causes the bonds to sell at either a discount or a premium.

- A **discount** equals the excess of the face value over the issue price. The issue price will be less than the face value when the market interest rate is higher than the face interest rate.
- A **premium** equals the excess of the issue price over the face value. The issue price will be more than the face value when the market interest rate is lower than the face interest rate.

Discounts or premiums are contra-accounts that are subtracted from or added to bonds payable on the balance sheet.

## Characteristics of Bonds

A bond indenture can be written to fit an organization's financing needs. As a result, the bonds issued in today's financial markets have many different features. We describe several of the more important features in the following paragraphs.

**Unsecured and Secured Bonds** Bonds can be either unsecured or secured.

- **Unsecured bonds** (or *debenture bonds*) are issued on the basis of a corporation's general credit.
- **Secured bonds** carry a pledge of certain corporate assets as a guarantee of repayment. A pledged asset may be a specific asset, such as a truck, or a general category of asset, such as property, plant, and equipment.

**Term and Serial Bonds** When all the bonds of an issue mature at the same time, they are called **term bonds**. For instance, a company may decide to issue \$1,000,000 worth of bonds, all due 20 years from the date of issue.

When the bonds of an issue mature on different dates, they are called **serial bonds**. For example, suppose that a \$1,000,000 bond issue calls for paying \$200,000 of the principal every five years. This arrangement means that after the issuing company makes the first \$200,000 payment, \$800,000 of the bonds would remain outstanding for the next five years, \$600,000 for the next five years, and so on. A company may issue serial bonds to ease the task of paying off what it owes on the bonds.

**Callable and Convertible Bonds** When bonds are callable and convertible, a company may be able to retire them before their maturity dates. When a company does retire a bond issue before its maturity date, it is called **early extinguishment of debt**. Doing so can be to a company's advantage.

**Callable bonds** give the issuer the right to buy back and retire the bonds before maturity at a specified **call price**, which is usually above face value. Callable bonds give a company flexibility in financing its operations. For example, if bond interest rates drop, the company can call the bonds and reissue debt at a lower interest rate. A company might also call its bonds if it has earned enough to pay off the debt, if the reason for having the debt no longer exists, or if it wants to restructure its debt to equity ratio. The bond indenture states the time period and the prices at which the bonds can be redeemed.

**Convertible bonds** allow the bondholder to exchange a bond for a specified number of shares of common stock. The face value of a convertible bond when issued is greater than the market value of the shares to which it can be converted. However, if the market price of the common stock rises above a certain level, the value of the bond rises in relation to the value of the common stock. Even if the stock price does not rise, the investor still holds the bond and receives both the periodic interest payments and the face value at the maturity date.

One advantage of issuing convertible bonds is that the interest rate is usually lower because investors are willing to give up some current interest in the hope that the value

**STUDY NOTE:** Do not confuse the terms indenture and debenture. An indenture is a bond contract, whereas a debenture is an unsecured bond. A debenture bond of a stable company actually might be a less risky investment than a secured bond of an unstable company.

**STUDY NOTE:** An advantage of issuing serial bonds is that the organization retires the bonds over a period of years, rather than all at once.

of the stock will increase and the value of the bonds will, therefore, also increase. In addition, if the bonds are both callable and convertible and the market value of the stock rises to a level at which the bond is worth more than face value, management can avoid repaying the bonds by calling them for redemption, thereby forcing the bondholders to convert their bonds into common stock. The bondholders will agree to convert because no gain or loss results from the transaction.

**Registered and Coupon Bonds** **Registered bonds** are issued in the names of the bondholders. The issuing organization keeps a record of the bondholders' names and addresses and pays them interest by check. Most bonds today are registered.

**Coupon bonds** are not registered with the organization. Instead, they bear coupons stating the amount of interest due and the payment date. The bondholder removes the coupons from the bonds on the interest payment dates and presents them at a bank for collection.

## APPLY IT!

Match each term that follows with the term that could be an alternate (or sometimes opposite) term.

- |                       |                         |
|-----------------------|-------------------------|
| a. Face interest rate | 1. Secured              |
| b. Discount           | 2. Coupon               |
| c. Unsecured          | 3. Convertible          |
| d. Term               | 4. Premium              |
| e. Registered         | 5. Market interest rate |
| f. Callable           | 6. Serial               |

### SOLUTION

1. c, 2. e, 3. f, 4. b, 5. a, 6. d

**TRY IT! SE3, E2A, E2B**

## LO 3 Accounting for the Issuance of Bonds

When the board of directors decides to issue bonds, it is not necessary to make an entry to record the SEC's authorization of the bond issue. However, most companies *disclose* the authorization in the notes to their financial statements. The note lists the number and *value* of bonds authorized, the interest rate, the interest payment dates, and the life of the bonds.

If the face interest rate on the bonds issued equals the market interest rate, the bonds will sell at their face value. If the face rate is less than the market rate, the bonds will sell at a discount. If the face rate is greater than the market rate, the bonds will sell at a premium.

### Bonds Issued at Face Value

**Transaction** Carrot Corporation issues \$200,000 of 7 percent, five-year bonds on January 1, 2014, and sells them on the same date for their face value. The bond indenture states that interest is to be paid on January 1 and July 1 of each year.

**Analysis** The journal entry to record the issuance of the bonds at face value

- ▲ *increases* the *Cash* account with a debit
- ▲ *increases* the *Bonds Payable* account with a credit

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>			<b>Bonds Payable</b>				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
Jan. 1	200,000		Jan. 1	200,000			

**Journal Entry**

2014		<i>Dr.</i>	<i>Cr.</i>
Jan. 1	Cash	200,000	
	Bonds Payable		200,000
	Sold \$200,000 of 7% 5-year bonds at face value		

$$A = L + SE$$

$$+200,000 = +200,000$$

**STUDY NOTE:** When calculating semiannual interest, multiply the annual rate by one-half year.

**Interest Expense** Carrot pays interest on January 1 and July 1 of each year. Thus, Carrot would owe the bondholders \$7,000 interest on July 1, 2014:

$$\begin{aligned} \text{Interest} &= \text{Principal} \times \text{Rate} \times \text{Time} \\ &= \$200,000 \times \frac{7}{100} \times 6/12 \text{ year} \\ &= \$7,000 \end{aligned}$$

**Analysis** The journal entry to record the interest paid to the bondholders on each semiannual interest payment date (January 1 or July 1)

- ▲ increases the *Bond Interest Expense* account with a debit
- ▼ ▲ decreases the *Cash* account with a credit (or increases the *Interest Payable* account with a credit)

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>						<b>Bond Interest Expense</b>	
<i>Dr.</i>	<i>Cr.</i>				<i>Dr.</i>	<i>Cr.</i>	
	7,000				7,000		

**Journal Entry**

July 1	Bond Interest Expense	<i>Dr.</i>	<i>Cr.</i>
	Cash (Interest Payable)	7,000	7,000
	Made semiannual interest payment to bondholders of 7 percent, 5-year bonds		

$$A^* = L + SE$$

$$-7,000 = -7,000$$

\*Assumes cash paid.

**Comment** It is common for bond interest to be paid twice per year.

**Bonds Issued at a Discount**

**Transaction** Carrot issues \$200,000 of 7 percent, five-year bonds at 95.9445 on January 1, 2014, when the market interest rate is 8 percent. In this case, the bonds are being issued at a discount because the market interest rate exceeds the face interest rate.

**Analysis** The entry to record the issuance of the bonds at a discount

- ▲ increases the *Cash* account with a debit for the amount of the bond issue less the discount
- ▲ increases the *Unamortized Bond Discount* account with a debit for the amount of discount
- ▲ increases the *Bonds Payable* account with a credit for the amount of the bond issued

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>			<b>Unamortized Bond Discount</b>				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
Jan. 1 191,889			Jan. 1 8,111				
			<b>Bonds Payable</b>				
			<i>Dr.</i>	<i>Cr.</i>			
				Jan. 1 200,000			

$$\begin{array}{rcl}
 \mathbf{A} & = & \mathbf{L} + \mathbf{SE} \\
 +191,889 & & -8,111 \\
 & & +200,000
 \end{array}$$

**Journal Entry**

		<i>Dr.</i>	<i>Cr.</i>
2014			
Jan. 1	Cash	191,889	
	Unamortized Bond Discount	8,111	
	Bonds Payable		200,000
	Sold \$200,000 of 7%, 5-year bonds at 95.9445		
	Face amount of bonds		\$200,000
	Less purchase price of bonds (\$200,000 × 0.959445)	191,889	
	Unamortized bond discount	<u>8,111</u>	

**Comment** If a balance sheet is prepared immediately after the bonds are issued at a discount, the liability for bonds payable is reported as follows.

Long-term liabilities

7% bonds payable, due 1/1/2019	\$200,000	
Less unamortized bond discount	<u>8,111</u>	\$191,889

Unamortized Bond Discount is a contra-liability account. Its balance is deducted from the face amount of the bonds to arrive at the carrying value, or present value, of the bonds. The bond discount is described as unamortized because it will be amortized (written off) over the life of the bonds.



## Business Perspective

### 100-Year Bonds Are Not for Everyone

© Alija / iStockphoto.com

With interest rates on long-term debt at historically low levels, some companies attempt to lock in those low costs for long periods. In 1993, in a classic example, **The Walt Disney Company** aggressively issued \$150 million of 100-year bonds at a yield of only 7.5 percent. Among the others that followed Walt Disney's lead by issuing 100-year bonds were the **Coca-Cola Company**, **Columbia HCA Healthcare**, **Bell South**, **IBM**, and even the People's Republic of China. Some analysts wondered if even Mickey Mouse could survive 100 years. In fact, in 2012, interest rates had dropped so far that Disney is now paying more than the market rate of only 5.7 percent. Investors who purchased the bonds have had a gain because the bonds are now selling at a premium at \$132.<sup>3</sup>



## Bonds Issued at a Premium

**Transaction** Carrot issues \$200,000 of 7 percent, five-year bonds for \$208,530 on January 1, 2014, when the market interest rate is 6 percent. This means that investors will purchase the bonds at 104.265 percent of their face value. In this case, the bonds are being issued at a premium because the face interest rate exceeds the market rate for similar investments.

**Analysis** The journal entry to record the bond issuance at a premium

- ▲ increases the *Cash* account for the amount of the bond issue plus the premium
- ▲ increases the *Unamortized Bond Premium* account for the amount of the premium
- ▲ increases the *Bonds Payable* account for the amount of the bond issue

### Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>			<b>Unamortized Bond Premium</b>				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
Jan. 1	208,530			Jan. 1		8,530	
			<b>Bonds Payable</b>				
			<i>Dr.</i>	<i>Cr.</i>			
				Jan. 1		200,000	

### Journal Entry

	2014								
→	Jan. 1	Cash			<i>Dr.</i>	<i>Cr.</i>			
		Unamortized Bond Premium			208,530		8,530		
		Bonds Payable					200,000		←
		Sold \$200,000 of 7% 5-year bonds at 104.265							

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+208,530		+8,530		
		+200,000		

**Comment** Immediately after this entry is made, bonds payable would be presented on the balance sheet as follows.

Long-term liabilities		
7% bonds payable, due 1/1/2019	\$200,000	
Plus unamortized bond premium	8,530	\$208,530

Here, the carrying value of the bonds payable is \$208,530, which equals the face value of the bonds plus the unamortized bond premium. This means that the purchasers were willing to pay a premium of \$8,530 to buy these bonds because their face interest rate was higher than the market interest rate.

## Bond Issue Costs

The costs of issuing bonds can amount to as much as 5 percent of a bond issue. These costs often include the fees of underwriters, whom corporations hire to take care of the details of marketing a bond issue. Because the issue costs benefit the whole life of a bond issue, they are spread over that period. It is generally accepted practice to establish a separate account for these costs and to amortize them over the life of the bonds.

Because issue costs decrease the amount of money a company receives from a bond issue, they have the effect of raising the discount or lowering the premium on the issue. Thus, bond issue costs can be spread over the life of the bonds through the amortiza-

**STUDY NOTE:** The carrying amount is always the face value of the bonds less the unamortized discount or plus the unamortized premium.

tion of a discount or premium. This method simplifies recordkeeping. In the rest of our discussion, we assume that all bond issue costs increase the discounts or decrease the premiums on bond issues.

## APPLY IT!

Nico Foods is planning to issue \$1,000,000 in long-term bonds. Depending on market conditions, Nico's CPA advises that the bonds could be issued at (a) 99, (b) 100, or (c) 101. Calculate the amount that Nico would receive under each alternative. Indicate whether it is at face value, a discount or a premium, and the amount of discount or premium of each.

### SOLUTION

- (a)  $\$1,000,000 \times 0.99 = \$990,000$ ; a discount of \$10,000
- (b)  $\$1,000,000 \times 1.00 = \$1,000,000$ ; at face value; no discount or premium
- (c)  $\$1,000,000 \times 1.01 = \$1,010,000$ ; a premium of \$10,000

**TRY IT! SE5, E6A, E6B**

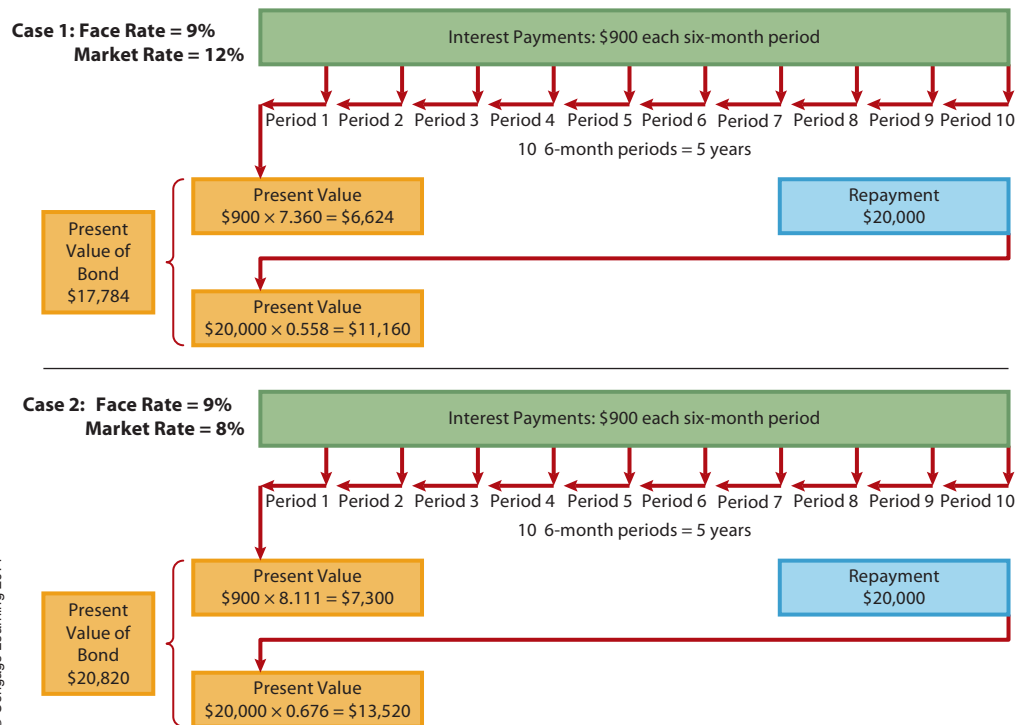
## Lo 4 Using Present Value to Value a Bond

A bond's value is determined by summing the following two present value amounts, based on concepts presented previously in Chapter 11:

- a series of fixed interest payments
- a single payment at maturity

As noted, the amount of interest a bond pays is fixed over its life. The market interest rate, on the other hand, varies from day to day and is the rate used to determine the bond's present value. Thus, the amount investors are willing to pay for a bond varies because the bond's present value changes as the market interest rate changes. In the next sections, we show how to calculate the present value of a bond when the market rate is above the face value and when it is below the face value. Exhibit 2 illustrates both examples.

**Exhibit 2**  
Using Present Value to Value a \$20,000, 9 Percent, Five-Year Bond



### Market Rate Above Face Rate

**Measure** Calculate the present value of a bond when the market rate is above the face value.

**Example** A bond has a face value of \$20,000 and pays fixed interest of \$900 every six months (a 9 percent annual rate). The bond is due in five years. If the market interest rate today is 12 percent, what is the present value of the bond?

**Table Computation** Use Table 2 in Appendix B to calculate the present value of the periodic interest payments of \$900, and use Table 1 in the same appendix to calculate the present value of the single payment of \$20,000 at maturity. Because interest payments are made every six months, the compounding period is half a year. Thus, we have to convert the annual rate to a semiannual rate of 6 percent ( $12\% \div 2$  six-month periods per year) and use ten periods ( $5 \text{ years} \times 2$  six-month periods per year). The present value of the bond is therefore computed as follows.

Present value of 10 periodic payments at 6%: $\$900 \times 7.360$ (from Table 2 Appendix B)	\$ 6,624
Present value of a single payment at the end of 10 periods at 6%: $\$20,000 \times 0.558$ (from Table 1 in Appendix B)	<u>11,160</u>
Present value of \$20,000 bond	<u>\$17,784</u>

The market interest rate has increased so much since the bond was issued—from 9 percent to 12 percent—that the value of the bond today is only \$17,784. That amount is all investors would be willing to pay at this time for a bond that provides income of \$900 every six months and a return of the \$20,000 principal in five years.

### Market Rate Below Face Rate

**Measure** Calculate the present value of a bond when the market rate is below the face value.

**Example** Suppose the market interest rate on the bond described above falls to 8 percent (4 percent semiannually). The present value of the bond will be greater than the face value of \$20,000.

#### Table Computation

Present value of 10 periodic payments at 4%: $\$900 \times 8.111$ (from Table 2 in Appendix B)	\$ 7,300
Present value of a single payment at the end of 10 periods at 4%: $\$20,000 \times 0.676$ (from Table 2 in Appendix B)	<u>13,520</u>
Present value of \$20,000 bond	<u>\$20,820</u>

## APPLY IT!

Romero Company's \$500,000 bond issue pays semiannual interest of \$16,000 and is due in 20 years. The market interest rate is 6 percent. Calculate the present value of the bond issue.

#### SOLUTION

Present value of 40 periodic payments of 3% (from Table 2 in Appendix B):

$$\$16,000 \times 23.115 = \$369,840$$

Present value of a single payment at the end of 20 years (40 periods) at 3% (from Table 1 in Appendix B):

$$\$500,000 \times 0.307 = 153,500$$

$$\text{Total value of the bond issue} = \underline{\underline{\$523,340}}$$

**TRY IT! SE4, E3A, E4A, E3B, E4B**

## LO 5 Amortization of Bond Discounts and Premiums

To record interest expense properly and ensure that the carrying value of bonds payable at maturity equals face value, it is necessary to systematically reduce the bond discount or premium—that is, to *amortize* them—over the life of the bonds. This can be accomplished by using either the straight-line method or the effective interest method.

### Amortizing a Bond Discount

In one of our earlier examples, Carrot Corporation issued \$200,000 of five-year bonds at a time when the market interest rate of 8 percent exceeded the face interest rate of 7 percent. The bonds sold for \$191,889, resulting in an unamortized bond discount of \$8,111.

**STUDY NOTE:** The carrying amount always approaches the face value over the life of the bond.

Because it affects interest expense each year, the bond discount should be amortized over the life of the bond issue. In this way, the unamortized bond discount will decrease gradually over time, and the carrying value of the bond issue (face value less unamortized discount) will increase gradually. By the maturity date, the carrying value of the bond issue will equal its face value, and the unamortized bond discount will be zero.

**STUDY NOTE:** A bond discount is a component of interest cost because it represents the amount in excess of the issue price that a corporation must pay on the maturity date.

**Calculating Total Interest Expense** When a corporation issues bonds at a discount, the market (or effective) interest rate that it pays is greater than the face interest rate on the bonds. The reason is that the interest expense is the stated interest payments *plus* the amount of the bond discount. That is, although the company does not receive the full face value of the bonds on issue, it still must pay back the full face value at maturity. The difference between the issue price and the face value must be added to the total interest payments to arrive at the actual interest expense.

### Interest Expense for Bond Issued at a Discount

To have each year's interest expense reflect the market interest rate, the discount must be allocated over the remaining life of the bonds as an increase in the interest expense each period. Thus, interest expense for each period will exceed the actual payment of interest by the amount of the bond discount amortized over the period. This process of allocation is called *amortization of the bond discount*.

The total expense to Carrot of issuing its \$200,000 bonds at a discount is as follows.

Cash to be paid to bondholders	
Face value at maturity	\$200,000
Interest payments ( $\$200,000 \times 0.07 \times 5$ years)	70,000
Total cash paid to bondholders	<u>\$270,000</u>
Less cash received from bondholders	191,889
Total interest cost	<u>\$ 78,111</u>
Or, alternatively:	
Interest payments ( $\$200,000 \times 0.07 \times 5$ years)	\$ 70,000
Bond discount	8,111
Total interest cost	<u>\$ 78,111</u>

The total interest cost of \$78,111 is made up of \$70,000 in interest payments and the \$8,111 bond discount. Thus, the bond discount *increases* the interest paid on the bonds from the face interest rate to the market interest rate. The market (or effective) interest rate is the real interest cost of the bond over its life.

**STUDY NOTE:** The discount on a zero coupon bond represents the interest that will be paid (in its entirety) on the maturity date.

Some bonds do not require periodic interest payments. These bonds, called **zero coupon bonds**, are simply a promise to pay a fixed amount at the maturity date. They are issued at a large discount because the only interest that the buyer earns or the issuer pays is the discount. For example, a five-year, \$200,000 zero coupon bond issued when the market rate is 10 percent, compounded semiannually, would sell for only \$122,800. That amount is the present value of a single payment of \$200,000 at the end of five years. The discount of \$77,200 (\$200,000 – \$122,800) is the total interest expense, which is amortized over the life of the bond.

**Straight-Line Method** The **straight-line method** equalizes amortization of a bond discount for each interest period in the life of the bonds.

### Amortizing a Bond Discount Using the Straight-Line Method

**Transaction** Using the Carrot Corporation example, the interest payment dates of the bond issue are January 1 and July 1 of each year, and the bonds mature in five years.

**Bond Discount Amortized and Interest Expense** With the straight-line method, the amount of the bond discount amortized and the interest expense for each semiannual period are calculated in four steps.

**Step 1:** Determine the total number of interest payments.

$$\begin{aligned}\text{Total Interest Payments} &= \text{Interest Payments per Year} \times \text{Life of Bonds} \\ &= 2 \times 5 = 10\end{aligned}$$

**Step 2:** Determine the amount of bond discount amortization per period.

$$\begin{aligned}\text{Amortization of Bond Discount per Interest Period} &= \frac{\text{Bond Discount}}{\text{Total Interest Payments}} \\ &= \frac{\$8,111}{10} \\ &= \$811^*\end{aligned}$$

\* Rounded

**Step 3:** Determine the cash interest payment.

$$\begin{aligned}\text{Cash Interest Payment} &= \text{Face Value} \times \text{Face Interest Rate} \times \text{Time} \\ &= \$200,000 \times 0.07 \times 6/12 = \$7,000\end{aligned}$$

**Step 4:** Determine the interest expense per period.

$$\begin{aligned}\text{Interest Expense per Interest Period} &= \text{Interest Payment} + \text{Amortization of Bond Discount} \\ &= \$7,000 + \$811 = \$7,811\end{aligned}$$

**Analysis** The journal entry to record the bond discount amortized and interest expense

- ▲ *increases* the *Bond Interest Expense* account with a debit for the amount calculated in Step 4,
- ▼ *decreases* the *Unamortized Bond Discount* account with a credit for the amount calculated in Step 2, and
- ▼▲ *decreases* the *Cash* account (or *increases* the *Interest Payable* account with a credit) for the amount in Step 3.

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
Cash			Unamortized Bond Discount			Bond Interest Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	July 1 7,000			July 1 811		July 1 7,811	

**Journal Entry**

2014							
	July 1	Dr.	Bond Interest Expense	Cr.	7,811	←	
			Unamortized Bond Discount			811	
			Cash			7,000	

Paid semiannual interest to bondholders and amortized the discount on 7%, 5-year bonds

**A\*** = **L** + **SE**  
 -7,000 = +811 -7,811  
 \*Assumes cash paid.

**Comment** Notice that the bond interest expense is \$7,811, but the amount paid to the bondholders is the \$7,000 face interest payment. The difference of \$811 is the credit to Unamortized Bond Discount. This lowers the debit balance of Unamortized Bond Discount and raises the carrying value of the bonds payable by \$811 each interest period. If no changes occur in the bond issue, this entry will be made every six months during the life of the bonds. When the bond issue matures, the Unamortized Bond Discount account will have a zero balance, and the carrying value of the bonds will be \$200,000—exactly equal to the amount due the bondholders.

Although the straight-line method has long been used, it has a certain weakness. When it is used to amortize a discount, the carrying value goes up each period, but the bond interest expense stays the same; thus, the rate of interest falls over time. Conversely, when this method is used to amortize a premium, the rate of interest rises over time. The Accounting Principles Board, therefore, holds that the straight-line method should be used only when it does not lead to a material difference from the effective interest method.<sup>4</sup> A *material difference* is one that affects the evaluation of a company.

**Effective Interest Method** When the **effective interest method** is used to compute the interest and amortization of a bond discount, a constant interest rate is applied to the carrying value of the bonds at the beginning of each interest period. This constant rate is the market rate (i.e., the effective rate) at the time the bonds were issued. The amount amortized each period is the difference between the interest computed by using the market rate and the actual interest paid to bondholders.

**Amortizing a Bond Discount Using the Effective Interest Method**

**Transaction** Use the same facts for Carrot that we used earlier—a \$200,000 bond issue at 7 percent, with a five-year maturity and interest to be paid twice a year. The market rate at the time the bonds were issued was 8 percent, so the bonds sold for \$191,889, a discount of \$8,111. Exhibit 3 shows the interest and amortization of the bond discount.

**Carrying Value, Interest Expense, Discount Amortized, and Discount Unamortized** The amounts in Exhibit 3 for period 1 were computed as follows. (Amounts are rounded to the nearest dollar.)

**Column A** The carrying value of the bonds is computed as:

$$\text{Face Value} - \text{Unamortized Discount} = \text{Carrying Value}$$

$$\$200,000 - \$8,111 = \$191,889$$



**Column B** The interest expense to be recorded is the effective interest, computed as:

$$\begin{aligned} \text{Carrying Value} \times \text{Market Interest Rate} \times \text{Interest Time Period} &= \text{Interest Expense} \\ \$191,889 \times 0.08 \times 6/12 &= \$7,676 \end{aligned}$$

**Column C** The interest paid in the period is a constant amount, computed as:

$$\begin{aligned} \text{Face Value} \times \text{Face Interest Rate} \times \text{Interest Time Period} &= \text{Interest Payments} \\ \$200,000 \times 0.07 \times 6/12 &= \$7,000 \end{aligned}$$

**Column D** The discount amortized is computed as:

$$\begin{aligned} \text{Interest Expense} - \text{Interest Payment} &= \text{Amortized Discount} \\ \$7,676 - \$7,000 &= \$676 \end{aligned}$$

**Column E** The unamortized bond discount is computed as:

$$\begin{aligned} \text{Discount at the Beginning of the Period} - \text{Current Period Amortization} &= \text{Unamortized Discount} \\ \$8,111 - \$676 &= \$7,435 \end{aligned}$$

The unamortized discount decreases in each interest payment period because it is amortized as a portion of interest expense.

**Column F** The carrying value of the bonds at the end of the period is computed as:

$$\begin{aligned} \text{Carrying Value at Beginning of Period} + \text{Amortization During Period} &= \text{Carrying Value at End of Period} \\ \$191,889 + \$676 &= \$192,565 \end{aligned}$$

**STUDY NOTE:** Whether a bond is sold at a discount or a premium, its carrying value will equal its face value on the maturity date.

Notice that the sum of the carrying value and the unamortized discount (column F + column E) always equals the face value of the bonds (for example, \$192,565 + \$7,435 = \$200,000).

**Analysis** The journal entry to record the bond discount amortized and interest expense is exactly like the one when the straight-line method is used. However, the amounts debited and credited to the various accounts are different. This journal entry

- ▲ increases the *Bond Interest Expense* account with a debit for the amount calculated in column B
- ▼ decreases the *Unamortized Bond Discount* account with a credit for the amount calculated in column D
- ▼▲ decreases the *Cash* account (or increases the *Interest Payable* account) with a credit for the amount in column C

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>			<b>Unamortized Bond Discount</b>			<b>Bond Interest Expense</b>	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
July 1	7,000		July 1	676		July 1	7,676

**Journal Entry**

		Dr.	Cr.
2014 July 1	Bond Interest Expense	7,676	
	Unamortized Bond Discount		676
	Cash		7,000
Paid semiannual interest to bondholders and amortized the discount on 7%, 5-year bonds			

$$\begin{matrix} \mathbf{A^*} & = & \mathbf{L} & + & \mathbf{SE} \\ -7,000 & & +676 & & -7,676 \end{matrix}$$

\*Assumes cash paid.

**Comment** Although an interest and amortization table is useful because it can be prepared in advance for all periods, it is not necessary to have one to determine the amortization of a discount for any one interest payment period. It is necessary only to multiply the carrying value by the effective interest rate and subtract the interest payment from the result. For example, the amount of discount to be amortized in the seventh interest payment period is \$855, calculated as:

$$\begin{aligned} (\text{Carrying Value} \times \text{Interest Rate}) - \text{Interest Payment} &= \text{Amortized Discount} \\ (\$196,370 \times 0.04) - \$7,000 &= \$855 \end{aligned}$$

**Exhibit 3****Interest and Amortization Table of a Bond Discount: Effective Interest Method**

Semiannual Interest Period	A Carrying Value at Beginning of Period	B Semiannual Interest Expense at 8% to Be Recorded* (4% × A)	C Semiannual Interest Payment to Bondholders (3½% × \$200,000)	D Amortization of Bond Discount (B – C)	E Unamortized Bond Discount at End of Period (E – D)	F Carrying Value at End of Period (A + D)
0					\$8,111	\$191,889
1	\$191,889	\$7,676	\$7,000	\$676	7,435	192,565
2	192,565	7,703	7,000	703	6,732	193,268
3	193,268	7,731	7,000	731	6,001	193,999
4	193,999	7,760	7,000	760	5,241	194,759
5	194,759	7,790	7,000	790	4,451	195,549
6	195,549	7,822	7,000	822	3,629	196,371
7	196,371	7,855	7,000	855	2,774	197,226
8	197,226	7,889	7,000	889	1,885	198,115
9	198,115	7,925	7,000	925	960	199,040
10	199,040	7,960**	7,000	960	—	200,000

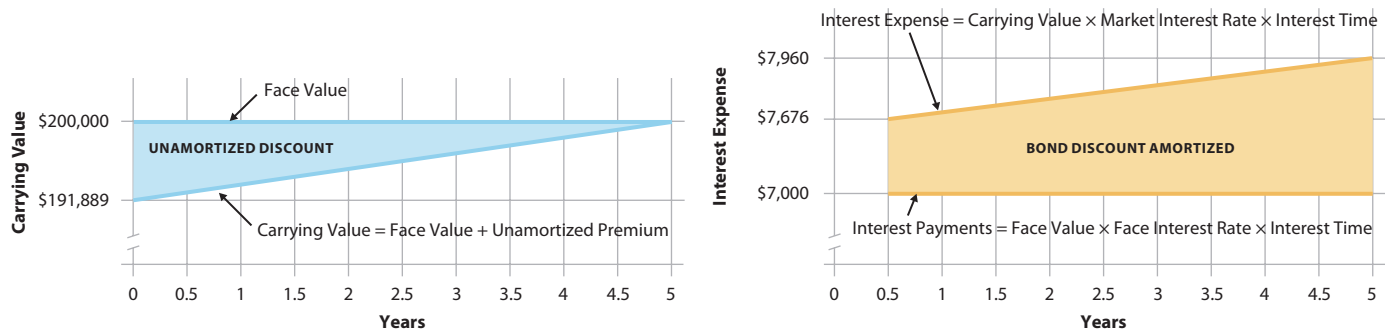
\* Rounded

\*\* Last period's interest expense equals \$7,960 (\$7,000 + \$960). It does not equal \$7,962 (\$199,040 × 0.04) because of the cumulative effect of rounding.

© Cengage Learning 2014

**STUDY NOTE:** The bond interest increases each period because the carrying value of the bonds (the principal on which the interest is calculated) increases each period.

Exhibit 4, which is based on the data in Exhibit 3, shows how the effective interest method affects the amortization of a bond discount. Notice that the carrying value at the beginning of Period 1 (the issue price) is initially less than the face value but that it gradually increases toward the face value over the life of the bond issue. Notice also that interest expense exceeds interest payments by the amount of the bond discount amortized. Interest expense increases gradually over the life of the bond because it is based on the gradually increasing carrying value (multiplied by the market interest rate).

**Exhibit 4****Carrying Value and Interest Expense—Bonds Issued at a Discount**

© Cengage Learning 2014

## Amortizing a Bond Premium

**STUDY NOTE:** The bond interest expense recorded is less than the amount of the interest paid because of the amortization of the bond premium. Accrual accounting dictates that the premium be amortized over the life of the bond.

Like a discount, a bond premium must be amortized over the life of the bonds so that it can be matched to its effects on interest expense during that period. In the following sections, we calculate Carrot's total interest expense and amortize its bond premium using the straight-line and effective interest methods.

**Calculation of Total Interest Expense** When bondholders pay more than face value for the bonds, the premium represents an amount that they will not receive at maturity. The premium is in effect a reduction, in advance, of the total interest paid on the bonds over the life of the bond issue. The total interest expense over the issue's life needs to be determined.

**STUDY NOTE:** A bond premium is deducted from interest payments in calculating total interest expense because a bond premium represents an amount over the face value of a bond that the corporation never has to return to bondholders. In effect, it reduces the higher-than-market interest the corporation is paying on the bond.

### Interest Expense for a Bond Issued at a Premium

In our earlier example of bonds issued at a premium, Carrot issued \$200,000 of five-year bonds when the market interest rate was 6 percent and the face interest rate was 7 percent. The bonds sold for \$208,530, which resulted in an unamortized bond premium of \$8,530 (\$208,530 – \$200,000).

The total interest expense over the bond issue's life is computed as follows.

Cash to be paid to bondholders	
Face value at maturity	\$200,000
Interest payments ( $\$200,000 \times 0.07 \times 5$ years)	70,000
Total cash paid to bondholders	<u>\$270,000</u>
Less cash received from bondholders	208,530
Total interest expense	<u>\$ 61,470</u>

Alternatively, the total interest expense can be computed as follows:

Interest payments ( $\$200,000 \times 0.07 \times 5$ years)	\$ 70,000
Less bond premium	8,530
Total interest expense	<u>\$ 61,470</u>

Notice that the total interest payments of \$70,000 exceed the total interest expense of \$61,470 by \$8,530, the amount of the bond premium.

**Straight-Line Method** Under the straight-line method, the bond premium is spread evenly over the life of the bond issue.

### Amortizing a Bond Premium Using the Straight-Line Method

**Transaction** When bonds are issued at a premium, interest expense will be less than the interest rate on the bonds due to the amortization of the premium.

**Bond Premium Amortized and Interest Expense** As with bond discounts, the amount of the bond premium amortized and the interest expense for each semiannual period are computed in four steps.

**Step 1:** Determine the number of interest payments.

$$\begin{aligned} \text{Total Interest Payments} &= \text{Interest Payments per Year} \times \text{Life of Bonds} \\ &= 2 \times 5 = 10 \end{aligned}$$

**Step 2:** Determine the amount of bond premium amortization per period.

$$\begin{aligned} \text{Amortization of Bond Premium per Interest Period} &= \frac{\text{Bond Premium}}{\text{Total Interest Payments}} \\ &= \frac{\$8,530}{10} \\ &= \$853 \end{aligned}$$

**Step 3:** Determine the cash interest payment.

$$\begin{aligned} \text{Cash Interest Payment} &= \text{Face Value} \times \text{Face Interest Rate} \times \text{Time} \\ &= \$200,000 \times 0.07 \times 6/12 = \$7,000 \end{aligned}$$

**Step 4:** Determine the interest expense per period.

$$\begin{aligned} \text{Interest Expense per Interest Period} &= \text{Interest Payment} - \text{Amortization of Bond Premium} \\ &= \$7,000 - \$853 = \$6,147 \end{aligned}$$

**Analysis** The journal entry to record the bond premium amortized and interest expense

- ▲ *increases* the *Bond Interest Expense* account with a debit for the amount calculated in Step 4
- ▼ *decreases* the *Unamortized Bond Premium* account with a debit for the amount calculated in Step 2
- ▼▲ *decreases* the *Cash* account (or *increases* the *Interest Payable* account) with a credit for the amount in Step 3

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
Cash		Unamortized Bond Premium		Bond Interest Expense			
Dr.	Cr.	Dr.	Cr.	Dr.	Cr.		
July 1	7,000	July 1	853	July 1	6,147		

**Journal Entry**

	2014						
	July 1	Bond Interest Expense			Dr.	6,147	
		Unamortized Bond Premium			Cr.	853	
		Cash					Cr.
							7,000

Paid semiannual interest to bondholders and amortized the premium on 7%, 5-year bonds

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
-7,000		-853		-6,147

**STUDY NOTE:** The bond interest expense recorded exceeds the amount of interest paid because of the amortization of the bond discount. Accrual accounting dictates that the discount be amortized over the life of the bond.

**Comment** Note that the bond interest expense is \$6,147, but the amount that bondholders receive is the \$7,000 face interest payment. The difference of \$853 is the debit to Unamortized Bond Premium. This lowers the credit balance of the Unamortized Bond Premium account and the carrying value of the bonds payable by \$853 each interest period. If the bond issue remains unchanged, the same entry will be made on every semiannual interest date over the life of the bond issue. When the bond issue matures,

the balance in the Unamortized Bond Premium account will be zero, and the carrying value of the bonds payable will be \$200,000—exactly equal to the amount due the bondholders.

**Effective Interest Method** Under the straight-line method, the effective interest rate changes constantly, because it is determined by comparing the fixed interest expense with a carrying value that changes as a result of amortizing the discount or premium. To apply a fixed interest rate over the life of the bonds based on the actual market rate at the time of the bond issue, one must use the effective interest method. With this method, the interest expense decreases slightly each period (see Exhibit 5, column B) because the amount of the bond premium amortized increases slightly (column D). This occurs because a fixed rate is applied each period to the gradually decreasing carrying value (column A).

### Exhibit 5

#### Interest and Amortization Table of a Bond Premium: Effective Interest Method

	A	B	C	D	E	F
Semiannual Interest Period	Carrying Value at Beginning of Period	Semiannual Interest Expense at 6% to Be Recorded* (3% × A)	Semiannual Interest Payment to Bondholders (3½% × \$200,000)	Amortization of Bond Premium (C – B)	Unamortized Bond Premium at End of Period (E – D)	Carrying Value at End of Period (A – D)
0					\$8,530	\$208,530
1	\$208,530	\$6,256	\$7,000	\$744	7,786	207,786
2	207,786	6,234	7,000	766	7,020	207,020
3	207,020	6,211	7,000	789	6,231	206,231
4	206,231	6,187	7,000	813	5,418	205,418
5	205,418	6,163	7,000	837	4,581	204,581
6	204,581	6,137	7,000	863	3,718	203,718
7	203,718	6,112	7,000	888	2,830	202,830
8	202,830	6,085	7,000	915	1,915	201,915
9	201,915	6,057	7,000	943	972	200,972
10	200,972	6,028**	7,000	972	—	200,000

\* Rounded

\*\* Last period's interest expense equals \$6,028 (\$7,000 – \$972); it is actually equal to \$6,029 (\$200,972 × 0.03) but the difference is because of the cumulative effect of rounding.

© Cengage Learning 2014

### Amortizing a Bond Premium Using the Effective Interest Method

**Transaction** When bonds are issued at a premium, interest expense will be less than the interest rate on the bonds due to the amortization of the premium.

**Analysis** The journal entry to record the bond premium amortized and interest expense is exactly like the one when the straight-line method is used. However, the amounts debited and credited to the various accounts are different. The journal entry to record the bond premium amortized and interest expense using the effective interest method

- ▲ increases the *Bond Interest Expense* account with a debit for the amount calculated in column B
- ▼ decreases the *Unamortized Bond Premium* account with a debit for the amount calculated in column D
- ▼ ▲ decreases the *Cash* account (or increases the *Interest Payable* account) with a credit for the amount in column C

Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>			<b>Unamortized Bond Premium</b>			<b>Bond Interest Expense</b>	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	July 1 7,000		July 1 744			July 1 6,256	

Journal Entry

2014							
July 1	Bond Interest Expense				Dr.	Cr.	
	Unamortized Bond Premium				6,256		
	Cash						7,000
					744		
	Paid semiannual interest to bondholders and amortized the premium on 7%, 5-year bonds						

A = L + SE  
 -7,000 = -744 + -6,256

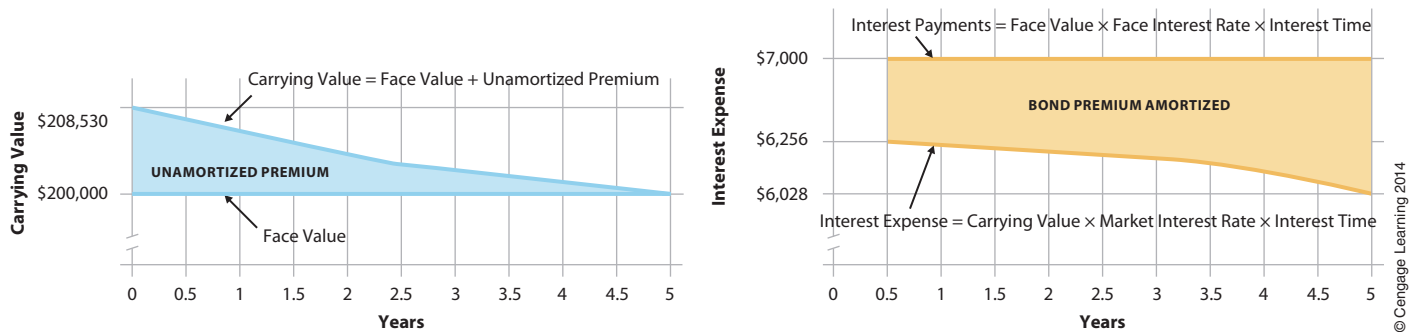
**Comment** Note that the unamortized bond premium (column E) decreases gradually to zero as the carrying value decreases to the face value (column F). To find the amount of premium amortized in any one interest payment period, subtract the effective interest expense (the carrying value times the effective interest rate, column B) from the interest payment (column C). In semiannual interest period 5, for example, the amortization of premium is \$837, which is calculated as follows.

$$\text{Interest Payment} - (\text{Carrying Value} \times \text{Interest Rate}) = \text{Amortized Premium}$$

$$\$7,000 - (\$205,418 \times 0.03) = \$837$$

Exhibit 6, which is based on the data in Exhibit 5, shows how the effective interest method affects the amortization of a bond premium. Note that the carrying value at the beginning of Period 1 (issue price) is initially greater than the face value, but that it gradually decreases toward the face value over the bond issue's life. Also, the interest payments exceed interest expense by the amount of the premium amortized. Interest expense decreases gradually over the life of the bond because it is based on the gradually decreasing carrying value (multiplied by the market interest rate).

**Exhibit 6**  
 Carrying Value and Interest Expense—Bonds Issued at a Premium





## APPLY IT!

On June 1, Scott Corporation issues \$4,000,000 of 8 percent, 20-year bonds at 97. Interest is payable semiannually, on May 31 and November 30. Scott's fiscal year ends on November 30.

- Using the straight-line method of amortization, prepare journal entries for June 1 and November 30.
- Using the effective interest method and assuming the same facts as above except that the market rate of interest is 9 percent, prepare the journal entry for November 30.

### SOLUTION

		<i>Dr.</i>	<i>Cr.</i>
1.			
June 1	Cash	3,880,000	
	Unamortized Bond Discount	120,000	
	Bonds Payable		4,000,000
	Issue of \$4,000,000 of 8%, 20-year bonds at 97 \$4,000,000 × 0.97 = \$3,880,000		
Nov. 30	Bond Interest Expense	163,000	
	Unamortized Bond Discount		3,000
	Cash		160,000
	Paid bondholders semiannual interest and amortized the discount on 8%, 20-year bonds \$120,000 ÷ 40 periods = \$3,000 \$4,000,000 × 0.04 = \$160,000		
2.			
Nov. 30	Bond Interest Expense	174,600	
	Unamortized Bond Discount		14,600
	Cash		160,000
	Paid bondholders semiannual interest and amortized the discount on 8%, 20-year bonds \$3,880,000 × 0.045 = \$174,600 \$4,000,000 × 0.04 = \$160,000		

**TRY IT! SE5, SE6, SE7, E6A, E7A, E8A, E9A, E12A, E16A, E6B, E7B, E8B, E9B, E12B, E16B**

## LO 6 Retirement and Conversion of Bonds

Two ways in which a company can reduce its bond debt are by:

- retiring the bonds or
- converting the bonds into common stock.

### Retirement of Bonds

Usually, companies repay bonds when they are due—on the maturity date. However, as noted when discussing callable and convertible bonds, retiring a bond issue before its maturity date can be to a company's advantage. For example, when interest rates drop, many companies refinance their bonds at the lower rate. Although companies usually pay a premium for early extinguishment of bond debt, what they save on interest can make the refinancing cost-effective. Bonds may be retired either by calling the bonds or by buying them back from the bondholders on the open market. In either case, the transaction analysis is the same.

#### Retirement of Bonds

**Transaction** Suppose Carrot Corporation can call, or retire, at 105 the \$200,000 of bonds it issued at a premium (104.265) on January 1, 2014, and that it decides to do so on July 1, 2017. The retirement thus takes place on the seventh interest payment date. Assume that the entry for the required interest payment and the amortization of the premium has been made.

**Analysis** The journal entry to record the retirement of the bonds

- ▼ *decreases* the *Bonds Payable* account with a debit for the face amount to remove the bonds from the balance sheet

- ▼ *decreases* the *Unamortized Bond Premium* account with a debit (or the *Unamortized Bond Discount* account with a credit) to remove the related premium (or discount) with a credit from the records
- ▼ *decreases* the *Cash* account for the amount required to call the bonds
- ▲ *increases* the *Loss on Retirement of Bonds* account with a debit (or *increases* the *Gain on Retirement of Bonds* account with a credit) for the net amount

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>			<b>Bond Payable</b>			<b>Loss on Retirement of Bonds</b>	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	July 1 210,000		July 1 200,000			July 1 7,170	
			<b>Unamortized Bond Premium</b>				
			Dr.	Cr.			
			July 1 2,830				

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
-210,000		-200,000		-7,170
		-2,830		

2017						Dr.	Cr.		
July 1	Bonds Payable					200,000			
	Unamortized Bond Premium					2,830			
	Loss on Retirement of Bonds					7,170			
	Cash							210,000	
	Retired 7% bonds at 105								

**Comment** In this entry, the cash paid is the face value times the call price ( $\$200,000 \times 1.05 = \$210,000$ ). The unamortized bond premium can be found in column E of Exhibit 5 on the seventh period line. The loss on retirement of bonds occurs because the call price of the bonds is greater than the carrying value ( $\$210,000 - \$202,830 = \$7,170$ ). Sometimes, a rise in the market interest rate can cause the market value of bonds to fall considerably below their face value. If it has the cash to do so, the company may find it advantageous to purchase the bonds on the open market and retire them. For example, if Carrot were able to purchase the above bonds on the open market at 85, a gain would be *recognized* for the difference between the purchase price of the bonds and the carrying value of the retired bonds.

## Conversion of Bonds

When a bondholder converts bonds to common stock, the company records the common stock at the carrying value of the bonds. The bond liability and the unamortized discount or premium are written off the books. For this reason, no gain or loss on the transaction is recorded.

### Conversion of Bonds to Common Stock

**Transaction** Suppose that Carrot Corporation does not call its bonds on July 1, 2017. Instead, the corporation’s bondholders decide to convert all their bonds to \$8 par value common stock under a convertible provision of 40 shares of common stock for each \$1,000 bond.

**Analysis** The journal entry to record the conversion of bonds to common stock

- ▼ *decreases* the *Bonds Payable* account with a debit for the face amount to remove the bonds from the balance sheet
- ▼ *decreases* the *Unamortized Bond Premium* account with a debit (or the *Unamortized Bond Discount* account with a credit) to remove the related premium (or discount) from the records

- ▲ increases the *Common Stock* account for the par value of the shares
- ▲ increases the *Additional Paid-in Capital* account for the amount required to balance the entry

### Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
			<b>Bonds Payable</b>			<b>Common Stock</b>	
			<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
			July 1	200,000		July 1	64,000
			<b>Unamortized Bond Premium</b>			<b>Additional Paid-in Capital</b>	
			<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>
			July 1	2,830		July 1	138,830

### Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
		-200,000		+64,000
		-2,830		+138,830

		<i>Dr.</i>	<i>Cr.</i>
2017			
July 1	Bonds Payable	200,000	
	Unamortized Bond Premium	2,830	
	Common Stock		64,000
	Additional Paid-in Capital		138,830
	Converted 7% bonds payable into \$8 par 138,828 value common stock at a rate of 40 shares for each \$1,000 bond		

**Comment** The unamortized bond premium is found in column E of Exhibit 5 on the seventh period line. At a rate of 40 shares for each \$1,000 bond, 8,000 shares will be issued, with a total par value of \$64,000 (8,000 × \$8). The Common Stock account is credited for the amount of the par value of the stock issued. In addition, Additional Paid-in Capital is credited for the difference between the carrying value of the bonds and the par value of the stock issued (\$202,830 – \$64,000 = \$138,830). No gain or loss is recorded.

## APPLY IT!

Assume that in the Carrot example of retirement in this section the company is able to buy the \$200,000 in bonds on the open market at 95 and retire them. The Unamortized Bond Premium remains at \$2,830. Prepare the journal entry to record the purchase and retirement on July 1, 2017.

### SOLUTION

2017			
July 1	Bonds Payable	200,000	
	Unamortized Bond Premium	2,830	
	Gain on Retirement of Bonds		12,830
	Cash		190,000
	Retired 7% bonds at 95		

**TRY IT! SE8, SE9, E10A, E11A, E13A, E10B, E11B, E13B**

## LO 7 Other Bonds Payable Issues

Among the other issues involved in accounting for bonds payable are the sale of bonds between interest payment dates and the year-end accrual of bond interest expense.

### Sale of Bonds Between Interest Dates

Although corporations may issue bonds on an interest payment date, as in the previous examples, they often issue them between interest payment dates. When that is the case,

they generally collect from the investors the interest that would have accrued for the partial period preceding the issue date. At the end of the first interest period, they pay the interest for the entire period. In other words, the interest collected when bonds are sold is returned to investors on the next interest payment date.

There are two reasons for following this procedure:

- From a practical standpoint, if a company issued bonds on several different days and did not collect the accrued interest, records would have to be maintained for each bondholder and date of purchase. The interest due each bondholder would, therefore, have to be computed for a different time period. Clearly, this procedure would involve large bookkeeping costs. On the other hand, if accrued interest is collected when the bonds are sold, the corporation can pay the interest due for the entire period on the interest payment date, thereby eliminating the extra computations and costs.
- When accrued interest is collected in advance, the amount is subtracted from the full interest paid on the interest payment date. Thus, the resulting interest expense represents the amount for the time the money was borrowed.

### Bonds Issued Between Interest Payment Dates

**Transaction** Suppose Carrot Corporation sold \$200,000 of 7 percent, five-year bonds for face value on May 1, 2014, rather than on January 1, 2014. Carrot pays interest on January 1 and July 1 of each year.

**Analysis** The journal entry to record bonds sold between interest dates

- ▲ increases the *Cash* account for the amount the bond issue plus the accrued interest
- ▼ decreases the *Bond Interest Expense* account for the amount of the accrued interest
- ▲ increases the *Bonds Payable* account for the amount of the bond issue

### Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
Cash			Bonds Payable			Bond Interest Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
May 1	204,667			May 1	200,000	May 1	4,667

**A** = **L** + **SE**

+204,667 = +200,000 + +4,667

**Journal Entry**

2014							
May 1	Cash				Dr.	Cr.	
		204,667					
	Bond Interest Expense					4,667	
	Bonds Payable						200,000
	Sold 7%, 5-year bonds at face value plus 4 months' accrued interest						
	$\$200,000 \times 0.07 \times 4/12 = \$4,667$						

**Comment** Cash is debited for the amount received, \$204,667 (the face value of \$200,000 plus four months' accrued interest of \$4,667). Bond Interest Expense is credited for the \$4,667 of accrued interest, and Bonds Payable is credited for the face value of \$200,000.

### Interest Payment for Bonds Issued Between Interest Payment Dates

**Transaction** On July 1, the first semiannual interest payment is made.

**Analysis** The journal entry to record the first semiannual interest payment

- ▲ increases the *Bond Interest Expense* account for the amount of interest paid
- ▼ decreases the *Cash* account for the amount of cash paid

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Cash</b>						<b>Bond Interest Expense</b>	
Dr.	Cr.				Dr.	Cr.	
	July 1	7,000			July 1	7,000	

**Journal Entry**

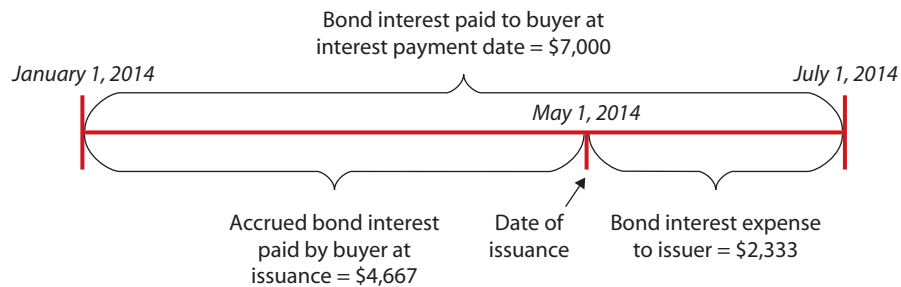
2014			Dr.	Cr.
July 1	Bond Interest Expense		7,000	
	Cash			7,000
	Paid semiannual interest $\$200,000 \times 0.07 \times 6/12 = \$7,000$			

**A** = **L** + **SE**  
-7,000 = -7,000

**Comment** Notice that the entire half-year interest is debited to Bond Interest Expense and credited to Cash because Carrot pays bond interest every six months, in full six-month amounts. Exhibit 7 illustrates this process. The actual interest expense for the two months that the bonds were outstanding is \$2,333. This amount is the net balance of the \$7,000 debit to Bond Interest Expense on July 1 less the \$4,667 credit to Bond Interest Expense on May 1. The following T account clearly shows these steps:

Bond Interest Expense			
	Dr.		Cr.
Bal.	0	May 1	4,667
July 1	7,000		
<b>Bal.</b>	<b>2,333</b>		

**Exhibit 7**  
Interest Expense When Bonds Are Issued Between Interest Dates



**Year-End Accrual of Bond Interest Expense**

**STUDY NOTE:** Accrual accounting dictates that both the accrued interest and the amortization of a premium or discount be recorded at year-end.

Bond interest payment dates rarely correspond with a company’s fiscal year. Therefore, an adjustment must be made to accrue the interest expense on the bonds from the last interest payment date to the end of the fiscal year. In addition, any discount or premium on the bonds must be amortized for the partial period.

**Year-End Accrual of Bond Interest Expense When Year-End Falls Between Bond Interest Dates**

**Transaction** In the example of bonds issued at a premium, Carrot Corporation issued \$200,000 of bonds on January 1, 2014, at 104.265 percent of face value. Suppose Carrot’s fiscal year ends on September 30, 2014. In the period since the interest payment and amortization of the premium on July 1, three months’ worth of interest has accrued.

**Analysis** Under the effective interest method, the adjusting entry

- ▲ increases the *Bond Interest Expense* account
- ▼ decreases the *Unamortized Bond Premium* account
- ▲ increases the *Bond Interest Payable* account

**Application of Double Entry**

Assets	=	Liabilities	+	Stockholders' Equity
		<b>Unamortized Bond Premium</b>		<b>Bond Interest Expense</b>
		Dr.   Cr.		Dr.   Cr.
		Sept. 30 383		Sept. 30 3,117
		<b>Bond Interest Payable</b>		
		Dr.   Cr.		
		Sept. 30 3,500		

**Journal Entry**

<b>A</b>	<b>=</b>	<b>L</b>	<b>+</b>	<b>SE</b>
		-383		-3,117
		+3,500		

		<b>Dr.</b>	<b>Cr.</b>
2014			
Sept. 30	Bond Interest Expense	3,117	
	Unamortized Bond Premium	383	
	Bond Interest Payable		3,500
	To record accrual of interest on 7% bonds payable for 3 months and amortization of one-half of the premium for the second interest payment period		

**Comment** This entry covers one-half of the second interest period. Unamortized Bond Premium is debited for \$383, which is one-half of \$766, the amortization of the premium for the second period from Exhibit 5. Bond Interest Payable is credited for \$3,500, which is three months' interest on the face value of the bonds ( $\$200,000 \times 0.07 \times 3/12$ ). Bond Interest Expense is debited for \$3,117 ( $\$3,500 - \$383$ ), which is the bond interest expense for the three-month period (or one-half of \$6,234).

**Payment of Interest When the Interest Payment Date Falls After Year-End Accrual**

**Transaction** On the interest payment date of January 1, 2015, Carrot Corporation makes the entry to pay the bondholders and amortize the premium.

**Analysis** The journal entry to pay the bondholders and amortize the premium

- ▲ increases the *Bond Interest Expense* account
- ▼ decreases the *Bond Interest Payable* account
- ▼ decreases the *Unamortized Bond Premium* account
- ▼ decreases the *Cash* account



## Application of Double Entry

Assets		=	Liabilities		+	Stockholders' Equity	
Cash			Bond Interest Payable			Bond Interest Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	Jan. 1 7,000		Jan. 1 3,500			Jan. 1 3,117	
			<b>Unamortized Bond Premium</b>				
			Dr.	Cr.			
			Jan. 1 383				

## Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
-7,000		-3,500		-3,117
		-383		

2015							
Jan. 1	Bond Interest Expense			Dr.	3,117	Cr.	
	Bond Interest Payable				3,500		
	Unamortized Bond Premium				383		
	Cash						7,000
	Paid semiannual interest, including interest previously accrued, and amortized the premium for the period since the end of the fiscal year						

**Comment** One-half (\$3,500) of the amount paid (\$7,000) was accrued on September 30. Unamortized Bond Premium is debited for \$383, the remaining amount to be amortized for the period (\$766 - \$383). The resulting bond interest expense is the amount that applies to the three-month period from October 1 to December 31.

Bond discounts are recorded at year-end in the same way as bond premiums. The difference is that the amortization of a bond discount increases interest expense instead of decreasing it.

## APPLY IT!

Flis Associates sold \$1,000,000 in bonds on April 1. The bonds carry a face interest rate of 8 percent, which is to be paid on January 1 and July 1. Prepare journal entries for (a) the issue of the bonds on April 1 at 100 and (b) the interest payment on July 1. (c) How much was the total interest expense for the first six months of the year?

### SOLUTION

(a) Apr. 1	Cash	1,020,000	
	Bonds Payable		1,000,000
	Bond Interest Expense		20,000
	Issuance of 8 percent bonds		
(b) July 1	Bond Interest Expense	40,000	
	Cash		40,000
	Interest payment		
(c) Total interest expense:		\$40,000 - \$20,000 = \$20,000	

**TRY IT! SE7, SE10, E12A, E14A, E15A, E16A, E12B, E14B, E15B, E16B**

## LO 8

# Long-Term Leases

A company can obtain an operating asset in the following ways:

- **By borrowing money and buying the asset:** When a company uses this method, it records the asset and liability at the amount paid, and the asset is subject to periodic depreciation.
- **By renting the asset on a short-term lease:** When a company uses this method, the risks of ownership of the asset remain with the lessor (the owner), and the lease

is shorter than the asset’s useful life. This type of agreement is called an **operating lease**. Payments on operating leases are properly treated as rent expense.

- **By obtaining the asset on a long-term lease:** This is one of the fastest-growing ways of financing plant assets in the United States today. A long-term lease on a plant asset has several advantages. It requires no immediate cash payment, the rental payment is deducted in full for tax purposes, and it costs less than a short-term lease. Acquiring the use of plant assets under long-term leases does create several accounting challenges, however.

**Capital Leases** Long-term leases may be carefully structured, as they are by companies like **CVS**, so that they can be accounted for as operating leases. However, accounting standards require that a long-term lease be treated as a capital lease when it meets *all* of the following conditions:

- It cannot be canceled.
- Its duration is about the same as the useful life of the asset.
- It stipulates that the lessee has the option to buy the asset at a nominal price at the end of the lease.

**STUDY NOTE:** A capital lease is, in substance, an installment purchase, and the leased asset and related liability must be recognized at their present value.

A capital lease is, thus, more like a purchase or sale on installment than a rental. The lessee in a capital lease should record an asset, depreciation on the asset, and a long-term liability equal to the present value of the total lease payments during the lease term.<sup>5</sup> Much like a mortgage payment, each lease payment consists partly of interest expense and partly of repayment of debt.

To illustrate capital leases, we will use Urban Manufacturing Company, which enters into a long-term lease for a machine. The lease terms call for an annual payment of \$8,000 for six years, which approximates the useful life of the machine. At the end of the lease period, the title to the machine passes to Urban. This lease is clearly a capital lease and should be recorded as an asset and a liability. Present value techniques can be used to place a value on the asset and on the corresponding liability in a capital lease. An example of a payment schedule for a capital lease is presented in Exhibit 8.

**Exhibit 8**  
Payment Schedule on an 8 Percent Capital Lease

Year	A Lease Payment	B Interest (8%) on Unpaid Obligation* (D × 8%)	C Reduction of Lease Obligation (A – B)	D Balance of Lease Obligation (D – C)
Beginning				\$36,984
1	\$ 8,000	\$ 2,959	\$ 5,041	31,943
2	8,000	2,555	5,445	26,498
3	8,000	2,120	5,880	20,618
4	8,000	1,649	6,351	14,267
5	8,000	1,141	6,859	7,408
6	8,000	592**	7,408	—
	<u>\$48,000</u>	<u>\$11,016</u>	<u>\$36,984</u>	

\* Rounded  
 \*\* The last year’s interest equals \$592 (\$8,000 – \$7,408). It does not exactly equal \$593 ( $\$7,408 \times \frac{8}{100} \times 1$ ) because of the cumulative effect of rounding.

© Cengage Learning 2014

**Capital Lease Recognition**

**Transaction** Urban’s interest cost on the unpaid part of its obligation is 8 percent. Using the factor for 8 percent and six periods in Table 2 in Appendix B, the present value of the lease payments can be computed as follows.

$$\begin{aligned} \text{Periodic Payment} \times \text{Factor} &= \text{Present Value} \\ \$8,000 \times 4.623 &= \$36,984 \end{aligned}$$

**Analysis** The journal entry to record the lease

- ▲ increases the *Capital Lease Equipment* account with a debit
- ▲ increases the *Capital Lease Obligations* account with a credit

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Capital Lease Equipment</b>			<b>Capital Lease Obligations</b>				
<i>Dr.</i>	<i>Cr.</i>		<i>Dr.</i>	<i>Cr.</i>			
36,984				36,984			

**Journal Entry**

	<i>Dr.</i>	<i>Cr.</i>
Capital Lease Equipment	36,984	
Capital Lease Obligations		36,984
To record capital lease on machinery		

$$\begin{matrix} \mathbf{A} & = & \mathbf{L} & + & \mathbf{SE} \\ +36,984 & & +36,984 & & \end{matrix}$$

**Comment** Capital Lease Equipment is *classified* as a long-term asset. Capital Lease Obligations is *classified* as a long-term liability.

**Depreciation Recorded**

**Transaction** Each year, Urban must record depreciation on the leased asset. Assume straight-line depreciation, a six-year life, and no residual value.

**Analysis** The journal entry to record depreciation

- ▲ increases the *Depreciation Expense—Capital Lease Equipment* account with a debit
- ▲ increases the contra-asset account *Accumulated Depreciation—Capital Lease Equipment* with a credit

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
<b>Accumulated Depreciation—Capital Lease Equipment</b>						<b>Depreciation Expense—Capital Lease Equipment</b>	
<i>Dr.</i>	<i>Cr.</i>					<i>Dr.</i>	<i>Cr.</i>
	6,164					6,164	

**Journal Entry**

	<i>Dr.</i>	<i>Cr.</i>
Depreciation Expense—Capital Lease Equipment	6,164	
Accumulated Depreciation—Capital Lease Equipment		6,164
To record depreciation expense on capital lease		

$$\begin{matrix} \mathbf{A} & = & \mathbf{L} & + & \mathbf{SE} \\ -6,164 & & & & -6,164 \end{matrix}$$

**Comment** The depreciation expense is computed by dividing the present value of the capital lease by the term of the lease ( $\$36,984 \div 6 = \$6,164$ ).

**Lease Payment**

**Transaction** Refer to the data in Exhibit 8. Urban makes the first payment on its capital lease.

**Analysis** The journal entry to record the first lease payment

- ▲ increases the *Interest Expense* account with a debit
- ▼ decreases the *Capital Lease Obligations* account with credit
- ▼ decreases the *Cash* account with a credit

**Application of Double Entry**

Assets		=	Liabilities		+	Stockholders' Equity	
Cash			Capital Lease Obligations			Interest Expense	
Dr.	Cr.		Dr.	Cr.		Dr.	Cr.
	8,000		5,041			2,959	

**Journal Entry**

	Dr.	Cr.
Interest Expense (column B)	2,959	
Capital Lease Obligations (column C)		5,041
Cash (column A)		8,000
Made payment on capital lease		

$$\begin{array}{rclclcl}
 \mathbf{A} & = & \mathbf{L} & + & \mathbf{SE} \\
 -8,000 & & -5,041 & & -2,959
 \end{array}$$

**Comment** The interest expense for each year is computed by multiplying the interest rate (8 percent) by the amount of the remaining lease obligation. Exhibit 8 shows these calculations. This example suggests why companies are motivated to engage in off-balance-sheet financing for leases. By structuring long-term leases so that they can be accounted for as operating leases, companies avoid recording them on the balance sheet as long-term assets and liabilities. This practice, which is legal, not only improves the debt to equity ratio by showing less debt on the balance sheet, but also improves the return on assets by reducing the total assets.



## International Perspective

### IFRS Recording Liabilities and Assets Will Not Look the Same Under IFRS

Under U.S. GAAP, most leases are accounted for as operating expenses. Current lease payments are generally recorded as operating expenses, and future lease obligations appear as described in the footnotes to the financial statements. Under International Financial Reporting Standards (IFRS), lease obligations are recorded at fair value as a liability, and the related debt is recorded as an asset. Fair value is usually measured at the discounted present value of the future lease payments. The result is that more assets and liabilities will appear to be greater under IFRS than under GAAP.

## Pension Liabilities

Most employees of medium-sized and large companies are covered by a **pension plan**, a contract that requires a company to pay benefits to its employees after they retire. Some companies pay the full cost of the pension plan; but in many companies, employees share the cost by contributing part of their salaries or wages. The contributions from employer and employees are usually paid into a **pension fund**, which is invested on behalf of the employees. Pension benefits typically consist of monthly payments to retired employees and other payments upon disability or death.

Employers whose pension plans do not have sufficient assets to cover the present value of their pension obligations must record the amount of the shortfall as a liability. If a pension plan has sufficient assets to cover its obligations, no balance sheet reporting is required or permitted.

There are two kinds of pension plans:

- **Defined contribution plan:** The employer makes a fixed annual contribution, usually a percentage of the employee's gross pay. The amount of the contribution is specified in an agreement between the company and the employees. Retirement payments vary depending on how much the employee's retirement account earns. Employees usually control their own investment accounts, can make additional contributions of their own, and can transfer the funds if they leave the company. Examples of defined contribution plans include 401(k) plans, profit-sharing plans, and employee stock ownership plans (ESOPs). Companies prefer defined contribution plans because the employees assume the risk that their pension assets will earn a sufficient return to meet their retirement needs.
- **Defined benefit plan:** The employer contributes an amount annually to fund estimated future pension liability. The exact amount of the liability will not be known until the retirement or death of the current employees. Although the amount of future benefits is fixed, the annual contributions vary depending on assumptions about how much the pension fund will earn.

Annual pension expense under a defined contribution plan is simple and predictable. Pension expense equals the fixed amount of the annual contribution. In contrast, annual expense under a defined benefit plan is one of the most complex topics in accounting. The intricacies are reserved for advanced courses, but in concept, the procedure is simple. Computation of the annual expense takes into account the estimation of such factors as the average remaining service life of active employees, the long-run return on pension plan assets, and future salary increases. An accounting standard requires companies and other entities with defined benefit plans not backed by a fund sufficient to pay them to record the unfunded portion as a liability.<sup>6</sup> For many companies this can amount to millions or even billions of dollars.

Because pension expense under a defined benefit plan is not predictable and can vary from year to year, many companies are adopting the more predictable defined contribution plans.

## Long-Term Liabilities and the Financial Statements

As presented in Exhibit 9, long-term liabilities arise from a variety of financing and obligations. Long-term liabilities are amounts to be paid more than one year after the balance sheet date.

**Exhibit 9**  
Long-Term Liabilities on  
the Balance Sheet

<b>Balance Sheet</b>	
December 31, 2014	
<b>Assets</b>	<b>Liabilities</b>
Current assets	Current liabilities
Investments	Long-term liabilities:
Property, plant, and equipment	Bonds payable
Intangible assets	Notes payable
	Mortgage payable
	Capital lease obligation
	Pension and post-retirement liabilities
	Deferred income taxes
	Total long-term liabilities
	Total liabilities
	<b>Stockholders' Equity</b>
	Contributed capital
	Retained earnings
	Total stockholders' equity
<b>Total Assets = Total Liabilities + Stockholders' Equity</b>	

© Cengage Learning 2014

**APPLY IT!**

Eureka Corporation has leased a machine that has a useful life of 10 years. The terms of the lease are payments of \$60,000 per year for 10 years. Eureka currently is able to borrow money at a long-term interest rate of 12 percent. Calculate (a) the present value of the lease and (b) prepare the journal entry to record the lease agreement.

**SOLUTION**

(a) Present value of the lease is equal to periodic payment × factor (Table 2 in Appendix B: 12%, 10 periods)

$$\$60,000 \times 5.650 = \$339,000$$

(b) The journal entry to record the lease is:

Capital Lease Machine	339,000	
Capital Lease Obligations		339,000
To record the lease contract		

**TRY IT! SE11, E17A, E17B**



## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Evaluate a company's level of debt
- Debt to equity ratio
- Interest coverage ratio

## RELEVANT LEARNING OBJECTIVE

- LO 9** Evaluate the decision to issue long-term debt, including analyzing long-term debt.

## LO 9 Management Issues Related to Long-Term Debt Financing

A key decision for management is whether to rely solely on stockholders' equity for long-term funds or to rely partially on long-term debt. Some companies, such as **Microsoft** and **Apple**, do not issue long-term debt; but like **CVS** and **Southwest Airlines**, most companies find it useful to do so. To make a decision, it is important to know the advantages and disadvantages of issuing long-term debt and to analyze the risks of the issue of the company's finances. Further, it is also important to understand the long-term effects of more complex obligations such as leases and pensions.

### Evaluating the Decision to Issue Long-Term Debt

Because long-term debt must be paid at maturity and usually requires periodic payments of interest, issuing common stock has two advantages over issuing long-term debt:

- **Permanent financing:** Common stock does not have to be paid back.
- **Dividend payment optional:** Dividends on common stock are normally paid only if the company earns sufficient income.

Issuing long-term debt, however, has the following advantages over issuing common stock:

- **Stockholder control:** When a corporation issues long-term debt, common stockholders do not relinquish any of their control over the company because bondholders and other creditors do not have voting rights. In contrast, when a corporation issues additional shares of common stock, the votes of the new stockholders may force current stockholders and management to give up some control.
- **Tax advantage:** The interest on debt is tax-deductible, whereas dividends on common stock are not. For example, if a corporation pays \$100,000 in interest and its income tax rate is 30 percent, its net cost will be \$70,000 because it will save \$30,000 on income taxes. To pay \$100,000 in dividends on common stock, the corporation would have to earn \$142,857 before income taxes [ $\$100,000 \div (1 - 0.30)$ ].
- **Financial leverage:** If a corporation earns more from the funds it raises by incurring long-term debt than it pays in interest on the debt, the excess will increase its earnings for the stockholders. This concept is called **financial leverage** (or *trading on equity*). For example, if a company earns 10 percent on a \$1,000,000 investment financed by long-term 8 percent notes, it will earn \$20,000 before income taxes ( $\$100,000 - \$80,000$ ). The debt to equity ratio, which we will discuss later in this chapter, is considered an overall measure of a company's financial leverage.

Despite these advantages, debt financing is not always in a company's best interest. It may entail the following:

- **Financial risk:** A high level of debt exposes a company to financial risk. A company whose plans for earnings do not pan out, whose operations are subject to the ups and downs of the economy, or whose cash flow is weak may be unable to pay the principal amount of its debt at the maturity date or even to make periodic interest payments. Creditors can then force the company into bankruptcy. **TWA**, **Continental Airlines**, and **United Airlines** filed for bankruptcy protection because they could not make payments on their long-term debt and other liabilities. (While in bankruptcy, they restructured their debt and interest payments: TWA sold off its assets; Continental and United subsequently came out of bankruptcy. The latter two airlines have since merged.)



## Business Perspective

### How Does Debt Affect a Company's Ability to Borrow?

Credit ratings by agencies like **Standard & Poor's (S&P)** reflect the fact that the greater a company's debt, the greater its financial risk. S&P rates companies from AAA (best) to CCC (worst) based on various factors, including a company's debt to equity ratio, as shown below.

Rating	AAA	AA	A	BBB	BB	B	CCC
Debt to Equity Ratio*	4.5	34.1	42.9	47.9	59.8	76.0	75.7

\*Averages of companies with similar ratings. Ratings also take into effect other factors, such as the companies' profitability, interest coverage, and stability.

These ratings affect not only how much a company can borrow but also what the interest will cost. The lower its rating, the more a company must pay in interest, and vice versa.

For a company in a heavily debt-laden industry such as the auto industry, a change in credit rating can mean millions of dollars. For instance, when S&P lowered **General Motors'** credit ratings to "junk status" (i.e., BB), it meant that GM had to pay 1 or more percentage points in additional interest. On GM's \$291 billion debt, this amounted to about \$2–\$3 billion.<sup>7</sup> S&P proved to be correct in its downgrade, as GM subsequently went bankrupt and had to be bailed out by the federal government.

© Aljia / iStockphoto.com

- Negative financial leverage:** Financial leverage can work against a company if the earnings from its investments do not exceed its interest payments. For example, many small retail companies failed in recent years because they relied too heavily on debt financing before developing sufficient resources to ensure their survival.

## Evaluating Long-Term Debt

Financial leverage is advantageous as long as a company is able to make timely interest payments and repay the debt at maturity. Because failure to do so

can force a company into bankruptcy, a company must assess the financial risk involved. Financial risk is measured by the debt to equity ratio and the interest coverage ratio.

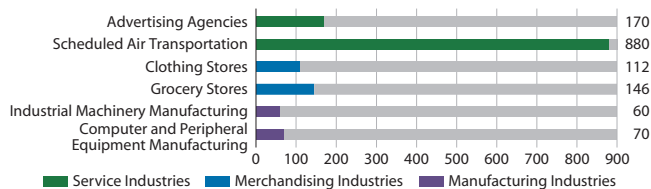
**Debt to Equity Ratio** To assess how much debt to carry, managers compute the **debt to equity ratio**, which shows the amount of debt a company carries in relation to its stockholders' equity. The higher this ratio, the greater the company's financial risk. Using data from Swan Manufacturing Company presented in the chapter opener, we can compute its debt to equity ratio in 2014 as follows (in thousands).

### RATIO

#### Debt to Equity Ratio: How Much Debt Does a Company Have in Relation to Its Stockholders' Equity?

$$\begin{aligned} \text{Debt to Equity Ratio} &= \frac{\text{Total Liabilities}}{\text{Total Stockholders' Equity}} \\ &= \frac{\$1,000,000}{\$3,200,000} = 0.31 \text{ Times (or 31\%)*} \end{aligned}$$

\* Rounded



Based on Bizmin Industry Financial Report, December 2011.

As illustrated, a debt to equity ratio of 0.31 times (or 31%) is relatively low, but it does not tell the whole story. As noted in the chapter opener, Swan also has long-term leases on various properties, which require annual payments of \$100,000. Swan structures these leases in such a way that they do not appear as liabilities on the balance sheet. This practice is called **off-balance-sheet financing** and, as used by Swan, is entirely legal. The leases are, however, long-term commitments of cash payments and so have the effect of long-term liabilities.

## Interest Coverage Ratio

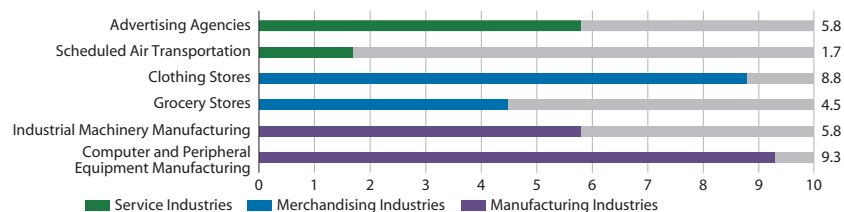
The **interest coverage ratio** measures the degree of protection a company has from default on interest payments. The lower this ratio, the greater the financial risk.

Most analysts want to see an interest coverage ratio of at least 3 or 4 times. Lower interest coverage would mean the company is at risk from a downturn in the economy. Swan's 2014 income statement shows that the company had income before income taxes of \$250,000 and interest expense of \$50,000. Using these figures, we can compute Swan's interest coverage ratio as follows.

### RATIO

#### Interest Coverage Ratio: How Many Times Does the Company's Income Exceed Its Interest Expense?

$$\begin{aligned} \text{Interest Coverage Ratio} &= \frac{\text{Income Before Income Taxes} + \text{Interest Expense}}{\text{Interest Expense}} \\ &= \frac{\$250,000 + \$50,000}{\$50,000} \\ &= \frac{\$300,000}{\$50,000} \\ &= 6.0 \text{ Times} \end{aligned}$$



Based on Bizmin Industry Financial Report, December 2011.

In comparison, Swan's strong interest coverage ratio of 6.0 times shows that it is in no danger of being unable to make interest payments. However, in computing this ratio, management will add the company's off-balance-sheet rent expense of \$100,000 to its interest expense. This procedure decreases the interest coverage ratio to about 2.7 times. Although still adequate to cover interest payments, the adjusted coverage ratio is far less robust, which demonstrates the significant effect that off-balance-sheet financing for leases can have on a company's financial situation.

## CASH FLOW

## Cash Flow Information

The best source of information concerning cash flows about short-term and long-term debt is the financing activities section of the statement of cash flows. For instance, **McDonald's** cash flows are clearly revealed in this excerpt from its 2011 statement of cash flows (in millions):<sup>8</sup>

Financing Activities	2011	2010	2009
Net short-term borrowings	\$ 260.6	\$ 3.1	\$ (285.4)
Long-term financing issuances	1,367.3	1,931.8	1,169.3
Long-term financing repayments	(624.0)	(1,147.5)	(664.6)

Note that McDonald's has little short-term borrowing and that the company's cash inflows for long-term borrowing for the three years exceeded cash outflows for long-term borrowing by \$2,032.3 million.

### APPLY IT!

Compute the interest coverage ratios for 2013 and 2014 from Travis Corporation's partial income statements that follow.

	2014	2013
Income from operations	\$27,500	\$34,000
Interest expense	5,000	4,000
Income before income taxes	\$22,500	\$30,000
Income taxes	8,250	10,200
Net income	\$14,250	\$19,800

### SOLUTION

2013

$$\frac{\$30,000 + \$4,000}{\$4,000} = \frac{\$34,000}{\$4,000} = 8.5 \text{ Times}$$

2014

$$\frac{\$22,500 + \$5,000}{\$5,000} = \frac{\$27,500}{\$5,000} = 5.5 \text{ Times}$$

**TRY IT! SE12, E18A, E18B**

## TriLevel Problem



Janine Lamontagne/jml5571/stockphoto.com

### Swan Manufacturing Company

The beginning of this chapter focused on Swan Manufacturing Company, whose management was considering how to finance the expansion of its metal window division. Ultimately, however, it decided to raise capital by issuing long-term bonds. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*How do the concepts of recognition, valuation, classification, and disclosure apply to long-term liabilities?*

#### Section 2: Accounting Applications

*How are long-term bonds accounted for in Swan's records?*

Swan's bond indenture stated that the company would issue \$2,500,000 of 8 percent, five-year bonds on January 1, 2015, and would pay interest semiannually on June 30 and December 31 in each of the five years. It also stated that the bonds would be callable at 104 and that each \$1,000 bond would be convertible to 30 shares of \$10 par value common stock.

Swan sold the bonds on January 1, 2015, at 96 because the market rate of interest for similar investments was 9 percent. It decided to amortize the bond discount by using the effective interest method. On July 1, 2017, management called and retired half the bonds, and investors converted the other half to common stock.

1. Prepare an interest and amortization schedule for the first five interest periods.
2. Prepare journal entries to record the sale of the bonds, the first two interest payments, the bond retirement, and the bond conversion.

**RATIO**
**Section 3: Business Applications**

*What should Swan consider in deciding to issue long-term debt?*

Using the figures presented for Swan in the chapter opener and recalling that the company had income before income taxes of \$250,000 and interest expense of \$50,000, compute its debt to equity ratio and interest coverage ratio in the first year of the bond issue. What is your assessment of Swan's level of debt?

**SOLUTION**
**Section 1: Concepts**

Generally accepted accounting principles require that long-term liabilities be *recognized* and recorded when an obligation occurs even though the obligation may not be due for many years. On the balance sheet, long-term liabilities are generally *valued* at the amount of money needed to pay the debt or at the fair market value of the goods or services to be delivered. A liability is *classified* as a long-term liability when it is due beyond one year or beyond the normal operating cycle. Because of the complex nature of many long-term liabilities, extensive *disclosures* in the notes to the financial statements are often required.

**Section 2: Accounting Applications**

- 1.

	A	B	C	D	E	F	G
1	<b>Interest and Amortization of Bond Discount</b>						
2	<b>Semiannual Interest Payment Date</b>	<b>Carrying Value at Beginning of Period</b>	<b>Semiannual Interest Expense* (9% × 1/2)</b>	<b>Semiannual Interest Paid (8% × 1/2)</b>	<b>Amortization of Discount</b>	<b>Unamortized Bond Discount at End of Period</b>	<b>Carrying Value at End of Period</b>
3	Jan. 1, 2015					\$100,000	\$2,400,000
4	June 30, 2015	\$2,400,000	\$108,000	\$100,000	\$8,000	92,000	2,408,000
5	Dec. 31, 2015	2,408,000	108,360	100,000	8,360	83,640	2,416,360
6	June 30, 2016	2,416,360	108,736	100,000	8,736	74,904	2,425,096
7	Dec. 31, 2016	2,425,096	109,129	100,000	9,129	65,775	2,434,225
8	June 30, 2017	2,434,225	109,540	100,000	9,540	56,235	2,443,765
9							

\*Rounded





$$\begin{aligned}
 \text{Interest Coverage} &= \frac{\text{Income Before Income Taxes} + \text{Interest Expense} + \text{Bond Interest Expense}}{\text{Interest Expense} + \text{Bond Interest Expense}} \\
 &= \frac{\$250,000 + \$50,000 + \$216,360}{\$50,000 + \$216,360} \\
 &= \frac{\$516,360}{\$266,360} \\
 &= 1.94 \text{ Times}^*
 \end{aligned}$$

\* Rounded

The increased debt will represent more risk, especially since Swan has long-term lease obligations.

## Chapter Review

**Explain the concepts underlying long-term liabilities, and identify the types of long-term liabilities.**

Lo 1

Long-term debt is used to finance assets and business activities, such as research and development, that will produce income in future years. The management issues related to long-term debt are whether to take on long-term debt, how much debt to carry, and what types of debt to incur. Common types of long-term debt are bonds, notes, mortgages, long-term leases, pension liabilities, other post-retirement benefits, and deferred income taxes.

**Describe the features of a bond issue and the major characteristics of bonds.**

Lo 2

A bond is a security that represents money borrowed from the investing public. When a corporation issues bonds, it enters into a contract, called a bond indenture, with the bondholders. The bond indenture defines the terms of the bond issue. A bond issue is the total value of bonds issued at one time. The prices of bonds are stated in terms of a percentage of the face value, or principal, of the bonds. The face interest rate is the fixed rate of interest paid to bondholders based on the face value. The market interest rate is the rate of interest paid in the market on bonds of similar risk. If the market rate fluctuates from the face interest rate before the bond issue date, the bonds will sell at either a discount or a premium.

A corporation can issue several types of bonds, each having different characteristics. For example, a bond issue may or may not require security (secured versus unsecured bonds). It may be payable at a single time (term bonds) or at several times (serial bonds). And the holder may receive interest automatically (registered bonds) or may have to return coupons to receive interest payable (coupon bonds). Bonds may also be callable and convertible.

**Record bonds issued at face value and at a discount or premium.**

Lo 3

Bondholders pay face value for bonds when the interest rate on the bonds approximates the market rate for similar investments. The issuing corporation records the bond issue at face value as a long-term liability in the Bonds Payable account. Bonds are issued at a discount when their face interest rate is lower than the market rate for similar investments. The difference between the face value and the issue price is debited to Unamortized Bond Discount. Bonds are issued at a premium when their face interest rate is greater than the market interest rate on similar investments. The difference between the issue price and the face value is credited to Unamortized Bond Premium.

**Use present values to determine the value of bonds.**

Lo 4

The value of a bond is determined by summing the present values of (1) the series of fixed interest payments of the bond issue and (2) the single payment of the face value at maturity. Tables 1 and 2 in the appendix on present value tables should be used in making these computations.

**Amortize bond discounts and bond premiums using the straight-line and effective interest methods.** **LO 5**

The straight-line method allocates a fixed portion of a bond discount or premium each interest period to adjust the interest payment to interest expense. The effective interest method, which is used when the effects of amortization are material, applies a constant rate of interest to the carrying value of the bonds. To find interest and the amortization of discounts or premiums, the effective interest rate is applied to the carrying value of the bonds (face value minus the discount or plus the premium) at the beginning of the interest period. The amount of the discount or premium to be amortized is the difference between the interest figured by using the effective rate and that obtained by using the face rate. The results of using the effective interest method on bonds issued at a discount or a premium are summarized below and compared with issuance at face value:

	Bonds Issued at		
	Face Value	Discount	Premium
Trend in carrying value over bond term	Constant	Increasing	Decreasing
Trend in interest expense over bond term	Constant	Increasing	Decreasing
Interest expense versus interest payments	Interest expense = interest payments	Interest expense > interest payments	Interest expense < interest payments
Classification of bond discount or premium	Not applicable	Contra-liability (deducted from Bonds Payable)	Adjunct-liability (added to Bonds Payable)

**Account for the retirement of bonds and the conversion of bonds into stock.** **LO 6**

Callable bonds can be retired before maturity at the option of the issuing corporation. The call price is usually an amount greater than the face value of the bonds, in which case the corporation recognizes a loss on the retirement of the bonds. Sometimes, a rise in the market interest rate causes the market value of the bonds to fall below face value. If a company purchases its bonds on the open market at a price below carrying value, it recognizes a gain on the transaction.

Convertible bonds allow the bondholder to convert bonds to the issuing corporation's common stock. When bondholders exercise this option, the common stock issued is recorded at the carrying value of the bonds being converted. No gain or loss is recognized.

**Record bonds issued between interest dates, and record year-end adjustments.** **LO 7**

When bonds are sold between the interest payment dates, the issuing corporation collects from investors the interest that has accrued since the last interest payment date. When the next interest payment date arrives, the corporation pays the bondholders interest for the entire interest period.

When the end of a corporation's fiscal year does not fall on an interest payment date, the corporation must accrue bond interest expense from the last interest payment date to the end of its fiscal year. This accrual results in the inclusion of the interest expense in the year it is incurred.

**Explain and demonstrate the accounting issues related to leases and pensions.** **LO 8**

An operating lease is a contract under which a company rents an asset. Payments on operating leases are properly treated as rent expense. On the other hand, a capital lease is a lease that cannot be canceled, has duration about the same as the useful life of the asset, or stipulates that the lessee has the option to buy the asset at a nominal price at the end of the lease. A capital lease is like a purchase or sale on installment. The lessee in a capital lease records an asset, depreciation on the asset, and a long-term liability equal to the present value of the total lease payments during the lease term.

A pension plan is a contract that requires a company to pay benefits to its employees after they retire. The two types of pension plans are defined contribution plans and defined benefit plans.

Evaluate the decision to issue long-term debt, including analyzing long-term debt. **LO 9**

Management needs to decide between issuing long-term debt and issuing common stock or a combination of these two options. The advantages of issuing long-term debt are that common stockholders do not relinquish any control, interest on debt is tax-deductible, and financial leverage can increase earnings. The disadvantages are that interest and principal must be paid on time and financial leverage can work against a company if an investment is not successful. The level of debt can be evaluated using the debt to equity ratio and the interest coverage ratio.

## Key Terms and Ratios

**bond** 549 (LO2)  
**bond certificate** 549 (LO2)  
**bond indenture** 549 (LO2)  
**bond issue** 549 (LO2)  
**bonds payable** 546 (LO1)  
**call price** 550 (LO2)  
**callable bonds** 550 (LO2)  
**capital lease** 548 (LO1)  
**convertible bonds** 550 (LO2)  
**coupon bonds** 551 (LO2)  
**deferred income taxes** 548 (LO1)  
**defined benefit plan** 576 (LO8)  
**defined contribution plan** 576 (LO8)  
**discount** 550 (LO2)

**early extinguishment of debt** 550 (LO2)  
**effective interest method** 559 (LO5)  
**face interest rate** 549 (LO2)  
**face value** 549 (LO2)  
**financial leverage** 578 (LO9)  
**long-term liabilities** 546 (LO1)  
**market interest rate** 549 (LO2)  
**mortgage** 547 (LO1)  
**notes payable** 547 (LO1)  
**off-balance-sheet financing** 580 (LO9)  
**operating lease** 573 (LO8)  
**pension fund** 576 (LO8)

**pension plan** 576 (LO8)  
**premium** 550 (LO2)  
**registered bonds** 551 (LO2)  
**secured bonds** 550 (LO2)  
**serial bonds** 550 (LO2)  
**straight-line method** 558 (LO5)  
**term bonds** 550 (LO2)  
**unsecured bonds** 550 (LO2)  
**zero coupon bonds** 558 (LO5)

### RATIOS

**debt to equity ratio** 579 (LO9)  
**interest coverage ratio** 580 (LO9)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 2, 9** **RATIO** **DQ1. BUSINESS APPLICATION** ► If a company with a high debt to equity ratio wants to increase its debt when the economy is weak, what kind of bond might it issue?
- LO 3** **DQ2.** What determines whether bonds are issued at a discount, premium, or face value?
- LO 4** **DQ3.** Why does the market price of a bond vary over time?
- LO 5** **DQ4.** When is it acceptable to use the straight-line method to amortize a bond discount or premium?
- LO 6** **DQ5.** Why are callable and convertible bonds considered to add to management's future flexibility in financing a business?
- LO 7** **DQ6. CONCEPT** ► Why must the accrual of bond interest be recorded at the end of an accounting period?
- LO 9** **DQ7. BUSINESS APPLICATION** ► How does a lender assess the risk that a borrower may default—that is, not pay interest and principal when due?
- LO 8** **DQ8. BUSINESS APPLICATION** ► Why might a company lease a long-term asset rather than buy it and issue long-term bonds?

## SHORT EXERCISES

### LO 1 Types of Long-Term Liabilities

**SE1.** Match the liabilities that follow with the statement to which it applies.

- |                                   |  |
|-----------------------------------|--|
| 1. Bonds payable                  | a. May result in a capital lease                                       |
| 2. Long-term notes payable        | b. Differences in income taxes on accounting income and taxable income |
| 3. Mortgage payable               | c. The most popular form of long-term financing                        |
| 4. Long-term lease                | d. Often used to purchase land and buildings                           |
| 5. Pension liabilities            | e. Often used interchangeably with bonds payable                       |
| 6. Other post-retirement benefits | f. Future health care costs are a major component                      |
| 7. Deferred income taxes          | g. May include 401(k), ESOPs, or profit-sharing                        |

### LO 1 Mortgage Payable

**SE2.** Hagler Corporation purchased a building by signing a \$150,000 long-term mortgage with monthly payments of \$1,200. The mortgage carries an interest rate of 8 percent per year. Prepare a monthly payment schedule showing the monthly payment, the interest for the month, the reduction in debt, and the unpaid balance for the first three months. (Round to the nearest dollar.)

### LO 2 Bond Characteristics

**SE3.** Match each term that follows with the related term.

- |                       |                         |
|-----------------------|-------------------------|
| 1. Discount           | a. Convertible          |
| 2. Callable           | b. Secured              |
| 3. Face interest rate | c. Coupon               |
| 4. Unsecured          | d. Market interest rate |
| 5. Registered         | e. Serial               |
| 6. Term               | f. Premium              |

### LO 4 Valuing Bonds Using Present Value

**SE4.** Sanchez, Inc., is considering the sale of two bond issues. Choice A is a \$1,200,000 bond issue that pays semiannual interest of \$64,000 and is due in 20 years. Choice B is a \$1,200,000 bond issue that pays semiannual interest of \$60,000 and is due in 15 years. Assume that the market interest rate for each bond is 12 percent. Calculate the amount that Sanchez will receive if both bond issues occur. (*Hint:* Calculate the present value of each bond issue and sum.)

### LO 3, 5 Straight-Line Method

**SE5.** On April 1, 2014, Angel Corporation issued \$8,000,000 in 8.5 percent, five-year bonds at 98. The semiannual interest payment dates are April 1 and October 1. Prepare journal entries to record the issue of the bonds by Angel on April 1, 2014, and the first two interest payments on October 1, 2014, and April 1, 2015. Use the straight-line method and ignore year-end accruals.

### LO 3, 5 Effective Interest Method

**SE6.** On March 1, 2014, Smart Way Freight Company sold \$200,000 of its 9.5 percent, 20-year bonds at 106. The semiannual interest payment dates are March 1 and September 1. The market interest rate is 8.9 percent. The firm's fiscal year ends August 31. Prepare journal entries to record the sale of the bonds on March 1, the accrual of interest and amortization of premium on August 31, and the first interest payment on September 1. Use the effective interest method to amortize the premium.

### LO 3, 5, 7 Year-End Accrual of Bond Interest

**SE7.** On October 1, 2014, Tender Corporation issued \$250,000 of 9 percent bonds at 96. The bonds are dated October 1 and pay interest semiannually. The market rate of

(Continued)

interest is 10 percent, and the company's year-end is December 31. Prepare the journal entries to record the issuance of the bonds, the accrual of the interest on December 31, 2014, and the payment of the first semiannual interest on April 1, 2015. Assume the company uses the effective interest method to amortize the bond discount.

**LO 6 Bond Retirement**

**SE8.** Noble Corporation has outstanding \$400,000 of 8 percent bonds callable at 104. On December 1, immediately after the payment of the semiannual interest and the amortization of the bond discount were recorded, the unamortized bond discount equaled \$10,500. On that date, \$240,000 of the bonds were called and retired. Prepare the journal entry to record the retirement of the bonds on December 1.

**LO 6 Bond Conversion**

**SE9.** Evergreen Corporation has \$2,000,000 of 6 percent bonds outstanding. There is \$40,000 of unamortized discount remaining on the bonds after the March 1, 2014, semiannual interest payment. The bonds are convertible at the rate of 20 shares of \$10 par value common stock for each \$1,000 bond. On March 1, 2014, bondholders presented \$1,200,000 of the bonds for conversion. Prepare the journal entry to record the conversion of the bonds.

**LO 7 Bond Issue Between Interest Dates**

**SE10.** Dawn Corporation sold \$400,000 of 9 percent, 10-year bonds for face value on September 1, 2014. The issue date of the bonds was May 1, 2014. The company's fiscal year ends on December 31, and this is its only bond issue. Prepare the journal entry to record the sale of the bonds on September 1 and the first semiannual interest payment on November 1, 2014. What is the bond interest expense for the year ended December 31, 2014?

**LO 8 Leases and Pensions Definitions**

**SE11.** Match each term that follows with the appropriate definition.

- |                              |   |
|------------------------------|---|
| 1. Defined benefit plan      | a. A contract that requires a company to pay benefits to its employees after they retire.   |
| 2. Capital lease             | b. A short-term lease used for renting assets where ownership of the asset remain with the lessor, and the lease is shorter than the asset's useful life.   |
| 3. Pension plan              | c. A plan in which the employer makes a fixed specified annual contribution, usually a percentage of the employee's gross pay.  |
| 4. Operating lease           | d. A long-term lease that cannot be canceled, has duration about the same as the useful life of the asset, and stipulates that the lessee has the option to buy the asset at a nominal price at the end of the lease. |
| 5. Defined contribution plan | e. A plan in which the employer contributes an amount annually to fund estimated future pension liability.  |

**LO 9 Bond Versus Common Stock Financing**

**SE12. BUSINESS APPLICATION** ► Indicate whether each of the following is an advantage or a disadvantage of using long-term bond financing rather than issuing common stock:

- Interest paid on bonds is tax-deductible.
- Investments are sometimes not as successful as planned.
- Financial leverage can have a negative effect when investments do not earn as much as the interest payments on the related debt.
- Bondholders do not have voting rights in a corporation.
- Positive financial leverage may be achieved.

## EXERCISES: SET A

### LO 1 Mortgage Payable

**E1A.** Pittman Corporation purchased a building by signing a \$75,000 long-term mortgage with monthly payments of \$1,000. The mortgage carries an interest rate of 12 percent.

1. Prepare a monthly payment schedule showing the monthly payment, the interest for the month, the reduction in debt, and the unpaid balance for the first three months. (Round to the nearest dollar.)
2. Prepare the journal entries to record the purchase and the first two monthly payments.

### LO 2 Bond Issue Features and Bond Characteristics

**E2A.** Match each term that follows with the appropriate definition.

- |                         |   |
|-------------------------|---|
| 1. Face interest rate   | a. A contract that defines the rights, privileges, and limitations of the bondholders.  |
| 2. Bond indenture       | b. Bonds that allow the bondholder to exchange a bond for a specified number of shares of common stock.   |
| 3. Secured bonds        | c. The fixed rate of interest paid to bondholders based on the face value of the bonds.   |
| 4. Bond issue           | d. Bonds that give the issuer the right to buy back and retire the bonds before maturity at a specified price, which is usually above face value. |
| 5. Coupon bonds         | e. The rate of interest paid in the market on bonds of similar risk.  |
| 6. Callable bonds       | f. The total value of bonds issued at one time.   |
| 7. Market interest rate | g. Bonds issued in the names of the bondholders.  |
| 8. Convertible bonds    | h. Bonds that carry a pledge of certain corporate assets as a guarantee of repayment.   |
| 9. Registered bonds     | i. Bonds not registered with the organization but bearing coupons stating the amount of interest due and the payment date.                        |

### LO 4 Valuing Bonds Using Present Value

**E3A.** Tsang, Inc., is considering the sale of two bond issues. Choice A is a \$1,600,000 bond issue that pays semiannual interest of \$128,000 and is due in 20 years. Choice B is a \$1,600,000 bond issue that pays semiannual interest of \$120,000 and is due in 15 years. Assume that the market interest rate for each bond is 12 percent. Calculate the amount that Tsang will receive if both bond issues are made. (*Hint:* Calculate the present value of each bond issue and sum.)

### LO 4 Valuing Bonds Using Present Value

**E4A.** Use the present value tables in Appendix B to calculate the issue price of a \$600,000 bond issue in each of the following independent cases. Assume interest is paid semiannually.

- a. A 10-year, 8 percent bond issue; the market interest rate is 10 percent.
- b. A 10-year, 8 percent bond issue; the market interest rate is 6 percent.
- c. A 10-year, 10 percent bond issue; the market interest rate is 8 percent.
- d. A 20-year, 10 percent bond issue; the market interest rate is 12 percent.
- e. A 20-year, 10 percent bond issue; the market interest rate is 6 percent.

### LO 4 Zero Coupon Bonds

**E5A.** The state of Idaho needs to raise \$50,000,000 for highway repairs. Officials are considering issuing zero coupon bonds, which do not require periodic interest payments. The current market interest rate for the bonds is 10 percent. What face value of

(Continued)



bonds must be issued to raise the needed funds, assuming the bonds will be due in 30 years and compounded annually? How would your answer change if the bonds were due in 50 years? How would both answers change if the market interest rate were 8 percent instead of 10 percent?

**LO 3, 5** **Straight-Line Method**

**E6A.** Norris Corporation issued \$2,000,000 in 10.5 percent, 10-year bonds on February 1, 2014, at 104. Semiannual interest payment dates are January 31 and July 31. Use the straight-line method and ignore year-end accruals.

1. With regard to the bond issue on February 1, 2014:
  - a. How much cash is received?
  - b. How much is Bonds Payable?
  - c. What is the difference between **a** and **b** called and how much is it?
2. With regard to the bond interest payment on July 31, 2014:
  - a. How much cash is paid in interest?
  - b. How much is the amortization?
  - c. How much is interest expense?
3. With regard to the bond interest payment on January 31, 2015:
  - a. How much cash is paid in interest?
  - b. How much is the amortization?
  - c. How much is interest expense?

**LO 3, 5** **Straight-Line Method**

**E7A.** Waterbury Corporation issued \$16,000,000 in 8.5 percent, five-year bonds on March 1, 2014, at 96. The semiannual interest payment dates are September 1 and March 1. Prepare the journal entries to record the issue of the bonds by Waterbury on March 1, 2014, and the first two interest payments on September 1, 2014, and March 1, 2015. Use the straight-line method and ignore year-end accruals.

**LO 3, 5** **Effective Interest Method**

**E8A.** Linz Company sold \$250,000 of 9.5 percent, 20-year bonds on April 1, 2014, at 106. The semiannual interest payment dates are March 31 and September 30. The market interest rate is 8.9 percent. The company's fiscal year ends September 30. Use the effective interest method to calculate the amortization. (Round to the nearest cent.)

1. With regard to the bond issue on April 1, 2014:
  - a. How much cash is received?
  - b. How much is Bonds Payable?
  - c. What is the difference between **a** and **b** called and how much is it?
2. With regard to the bond interest payment on September 30, 2014:
  - a. How much cash is paid in interest?
  - b. How much is the amortization?
  - c. How much is interest expense?
3. With regard to the bond interest payment on March 31, 2015:
  - a. How much cash is paid in interest?
  - b. How much is the amortization?
  - c. How much is interest expense?

**LO 3, 5** **Effective Interest Method**

**E9A.** On March 1, 2014, Minnow Corporation issued \$600,000 of 10 percent, five-year bonds. The semiannual interest payment dates are February 28 and August 31. Because the market rate for similar investments was 11 percent, the bonds had to be issued at a discount. The discount on the issuance of the bonds was \$24,335. The

company's fiscal year ends February 28. Prepare the journal entries to record the bond issue on March 1, 2014, the payment of interest, and the amortization of the discount on August 31, 2014 and on February 28, 2015. Use the effective interest method. (Round to the nearest dollar.)

**LO 6 Bond Retirement**

**E10A.** Freed Corporation has outstanding \$800,000 of 8 percent bonds callable at 104. On September 1, immediately after recording the payment of the semiannual interest and the amortization of the discount, the unamortized bond discount equaled \$21,000. On that date, \$480,000 of the bonds was called and retired.

1. How much cash must be paid to retire the bonds?
2. Is there a gain or loss on retirement, and if so, how much is it?

**LO 6 Bond Conversion**

**E11A.** Marisol Corporation has \$800,000 of 6 percent bonds outstanding. There is \$40,000 of unamortized discount remaining on these bonds after the July 1, 2014, semiannual interest payment. The bonds are convertible at the rate of 40 shares of \$5 par value common stock for each \$1,000 bond. On July 1, 2014, bondholders presented \$600,000 of the bonds for conversion.

1. Is there a gain or loss on conversion, and if so, how much is it?
2. How many shares of common stock are issued in exchange for the bonds?
3. In dollar amounts, how does this transaction affect the total liabilities and the total stockholders' equity of the company? In your answer, show the effects on four accounts.

**LO 5,7 Effective Interest Method and Interest Accrual**

**E12A.** The long-term debt section of Karidis Corporation's balance sheet at the end of its fiscal year, December 31, 2013, follows.

Long-term liabilities		
Bonds payable—8%, interest payable		
1/1 and 7/1, due 12/31/16	\$500,000	
Less unamortized bond discount	<u>40,000</u>	\$460,000

Using the effective interest method, prepare the journal entries relevant to the interest payments on July 1, 2014, December 31, 2014, and January 1, 2015. Assume a market interest rate of 10 percent.

**LO 4,6 Time Value of Money and Early Extinguishment of Debt**

**E13A.** Flanders, Inc., has a \$700,000, 8 percent bond issue that was issued a number of years ago at face value. There are now 10 years left on the bond issue, and the market interest rate is 16 percent. Interest is paid semiannually. The company purchases the bonds on the open market at the calculated current market value and retires the bonds.

1. Using present value tables, calculate the current market value of the bond issue.
2. Is there a gain or loss on retirement of the bonds, and if so, how much is it?

**LO 3,7 Bond Issue on and Between Interest Dates**

**E14A.** O'Brien, Inc., is authorized to issue \$3,600,000 in bonds on June 1. The bonds carry a face interest rate of 9 percent, which is to be paid on June 1 and December 1. Prepare journal entries to record the issue of the bonds by O'Brien under the assumptions that (a) the bonds are issued on September 1 at 100 and (b) the bonds are issued on June 1 at 105.

**LO 7 Bond Issue Between Interest Dates**

**E15A.** Fleetwood Corporation sold \$800,000 of 12 percent, 10-year bonds at face value on September 1, 2014. The issue date of the bonds was May 1, 2014.

1. Prepare the journal entries to record the sale of the bonds on September 1 and the first semiannual interest payment on November 1, 2014.
2. The company's fiscal year ends on December 31, and this is its only bond issue. What is the bond interest expense for the year ended December 31, 2014?

**LO 3, 5, 7 Year-End Accrual of Bond Interest**

**E16A.** Rapid Tech Corporation issued \$2,000,000 of 9 percent bonds on October 1, 2014, at 96. The bonds are dated October 1 and pay interest semiannually. The market interest rate is 10 percent, and Rapid Tech's fiscal year ends on December 31. Prepare the journal entries to record the issuance of the bonds, the accrual of the interest on December 31, 2014, and the first semiannual interest payment on April 1, 2015. Assume the company uses the effective interest method to amortize the bond discount.

**LO 8 Recording Lease Obligations**

**E17A. BUSINESS APPLICATION** ▶ Rigby Corporation has leased a piece of equipment that has a useful life of 12 years. This capital lease requires payments of \$86,000 per year for 12 years. Rigby currently is able to borrow money at a long-term interest rate of 15 percent. (Round to the nearest dollar.)

1. Calculate the present value of the lease.
2. Prepare the journal entry to record the lease agreement.
3. Prepare the journal entry to record depreciation of the equipment for the first year using the straight-line method.
4. Prepare the journal entries to record the lease payments for the first two years.

**LO 9 Interest Coverage Ratio**

**E18A. BUSINESS APPLICATION** ▶ Compute the interest coverage ratios for 2013 and 2014 from Dasbol Corporation's partial income statements that follow. (Round to one decimal place.) State whether the ratio improved or worsened over time.

	2014	2013
Income from operations	\$47,780	\$36,920
Interest expense	<u>11,600</u>	<u>6,600</u>
Income before income taxes	<u>\$36,180</u>	<u>\$30,320</u>
Income taxes	10,800	9,000
Net income	<u>\$25,380</u>	<u>\$21,320</u>

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS****LO 1, 2 Bond Terminology**

**P1.** Some common terms associated with bonds follow.

- |                     |                      |                            |
|---------------------|----------------------|----------------------------|
| a. Bond certificate | g. Term bonds        | m. Face interest rate      |
| b. Bond issue       | h. Serial bonds      | n. Market interest rate    |
| c. Bond indenture   | i. Registered bonds  | o. Effective interest rate |
| d. Unsecured bonds  | j. Coupon bonds      | p. Bond premium            |
| e. Debenture bonds  | k. Callable bonds    | q. Bond discount           |
| f. Secured bonds    | l. Convertible bonds |                            |

**REQUIRED**

1. For each of the statements that follow, identify the category above with which it is associated. (If two statements apply, choose the category with which it is most closely associated.)
  1. Occurs when bonds are sold at more than face value
  2. Rate of interest that will vary depending on economic conditions
  3. Bonds that may be exchanged for common stock
  4. Bonds that are not registered
  5. A bond issue in which all bonds are due on the same date
  6. Occurs when bonds are sold at less than face value
  7. Rate of interest that will be paid regardless of market conditions
  8. Bonds that may be retired at management's option
  9. A document that is evidence of a company's debt
  10. Same as market rate of interest
  11. Bonds for which the company knows who owns them
  12. A bond issue for which bonds are due at different dates
  13. The total value of bonds issued at one time
  14. Bonds whose payment involves a pledge of certain assets
  15. Same as debenture bonds
  16. Contains the terms of the bond issue
  17. Bonds issued on the general credit of the company
2. **ACCOUNTING CONNECTION** ► What effect will a decrease in interest rates below the face interest rate and before a bond is issued have on the cash received from the bond issue? What effect will the decrease have on interest expense? What effect will the decrease have on the amount of cash paid for interest?

LO 3, 5, 6, 9

SPREADSHEET

- ✓ 1d(3): Interest expense: \$374,400
- ✓ 2d(3): Interest expense: \$385,600

**Bond Basics—Straight-Line Method, Retirement, and Conversion**

**P2.** Sasina Corporation has \$8,000,000 of 9.5 percent, 25-year bonds dated May 1, 2014, with interest payable on April 30 and October 31. The company's fiscal year ends on December 31, and it uses the straight-line method to amortize bond premiums or discounts. The bonds are callable after 10 years at 103, or each \$1,000 bond is convertible into 40 shares of \$10 par value common stock.

**REQUIRED**

1. Assume the bonds are issued at 103.5 on May 1, 2014.
  - a. How much cash is received?
  - b. How much is Bonds Payable?
  - c. What is the difference between **a** and **b** called, and how much is it?
  - d. With regard to the bond interest payment on October 31, 2014:
    - (1) How much cash is paid in interest?
    - (2) How much is the amortization?
    - (3) How much is interest expense?
2. Assume the bonds are issued at 96.5 on May 1, 2014.
  - a. How much cash is received?
  - b. How much is Bonds Payable?
  - c. What is the difference between **a** and **b** called, and how much is it?
  - d. With regard to the bond interest payment on October 31, 2014:
    - (1) How much cash is paid in interest?
    - (2) How much is the amortization?
    - (3) How much is interest expense?
3. Assume the issue price in requirement **1** and that the bonds are called and retired 10 years later.
  - a. How much cash will have to be paid to retire the bonds?
  - b. Is there a gain or loss on the retirement, and if so, how much is it?

*(Continued)*

4. Assume the issue price in requirement 2 and that the bonds are converted to common stock 10 years later.
  - a. Is there a gain or loss on conversion, and if so, how much is it?
  - b. How many shares of common stock are issued in exchange for the bonds?
  - c. In dollar amounts, how does this transaction affect the total liabilities and the total stockholders' equity of the company? In your answer, show the effects on four accounts.
5. **BUSINESS APPLICATION** ▶ Assume that after 10 years market interest rates have dropped significantly and that the price of the company's common stock has risen significantly. Also assume that management wants to improve its credit rating by reducing its debt to equity ratio and that it needs what cash it currently has for expansion. Would management prefer the approach and result in requirement 3 or 4? Explain your answer. What would be a disadvantage of the approach you chose?

LO 3, 5

**GENERAL LEDGER**

- ✓ 1: Bond Interest Expense, May 31: \$439,184
- ✓ 2: Bond Interest Expense, May 31: \$457,350

**Bond Transactions—Effective Interest Method**

**P3.** Zapala Corporation has \$10,000,000 of 9 percent, 20-year bonds dated June 1, 2014, with interest payment dates of May 31 and November 30. The company's fiscal year ends November 30. It uses the effective interest method to amortize bond premiums or discounts.

**REQUIRED**

1. Assume the bonds are issued at 109.9 on June 1 to yield an effective interest rate of 8 percent. Prepare the journal entries for June 1, 2014, November 30, 2014, and May 31, 2015. (Round to the nearest dollar.)
2. Assume the bonds are issued at 91.4 on June 1 to yield an effective interest rate of 10 percent. Prepare the journal entries for June 1, 2014, November 30, 2014, and May 31, 2015. (Round to the nearest dollar.)
3. **ACCOUNTING CONNECTION** ▶ Explain the role that market interest rates play in causing a premium in requirement 1 and a discount in requirement 2.

LO 3, 5, 7

**SPREADSHEET**

- ✓ 2a: Total interest expense in 2014: \$474,200
- ✓ 2b: Total cash paid for interest in 2014: \$380,000

**Bonds Issued at a Discount and a Premium—Effective Interest Method**

**P4.** Yacuma Corporation issued bonds twice during 2014. The transactions follow.

- 2014
- Jan. 1 Issued \$2,000,000 of 9.2 percent, 10-year bonds dated January 1, 2014, with interest payable on June 30 and December 31. The bonds were sold at 98.1, resulting in an effective interest rate of 9.5 percent.
- Apr. 1 Issued \$4,000,000 of 9.8 percent, 10-year bonds dated April 1, 2014, with interest payable on March 31 and September 30. The bonds were sold at 101, resulting in an effective interest rate of 9.5 percent.
- June 30 Paid semiannual interest on the January 1 issue and amortized the discount, using the effective interest method.
- Sept. 30 Paid semiannual interest on the April 1 issue and amortized the premium, using the effective interest method.
- Dec. 31 Paid semiannual interest on the January 1 issue and amortized the discount, using the effective interest method.
- 31 Made an end-of-year adjusting entry to accrue interest on the April 1 issue and to amortize half the premium applicable to the second interest period.
- 2015
- Mar. 31 Paid semiannual interest on the April 1 issue and amortized the premium applicable to the second half of the second interest period.

**REQUIRED**

1. Prepare the journal entries to record the bond transactions. (Round to the nearest dollar.)

2. **ACCOUNTING CONNECTION** ► Describe the effect of the above transactions on profitability and liquidity by answering the following questions:
  - a. What is the total interest expense in 2014 for each of the bond issues?
  - b. What is the total cash paid in 2014 for each of the bond issues?
  - c. What differences, if any, do you observe, and how do you explain them?

LO 8

**Lease Versus Purchase**

SPREADSHEET

- ✓ 1a: Present value of lease: \$171,864
- ✓ 2a: Unpaid balance at the end of third month: \$157,582

**P5.** Wooster Corporation can either lease or buy a small garage next to its business that will provide parking for its customers. The company can lease the building for a period of 12 years, which approximates the useful life of the facility and thus qualifies as a capital lease. The terms of the lease are payments of \$24,000 per year for 12 years. Wooster currently is able to borrow money at a long-term interest rate of 9 percent. The company can purchase the building by signing an \$160,000 long-term mortgage with monthly payments of \$2,000. The mortgage also carries an interest rate of 9 percent.

**REQUIRED**

1. With regard to the lease option:
  - a. Calculate the present value of the lease. (Round to the nearest dollar.)
  - b. Prepare the journal entry to record the lease agreement.
  - c. Prepare the journal entry to record depreciation of the building for the first year using the straight-line method.
  - d. Prepare the journal entries to record the lease payments for the first two years.
2. With regard to the purchase option:
  - a. Prepare a monthly payment schedule showing the monthly payment, the interest for the month, the reduction in debt, and the unpaid balance for the first three months. (Round to the nearest dollar.)
  - b. Prepare the journal entries to record the purchase and the first two monthly payments.
3. **BUSINESS APPLICATION** ► Based on your calculations, which option seems to be best? Aside from cost, name an advantage and a disadvantage of each option.

**ALTERNATE PROBLEMS**

LO 3, 5, 6, 9

**Bond Basics—Straight-Line Method, Retirement, and Conversion**

- ✓ 1d(3): Interest expense: \$517,500
- ✓ 2d(3): Interest expense: \$532,500

**P6.** Cozumel Corporation has \$10,000,000 of 10.5 percent, 20-year bonds dated June 1, 2014, with interest payment dates of May 31 and November 30. After 10 years, the bonds are callable at 104, and each \$1,000 bond is convertible into 25 shares of \$20 par value common stock. The company's fiscal year ends on December 31. It uses the straight-line method to amortize bond premiums or discounts.

**REQUIRED**

1. Assume the bonds are issued at 103 on June 1, 2014.
  - a. How much cash is received?
  - b. How much is Bonds Payable?
  - c. What is the difference between **a** and **b** called, and how much is it?
  - d. With regard to the bond interest payment on November 30, 2014:
    - (1) How much cash is paid in interest?
    - (2) How much is the amortization?
    - (3) How much is interest expense?
2. Assume the bonds are issued at 97 on June 1, 2014.
  - a. How much cash is received?
  - b. How much is Bonds Payable?

*(Continued)*



- c. What is the difference between **a** and **b** called, and how much is it?
- d. With regard to the bond interest payment on November 30, 2014:
  - (1) How much cash is paid in interest?
  - (2) How much is the amortization?
  - (3) How much is interest expense?
3. Assume the issue price in requirement **1** and that the bonds are called and retired 10 years later.
  - a. How much cash will have to be paid to retire the bonds?
  - b. Is there a gain or loss on the retirement, and if so, how much is it?
4. Assume the issue price in requirement **2** and that the bonds are converted to common stock 10 years later.
  - a. Is there a gain or loss on the conversion, and if so, how much is it?
  - b. How many shares of common stock are issued in exchange for the bonds?
  - c. In dollar amounts, how does this transaction affect the total liabilities and the total stockholders' equity of the company? In your answer, show the effects on four accounts.
5. **BUSINESS APPLICATION** ► Assume that after 10 years, market interest rates have dropped significantly and that the price on the company's common stock has risen significantly. Also assume that management wants to improve its credit rating by reducing its debt to equity ratio and that it needs what cash it has for expansion. Which approach would management prefer—the approach and result in requirement **3** or **4**? Explain your answer. What would be a disadvantage of the approach you chose?

LO 3, 5

## GENERAL LEDGER

- ✓ 1: Bond Interest Expense, Feb. 28:  
\$377,071
- ✓ 2: Bond Interest Expense, Feb. 28:  
\$382,308

**Bond Transactions—Effective Interest Method**

**P7.** Krabna Corporation has \$8,000,000 of 9.5 percent, 25-year bonds dated March 1, 2014, with interest payable on February 28 and August 31. The company's fiscal year end is February 28. It uses the effective interest method to amortize bond premiums or discounts. (Round to the nearest dollar.)

**REQUIRED**

1. Assume the bonds are issued at 102.5 on March 1, 2014, to yield an effective interest rate of 9.2 percent. Prepare the journal entries for March 1, 2014, August 31, 2014, and February 28, 2015.
2. Assume the bonds are issued at 97.5 on March 1, 2014, to yield an effective interest rate of 9.8 percent. Prepare the journal entries for March 1, 2014, August 31, 2014, and February 28, 2015.
3. **ACCOUNTING CONNECTION** ► Explain the role that market interest rates play in causing a premium in requirement **1** and a discount in requirement **2**.

LO 3, 5, 7

## SPREADSHEET

- ✓ 2a: Total interest expense in 2014:  
\$889,352
- ✓ 2b: Total cash paid for interest in  
2014: \$778,000

**Bonds Issued at a Discount and a Premium—Effective Interest Method**

**P8.** Hart Corporation issued bonds twice during 2014. A summary of the transactions involving the bonds follows.

2014

- |       |    |   |
|-------|----|---|
| Jan.  | 1  | Issued \$6,000,000 of 9.9 percent, 10-year bonds dated January 1, 2014, with interest payable on June 30 and December 31. The bonds were sold at 102.6, resulting in an effective interest rate of 9.4 percent. |
| Mar.  | 1  | Issued \$4,000,000 of 9.2 percent, 10-year bonds dated March 1, 2014, with interest payable March 1 and September 1. The bonds were sold at 98.2, resulting in an effective interest rate of 9.5 percent.       |
| June  | 30 | Paid semiannual interest on the January 1 issue and amortized the premium, using the effective interest method.   |
| Sept. | 1  | Paid semiannual interest on the March 1 issue and amortized the discount, using the effective interest method.  |

- Dec. 31 Paid semiannual interest on the January 1 issue and amortized the premium, using the effective interest method.
- 31 Made an end-of-year adjusting entry to accrue interest on the March 1 issue and to amortize two-thirds of the discount applicable to the second interest period.
- 2015
- Mar. 1 Paid semiannual interest on the March 1 issue and amortized the remainder of the discount applicable to the second interest period.

**REQUIRED**

1. Prepare journal entries to record the bond transactions. (Round to the nearest dollar.)
2. **ACCOUNTING CONNECTION** ► Describe the effect on profitability and liquidity by answering the following questions:
  - a. What is the total interest expense in 2014 for each of the bond issues?
  - b. What is the total cash paid in 2014 for each of the bond issues?
  - c. What differences, if any, do you observe and how do you explain them?

**LO 8**

- ✓ 1a: Present value of lease: \$343,728
- ✓ 2a: Unpaid balance at the end of third month: \$315,164

**Lease Versus Purchase**

**P9.** Martha Corporation can either lease or buy a small garage next to its business that will provide parking for its customers. The company can lease the building for a period of 12 years, which approximates the useful life of the facility and thus qualifies as a capital lease. The terms of the lease are payments of \$48,000 per year for 12 years. Martha currently is able to borrow money at a long-term interest rate of 9 percent. The company can purchase the building by signing a \$320,000 long-term mortgage with monthly payments of \$4,000. The mortgage also carries an interest rate of 9 percent.

**REQUIRED**

1. With regard to the lease option:
  - a. Calculate the present value of the lease. (Round to the nearest dollar.)
  - b. Prepare the journal entry to record the lease agreement.
  - c. Prepare the journal entry to record depreciation of the building for the first year using the straight-line method.
  - d. Prepare the journal entries to record the lease payments for the first two years.
2. With regard to the purchase option:
  - a. Prepare a monthly payment schedule showing the monthly payment, the interest for the month, the reduction in debt, and the unpaid balance for the first three months. (Round to the nearest dollar.)
  - b. Prepare the journal entries to record the purchase and the first two monthly payments.
3. **BUSINESS APPLICATION** ► Based on your calculations, which option seems to be best? Aside from cost, name an advantage and a disadvantage of each option.

**CASES****LO 1, 2, 6****Conceptual Understanding: Bond Issue**

**C1. Eastman Kodak**, the more than 100-year-old photography company, recently declared bankruptcy after struggling for many years. One of its efforts to survive was a \$1 billion bond issue several years ago. Even though the company's credit rating was low at the time, the bond issue was well received by the investment community because the company offered attractive terms. The offering comprised \$500 million of 10-year unsecured notes and \$500 million of 30-year convertible bonds. The convertibles were callable after seven years and would be convertible into common stock about 40 to 45 percent higher than the current price.<sup>9</sup>

*(Continued)*

What are unsecured notes? Why would they carry a relatively high interest rate? What are convertible securities? Why are they good for the investor and for the company? Why would they carry a relatively low interest rate? What does *callable* mean? What advantage does this feature give the company?

**LO 2, 3 Conceptual Understanding: Bond Interest Rates and Market Prices**

**C2. Dow Chemical** is one of the largest chemical companies in the world. Among its long-term liabilities was a bond due in 2011 that carried a face interest rate of 6.125 percent.<sup>10</sup> This bond sold on the New York Stock Exchange at 104 5/8. Did this bond sell at a discount or a premium? Assuming the bond was originally issued at face value, did interest rates rise or decline after the date of issue? Would you have expected the market rate of interest on this bond to be more or less than 6.125 percent? Did the current market price affect either the amount that the company paid in semiannual interest or the amount of interest expense for the same period? Explain your answers.

**LO 6, 9 Conceptual Understanding: Characteristics of Convertible Debt**

**C3. Intel Corporation** designs and manufactures advanced integrated digital technology platforms. The company has never earned a profit. In 2009, Intel issued \$2,000,000,000 of junior subordinated convertible notes at 3.25 percent due in 2039 at face value. The notes are convertible into common stock at a price of \$22.45 per share, which at the time of issue was above the market price. The market value of Intel's common stock ranged from \$19.16 to \$25.66 in 2011.<sup>11</sup> What reasons can you suggest for Intel's management choosing notes that are convertible into common stock rather than simply issuing nonconvertible notes or issuing common stock directly? Are there any disadvantages to this approach? If the price of the company's common stock goes to \$17 per share, what would be the total theoretical value of the notes? If the holders of the notes were to elect to convert the notes into common stock, what would be the effect on the company's debt to equity ratio, and what would be the effect on the percentage ownership of the company by other stockholders?

**LO 8, 9 Conceptual Understanding: Effect of Long-Term Leases**

**C4. BUSINESS APPLICATION** ► Many companies use long-term leases to finance long-term assets. Although these leases are similar to mortgage payments, they are structured in such a way that they qualify as operating leases. As a result, the lease commitments do not appear on the companies' balance sheets.

In a recent year, **Continental Airlines** had almost \$15 billion in total operating lease commitments, of which \$1.5 billion was due in the current year. Further, the airline had total assets of \$12.686 billion and total liabilities of \$12.581 billion. Because of heavy losses in previous years, its stockholders' equity was only \$0.105 billion.

What effect do these types of leases have on the balance sheet? Why would the use of these long-term leases make a company's debt to equity ratio, interest coverage ratio, and free cash flow look better than they really are? What is a capital lease? How does the application of capital lease accounting provide insight into a company's financial health?

**LO 1, 8 Interpreting Financial Reports: Long-Term Debt, Leases, and Pensions**

**C5. BUSINESS APPLICATION** ► To answer the following questions, refer to the financial statements and the notes to the financial statements in **CVS Corporation's** annual report in the Supplement to Chapter 16:

1. Is it the practice of CVS to own or lease most of its buildings?
2. Does CVS lease property predominantly under capital leases or under operating leases? How much was rental expense for operating leases in 2011?
3. Does CVS have a defined benefit pension plan? Does it offer post-retirement benefits?

LO 1, 9

**Interpreting Financial Reports: Use of Debt Financing**

RATIO

**C6. BUSINESS APPLICATION** ▶ Refer to the annual report of **CVS Corporation** and the financial statements of **Southwest Airlines Co.** in the Supplement to Chapter 16. Calculate the debt to equity ratio and the interest coverage ratio for both companies' two most recent years. (Round to one decimal place.) Find the note to the financial statements that contains information on leases and lease commitments by CVS. Southwest's lease expenses were \$847 million and \$631 million in 2011 and 2010, respectively, and total lease commitments for future years were \$5,583 million. What effect do the total lease commitments and lease expense have on your assessment of the ratios you calculated? Evaluate and comment on the relative performance of the two companies with regard to debt financing. Which company has more risk of not being able to meet its interest obligations? How does leasing affect the analysis? Explain.

**Continuing Case: Annual Report Project**

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the balance sheet and accompanying notes of your company. Answer the following questions:

1. What percentage of total liabilities and stockholders' equity is long-term liabilities? Does the company have long-term notes or bonds and deferred income taxes? How do these liabilities differ from each other?
2. Find the disclosures about these leases in the notes to the financial statements. What are the total lease obligations of the company?
3. Find the disclosures about pensions in the notes to the financial statements. What kind of pension plan does the company have? Does it offer post-retirement benefits?



# CHAPTER 15

## The Statement of Cash Flows

### BUSINESS INSIGHT

#### Deliga Corporation

Deliga Corporation is a distributor of accessories for cell phones, iPods, iPhones, and other small electronic devices. Deliga's managers have just finished preparing the company's financial statements for 2015. Although they are satisfied with net sales for the year—\$825,000—they are concerned because cash flows from operating activities are less than net income (\$58,300 vs. \$82,200) and because cash and cash equivalents decreased by \$8,000 during the year. The company has recently been having difficulty paying its bills on time.

Strong cash flows are critical to achieving and maintaining liquidity. If cash flows exceed the amount a company needs for operations and expansion, it will not have to borrow additional funds. It can use excess cash to reduce debt, thereby lowering its debt to equity ratio and improving its financial position. That, in turn, can increase the market value of its stock.

Deliga's statement of cash flows provides the company's managers, as well as its stockholders and potential investors, with information that is essential to evaluating the strength of the company's cash flows and liquidity.

- 1. CONCEPT** ► *How do relevance and classification apply to the statement of cash flows?*
- 2. ACCOUNTING APPLICATION** ► *How is the statement of cash flows prepared using the indirect method?*
- 3. BUSINESS APPLICATION** ► *What measures may be used to explain the apparent cause of Deliga's operating cash flow problem and the decline in its cash and cash equivalents?*

### LEARNING OBJECTIVES

- LO 1** Describe the principal purposes and concepts underlying the statement of cash flows, and identify its components and format.
- LO 2** Use the indirect method to determine cash flows from operating activities.
- LO 3** Determine cash flows from investing activities.
- LO 4** Determine cash flows from financing activities.
- LO 5** Analyze the statement of cash flows.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Relevance
- Classification
- Disclosure

RELEVANT  
LEARNING OBJECTIVE

**Lo 1** Describe the principal purposes and concepts underlying the statement of cash flows, and identify its components and format.

## Lo 1 Concepts Underlying the Statement of Cash Flows

CASH FLOW

Cash flows enable a company to pay expenses, debts, employees' wages, and taxes and to invest in the assets it needs for its operations. Without sufficient cash flows, a company cannot grow and prosper. Because of the importance of cash flows, one must be alert to the possibility that items may be incorrectly *classified* in a statement of cash flows and that the statement may not fully *disclose* all pertinent information. This chapter identifies the classifications used in a statement of cash flows and explains how to analyze the statement.

The **statement of cash flows** shows how a company's operating, investing, and financing activities have affected cash during a period. It explains the net increase (or decrease) in cash during the period. For purposes of this statement, **cash** is defined as including both cash and cash equivalents. **Cash equivalents** are investments that can be quickly converted to cash. They have a maturity of 90 days or less when they are purchased, and they include the following:

- Money market accounts
- Commercial paper (short-term corporate notes)
- U.S. Treasury bills

A company invests in cash equivalents to earn interest on cash that would otherwise be temporarily idle. Suppose, for example, that a company has \$1,000,000 that it will not need for 30 days. To earn a return on this amount, the company could place the cash in an account that earns interest (such as a money market account), lend the cash to another corporation by purchasing that corporation's short-term notes (commercial paper), or purchase a short-term obligation of the U.S. government (a Treasury bill).

Cash equivalents should not be confused with short-term investments, also called **marketable securities**. Marketable securities have a maturity of more than 90 days but are intended to be held only until cash is needed for current operations. Purchases of marketable securities are treated as cash outflows, and sales of marketable securities are treated as cash inflows. Conversely, transfers between the Cash account and cash equivalents are not treated as cash inflows or cash outflows.

## Relevance of the Statement of Cash Flows

The statement of cash flows provides information about a company's cash receipts and cash payments during a period, as well as about a company's operating, investing, and financing activities. Some information about those activities may be inferred from other financial statements, but the statement of cash flows summarizes *all* transactions that affect cash.



### International Perspective

IFRS

#### How Universal Is the Statement of Cash Flows?

Despite the importance of the statement of cash flows in assessing the liquidity of companies in the United States, there has been considerable variation in its use and format in other countries. For example, in many countries, the statement shows the change in working capital rather than the change in cash and cash equivalents. Although the European Union's principal directives for financial reporting do not address the statement of cash flows, international accounting standards require it, and international financial markets expect it to be presented. As a result, most multinational companies include the statement in their financial reports. Most European countries adopted the statement of cash flows when the European Union adopted international accounting standards.

The information provided by the statement of cash flows is relevant to management in operating the business, as well as to investors and creditors in making investment and lending decisions. Management uses the statement of cash flows to:

- assess liquidity (e.g., to determine whether short-term financing is needed to pay current liabilities).
- determine dividend policy.
- evaluate the effects of major policy decisions involving investments and financing needs.

Investors and creditors use the statement of cash flows to assess a company's ability to:

- manage cash flows.
- generate positive future cash flows.
- pay its liabilities.
- pay dividends and interest.
- anticipate the need for additional financing.

## Classification of Cash Flows

**Amazon.com** is the largest online retailer in the world and one of the 500 largest companies in the United States. Exhibit 1 shows the company's consolidated statements of cash flows for 2011, 2010, and 2009. As you can see, this statement has three major classifications: operating, investing, and financing activities.

The *classifications* of operating, investing, and financing activities are illustrated in Exhibit 2 and summarized next.

**Operating Activities** The first section of the statement of cash flows is cash flow from operating activities. **Operating activities** involve the cash inflows and outflows from activities that enter into the determination of net income. Cash inflows in this category include cash receipts from the sale of goods and services and from the sale of trading securities. **Trading securities** are a type of marketable security that a company buys and sells for making a profit in the near term as opposed to holding them indefinitely for investment purposes. Cash inflows from operating activities also include interest received on loans and dividends received on investments. Cash outflows from operating activities include cash payments for wages, inventory, expenses, interest, taxes, and the purchase of trading securities.

**Investing Activities** The second section of the statement of cash flows is cash flows from investing activities. **Investing activities** involve the acquisition and sale of property, plant, and equipment and other long-term assets, including long-term investments. They also involve the acquisition and sale of short-term marketable securities, other than trading securities, and the making and collecting of loans. Cash flows provided by investing activities include the cash received from selling marketable securities and long-term assets and from collecting on loans. Cash flows used by investing activities include the cash expended on purchasing these securities and assets and the cash lent to borrowers. Cash outflows for property, plant, and equipment, or capital expenditures, are usually shown separately from cash inflows from sales of these assets, as they are in **Amazon.com**'s statement in Exhibit 1. However, when the inflows are not material, some companies combine these two lines to show the net amount of outflow.

**Financing Activities** The third section of the statement of cash flows is cash flows from financing activities. **Financing activities** involve obtaining resources from stockholders and creditors. Cash inflows include the proceeds from stock issues and from short- and long-term borrowing. Cash outflows include the repayments of loans (excluding interest) and payments to owners, including cash dividends. Treasury stock transactions are also considered financing activities. Repayments of accounts payable or accrued liabilities are not considered repayments of loans. They are classified as cash outflows under operating activities.

**Cash Balances** A reconciliation of the beginning and ending balances of cash appears at the bottom of the statement. These cash balances will tie into the cash balances on the balance sheet.

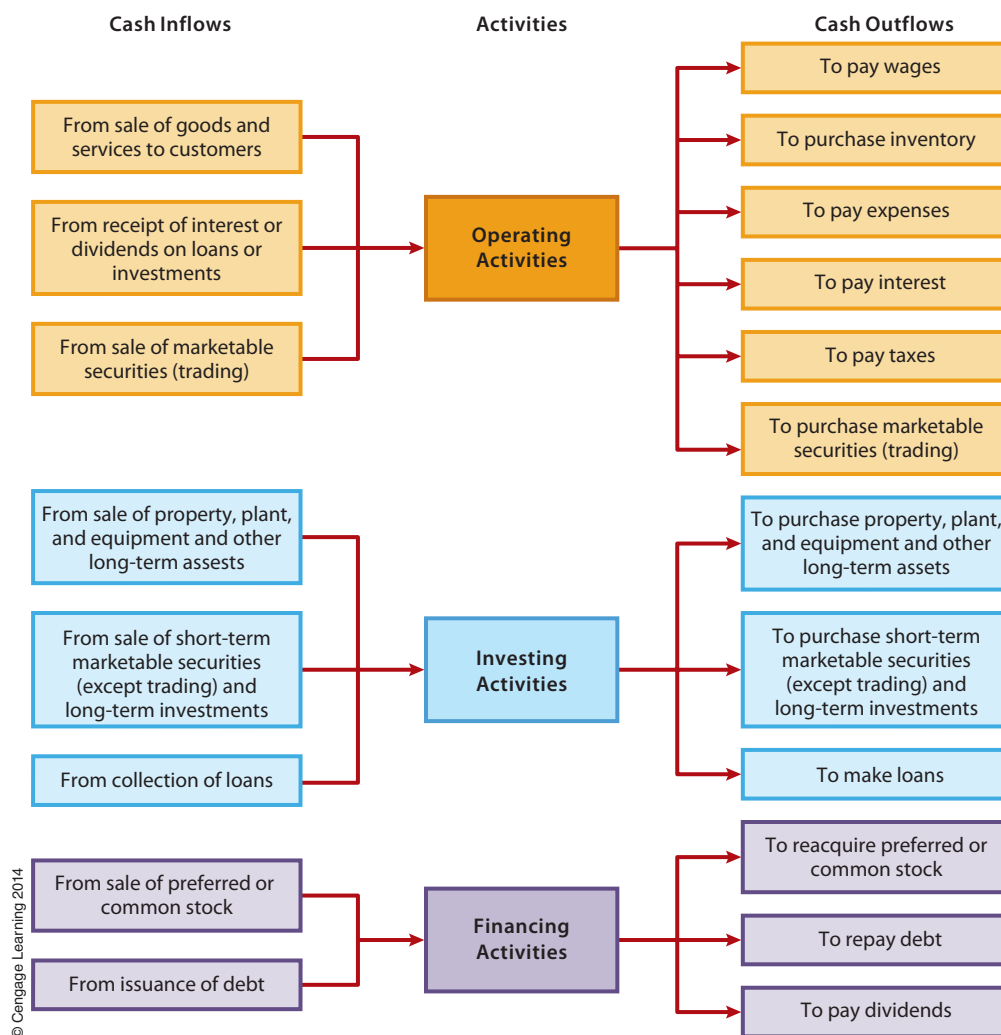
**STUDY NOTE:** Operating activities involve the day-to-day sale of goods and services, investing activities involve long-term assets and investments, and financing activities deal with stockholders' equity accounts and debt (borrowing).

**Exhibit 1****Consolidated Statement of Cash Flows**

<b>Amazon.com, Inc.</b>			
<b>Consolidated Statements of Cash Flows</b>			
<b>For the Years Ended</b>			
<b>(In millions)</b>	<b>2011</b>	<b>2010</b>	<b>2009</b>
<b>Operating Activities:</b>			
Net income	\$ 631	\$ 1,152	\$ 902
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation and amortization	1,083	568	378
Stock-based compensation	557	424	341
Other operating expense (income), net	154	106	103
Losses (gains) on sales of marketable securities, net	(4)	(2)	(4)
Other expense (income), net	(56)	(79)	(15)
Deferred income taxes	136	4	81
Excess tax benefits from stock-based compensation	(62)	(259)	(105)
Changes in operating assets and liabilities:			
Inventories	(1,777)	(1,019)	(531)
Accounts receivable, net and other	(866)	(295)	(481)
Accounts payable	2,997	2,373	1,859
Accrued expenses and other	1,067	740	300
Additions to unearned revenue	1,064	687	1,054
Amortization of previously unearned revenue	(1,021)	(905)	(589)
Net cash provided by operating activities	\$ 3,903	\$ 3,495	\$ 3,293
<b>Investing Activities:</b>			
Purchases of fixed assets, including internal-use software and website development	(1,811)	(979)	(373)
Acquisitions, net of cash received and other	(705)	(352)	(40)
Sales and maturities of marketable securities and other investments	6,843	4,250	1,966
Purchases of marketable securities and other investments	(6,257)	(6,279)	(3,890)
Net cash provided by (used in) investing activities	\$ (1,930)	\$ (3,360)	\$ (2,337)
<b>Financing Activities:</b>			
Excess tax benefits from exercises of stock options	62	259	105
Common stock repurchased (treasury stock)	(277)	—	—
Proceeds from long-term debt and other	177	143	87
Repayments of long-term debt and capital lease obligations	(444)	(221)	(472)
Net cash provided by (used in) financing activities	\$ (482)	\$ 181	\$ (280)
<b>Foreign-currency effect on cash and cash equivalents</b>	<b>1</b>	<b>17</b>	<b>(1)</b>
<b>Net (decrease) increase in cash and cash equivalents</b>	<b>\$ 1,492</b>	<b>\$ 333</b>	<b>\$ 675</b>
<b>Cash and cash equivalents, beginning of year</b>	<b>3,777</b>	<b>3,444</b>	<b>2,769</b>
<b>Cash and cash equivalents, end of year</b>	<b>\$ 5,269</b>	<b>\$ 3,777</b>	<b>\$ 3,444</b>

Source: Amazon.com, Inc., *Annual Report*, 2011 (adapted).

**Exhibit 2**  
Classification of Cash Inflows and Cash Outflows



## Required Disclosure of Noncash Investing and Financing Transactions

Companies occasionally engage in significant **noncash investing and financing transactions**. These transactions involve *only* long-term assets, long-term liabilities, or stockholders' equity. For instance, a company might exchange a long-term asset for a long-term liability, settle a debt by issuing capital stock, or take out a long-term mortgage to purchase real estate. Although noncash transactions represent significant investing and financing activities, they are not reflected in the body of the statement of cash flows because they do not affect current cash inflows or outflows. They will, however, affect future cash flows. For this reason, they must be *disclosed* in a separate schedule, usually following the statement of cash flows.

## Alternate Presentations of Operating Activities

There are two ways of presenting operating activities on the statement of cash flows.

- The **direct method** converts each item on the income statement from the accrual basis to the cash basis. The operating activities section of the statement of cash flows under the direct method follows in simplified format.

### Cash Flows from Operating Activities

Cash receipts from:		
Sales	xxx	
Interest	xxx	xxx
Less cash payments for:		
Purchases	xxx	
Operating expenses	xxx	
Interest payments	xxx	
Income taxes	xxx	xxx
Cash flows from operating activities		xxx

- The **indirect method** does not require the conversion of each item on the income statement. It lists only the items necessary to convert net income to cash flows from operations in the following format:

### Cash Flows from Operating Activities

Net income		xxx
Adjustments to reconcile net income to net cash flows from operating activities:		
Plus non-cash expenses	xxx	
Plus or minus changes in current assets and current liabilities	xxx	
Cash flows from operating activities		xxx

**STUDY NOTE:** The direct and indirect methods relate only to the operating activities section of the statement of cash flows. They are both acceptable for financial reporting purposes.

The direct and indirect methods always produce the same amount of cash flows from operating activities. The direct method presentation of operating cash flows is more straightforward than that of the indirect method, but it is more difficult to implement in practice. Few accounting systems provide the data easily to make the calculations necessary for the direct method. Further, when the direct method is presented, preparation and *disclosure* of the indirect method of presenting cash flows from operating activities is also required.

Analysts prefer the indirect method to the direct method because it begins with net income and derives cash flows from operations. Analysts can readily identify the factors that cause cash flows from operations to differ from net income. Companies prefer the indirect method because it is easier and less expensive to prepare. As a result, the indirect method is the overwhelming choice of most companies and accountants. A survey of large companies shows that 98 percent use this method.<sup>1</sup>



## International Perspective

### IFRS The Direct Method May Become More Important Under IFRS

In the interest of converging U.S. GAAP with international financial reporting standards (IFRS), the IASB is promoting the use of the direct method, even though it is more costly for companies to prepare. IFRS will continue to require a reconciliation of net income and net cash flows from operating activities similar to what is now done in the indirect method. **CVS's** statement of cash flows, as shown in the Supplement to Chapter 16, is one of the few U.S. companies to use the direct method with a reconciliation. Thus, its approach is very similar to what all companies may do if the U.S. adopts IFRS.

## APPLY IT!

Mango Corporation engaged in the transactions that follow. Identify each transaction as (a) an operating activity, (b) an investing activity, (c) a financing activity, (d) a noncash transaction, or (e) not on the statement of cash flows.

1. Purchased office equipment, a long-term investment.
2. Decreased accounts receivable.
3. Sold land at cost.
4. Issued long-term bonds for plant assets.
5. Increased inventory.
6. Issued common stock.
7. Repurchased common stock.
8. Issued notes payable.
9. Increased income taxes payable.
10. Purchased a 60-day Treasury bill.
11. Purchased a long-term investment.
12. Declared and paid a cash dividend.

### SOLUTION

1. b; 2. a; 3. b; 4. d; 5. a; 6. c; 7. c; 8. c; 9. a; 10. e (cash equivalent); 11. b; 12. c

### TRY IT! SE1, SE6, E1A, E1B

## SECTION 2

## ACCOUNTING APPLICATIONS

### ACCOUNTING APPLICATIONS

- Determining cash flows from operating activities using the indirect method
- Determining cash flows from investing activities
- Determining cash flows from financing activities

### RELEVANT LEARNING OBJECTIVES

- LO 2** Use the indirect method to determine cash flows from operating activities.
- LO 3** Determine cash flows from investing activities.
- LO 4** Determine cash flows from financing activities.

## LO 2 Step One: Determining Cash Flows from Operating Activities

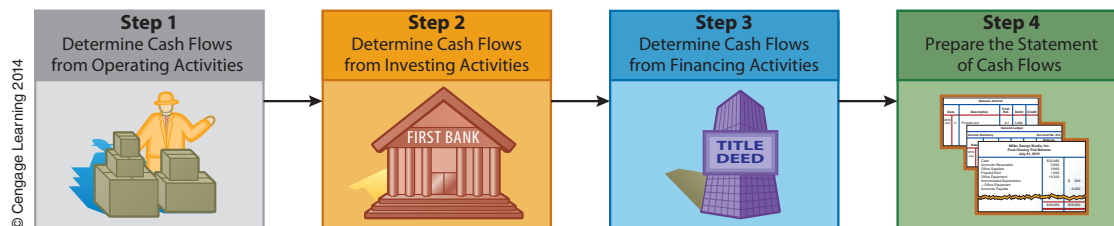
CASH FLOW

As shown in Exhibit 3, preparing a statement of cash flows involves four steps:

- **Step 1:** Determine cash flows from operating activities.
- **Step 2:** Determine cash flows from investing activities.
- **Step 3:** Determine cash flows from financing activities.
- **Step 4:** Prepare the statement of cash flows.

In this section, we begin with determining cash flows from operating activities.

**Exhibit 3**  
Preparation of the Statement of Cash Flows



To demonstrate the preparation of the statement of cash flows, we will use data for Eureka Corporation. Eureka’s income statement for 2014 is presented in Exhibit 4, and its balance sheets for December 31, 2014 and 2013 appear in Exhibit 5. Exhibit 5 also shows the balance sheet accounts that we use for analysis and whether the change in each account is an increase or a decrease.

**Exhibit 4**  
Income Statement

<b>Eureka Corporation</b>		
<b>Income Statement</b>		
<b>For the Year Ended December 31, 2014</b>		
Sales		\$698,000
Cost of goods sold		<u>520,000</u>
Gross margin		\$178,000
Operating expenses (including depreciation expense of \$37,000)		<u>147,000</u>
Operating income		\$ 31,000
Other income (expenses):		
Interest expense	\$(23,000)	
Interest income	6,000	
Gain on sale of investments	12,000	
Loss on sale of plant assets	<u>(3,000)</u>	<u>(8,000)</u>
Income before income taxes		\$ 23,000
Income taxes expense		<u>7,000</u>
Net income		<u>\$ 16,000</u>



**Exhibit 5****Comparative Balance Sheets Showing Changes in Accounts**

<b>Eureka Corporation</b>				
<b>Comparative Balance Sheets</b>				
<b>December 31, 2014 and 2013</b>				
	<b>2014</b>	<b>2013</b>	<b>Change</b>	<b>Increase or Decrease</b>
<b>Assets</b>				
Current assets:				
Cash	\$ 47,000	\$ 15,000	\$ 32,000	Increase
Accounts receivable (net)	47,000	55,000	(8,000)	Decrease
Inventory	144,000	110,000	34,000	Increase
Prepaid expenses	1,000	5,000	(4,000)	Decrease
Total current assets	<u>\$ 239,000</u>	<u>\$185,000</u>	<u>\$ 54,000</u>	
Investments	<u>\$ 115,000</u>	<u>\$127,000</u>	<u>\$ (12,000)</u>	Decrease
Plant assets	<u>\$ 715,000</u>	<u>\$505,000</u>	<u>\$210,000</u>	Increase
Less accumulated depreciation	<u>(103,000)</u>	<u>(68,000)</u>	<u>(35,000)</u>	Increase
Total plant assets	<u>\$ 612,000</u>	<u>\$437,000</u>	<u>\$175,000</u>	
Total assets	<u>\$ 966,000</u>	<u>\$749,000</u>	<u>\$217,000</u>	
<b>Liabilities</b>				
Current liabilities:				
Accounts payable	\$ 50,000	\$ 43,000	\$ 7,000	Increase
Accrued liabilities	12,000	9,000	3,000	Increase
Income taxes payable	3,000	5,000	(2,000)	Decrease
Total current liabilities	<u>\$ 65,000</u>	<u>\$ 57,000</u>	<u>\$ 8,000</u>	
Long-term liabilities:				
Bonds payable	<u>295,000</u>	<u>245,000</u>	<u>50,000</u>	Increase
Total liabilities	<u>\$ 360,000</u>	<u>\$302,000</u>	<u>\$ 58,000</u>	
<b>Stockholders' Equity</b>				
Common stock, \$5 par value	\$ 276,000	\$200,000	\$ 76,000	Increase
Additional paid-in capital	214,000	115,000	99,000	Increase
Retained earnings	141,000	132,000	9,000	Increase
Treasury stock	<u>(25,000)</u>	<u>0</u>	<u>(25,000)</u>	Increase
Total stockholders' equity	<u>\$ 606,000</u>	<u>\$447,000</u>	<u>\$159,000</u>	
Total liabilities and stockholders' equity	<u>\$ 966,000</u>	<u>\$749,000</u>	<u>\$217,000</u>	

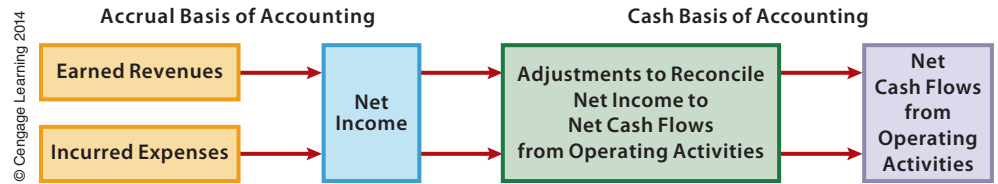
© Cengage Learning 2014

The income statement indicates how successful a company has been in earning an income from its operating activities. However, because that statement is prepared on an accrual basis, it does not reflect the inflow and outflow of cash related to operating activities. Revenues are recorded even though the company may not yet have received the cash, and expenses are recorded even though the company may not yet have expended the cash. Thus, to ascertain cash flows from operations in step 1 in preparing the statement of cash flows, the figures on the income statement must be converted from an accrual basis to a cash basis.

As Exhibit 6 shows, the indirect method focuses on adjusting items on the income statement to reconcile net income to net cash flows from operating activities. These items include the following:

- Depreciation, amortization, and depletion
- Gains and losses
- Changes in the balances of current asset and current liability accounts.

**Exhibit 6**  
Indirect Method of  
Determining Net  
Cash Flows from  
Operating Activities



These adjusting items can be seen in the schedule in Exhibit 7, which shows the reconciliation of Eureka’s net income to net cash flows from operating activities. Each adjusting item requires a different type of analysis as illustrated in the sections that follow.

**Exhibit 7**  
Schedule of Cash  
Flows from  
Operating Activities:  
Indirect Method

**Eureka Corporation**  
**Schedule of Cash Flows from Operating Activities**  
**For the Year Ended December 31, 2014**

Cash flows from operating activities:		
Net income		\$16,000
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation	\$ 37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Changes in current assets and current liabilities:		
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Decrease in income taxes payable	(2,000)	
		<u>14,000</u>
Net cash flows from operating activities		<u>\$30,000</u>

## Depreciation, Amortization, and Depletion

**STUDY NOTE:** Operating expenses on the income statement include depreciation expense, which does not require a cash outlay.

Although the cash payments made for plant assets, intangible assets, and natural resources appear in the investing activities section of the statement of cash flows, the depreciation expense, amortization expense, and depletion expense associated with these assets appear in the operating activities section. The amount of these expenses can usually be found in the income statement or in a note to the financial statements.

### Depreciation

**Financial Statement Information** Eureka’s income statement (Exhibit 4) shows \$37,000 of depreciation expense.

#### Journal Entry

$$\begin{array}{r}
 \mathbf{A} \\
 -37,000
 \end{array}
 =
 \begin{array}{r}
 \mathbf{L} \\
 -37,000
 \end{array}
 +
 \begin{array}{r}
 \mathbf{SE} \\
 -37,000
 \end{array}$$

	Dr.	Cr.
Depreciation Expense	37,000	
Accumulated Depreciation		37,000
To record annual depreciation on plant assets		

#### Cash Flow Analysis

Depreciation	\$37,000
--------------	----------

When depreciation expense is recorded, the Cash account is not affected. Thus, net income needs to be adjusted upward by the amount of depreciation, or \$37,000, because depreciation expense involves no current outlay of cash even though it appears on the income statement. Amortization and depletion expenses are handled in exactly the same way as depreciation expense.

## Gains and Losses

**STUDY NOTE:** Gains and losses by themselves do not represent cash flows; they are merely bookkeeping adjustments. For example, when a long-term asset is sold, the proceeds (cash received), not the gain or loss, constitute cash flow.

Like depreciation expense, gains and losses that appear on the income statement do not affect cash flows from operating activities and need to be subtracted from or added to net income. The actual cash flows from these transactions are reflected in the investing and financing activities sections of the statement of cash flows.

### Gain—Sale of Investments

**Financial Statement Information** Eureka's income statement (Exhibit 4) shows a \$12,000 gain on the sale of investments.

#### Cash Flow Analysis

Gain on sale of investments	(\$12,000)
-----------------------------	------------

This amount is subtracted from net income to reconcile net income to net cash flows from operating activities. The reason for doing this is that the \$12,000 is included in the investing activities section of the statement of cash flows as part of the cash from the sale of the investment. Because the gain has already been included in the calculation of net income, the \$12,000 gain must be subtracted to prevent double counting.

### Loss—Sale of Plant Assets

**Financial Statement Information** Eureka's income statement shows a \$3,000 loss on the sale of plant assets.

#### Cash Flow Analysis

Loss on sale of plant assets	\$3,000
------------------------------	---------

As was the case with depreciation expense, a loss on the sale of assets is added to net income to reconcile net income to net cash flows from operating activities. The cash received associated with the transaction that resulted in this loss is reflected in the investing activities section of the statement of cash flows.

## Changes in Current Assets

As explained in this section and the next, changes in current assets and current liabilities require a different approach to reconcile net income to cash flows from operating activities.

Decreases in current assets other than cash have positive effects on cash flows, and increases in current assets have negative effects on cash flows:

- ▼ A *decrease* in a current asset frees up invested cash, thereby increasing cash flow.
- ▲ An *increase* in a current asset consumes cash, thereby decreasing cash flow.

### Decrease in Current Assets—Accounts Receivable

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows an \$8,000 decrease in accounts receivable. We can conclude that collections were \$8,000 more than sales recorded for the year.

#### Cash Flow Analysis

Decrease in account receivable	\$8,000
--------------------------------	---------

Because net sales in 2014 were \$698,000, the total cash received from sales can be calculated as follows.

$$\begin{aligned} \text{Net Sales} + \text{Additional Cash Collections} &= \text{Total Cash Collections Received} \\ \$698,000 + \$8,000 &= \$706,000 \end{aligned}$$

The effect on Accounts Receivable can be illustrated as follows.

Accounts Receivable					
Sales to Customers	Beg. Bal.	55,000	Cash Collections	706,000	Cash Receipts from Customers
	Net Sales	698,000			
	<b>End. Bal.</b>	<b>47,000</b>			

To reconcile net income to net cash flows from operating activities, the \$8,000 decrease in accounts receivable is added to net income.

### Increase in Current Assets—Inventory

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$34,000 increase in inventory.

#### Cash Flow Analysis

Increase in inventory (\$34,000)

Because the cost of goods sold in 2014 was \$520,000, the total cash paid for inventory can be calculated as follows, as was done with accounts receivable.

$$\begin{aligned} \text{Cost of Goods Sold} + \text{Additional Purchases} &= \text{Total Purchases} \\ \$520,000 + \$34,000 &= \$554,000 \end{aligned}$$

Inventory					
Purchases from Supplier	Beg. Bal.	110,000	Cost of Goods Sold	520,000	Cost of Goods Sold to Customers
	Total Purchases	554,000			
	<b>End. Bal.</b>	<b>144,000</b>			

Thus, Eureka expended \$34,000 more in cash for purchases than it included in the cost of goods sold on its income statement. Because of this expenditure, net income is higher than net cash flows from operating activities, so \$34,000 must be deducted from net income.

### Decrease in Current Assets—Prepaid Expenses

**Financial Statement Information** Continuing with current assets, Eureka's balance sheet (Exhibit 5) shows a \$4,000 decrease in prepaid expenses.

#### Cash Flow Analysis

Decrease in prepaid expenses \$4,000

Using the same logic, the decrease shown on the balance sheet is added to net income because Eureka expended less cash on prepaid expenses than was included on the income statement.

## Changes in Current Liabilities

The effect that changes in current liabilities have on cash flows is the opposite of the effect of changes in current assets:

- ▲ An *increase* in a current liability represents a postponement of a cash payment, which frees up cash and increases cash flow in the current period; thus, it is added to net income.
- ▼ A *decrease* in a current liability consumes cash, which decreases cash flow; thus, it is deducted from net income.

### Increase in Current Liabilities—Accounts Payable

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$7,000 increase in accounts payable.

#### Cash Flow Analysis

Increase in accounts payable \$7,000

This means that Eureka paid \$7,000 less to creditors than the amount indicated in the cost of goods sold on its income statement, illustrated as follows.

$$\begin{aligned} \text{Purchases on Account}^* - \text{Amount Unpaid} &= \text{Total Cash Payments} \\ \$554,000 - \$7,000 &= \$547,000 \end{aligned}$$

The following T account illustrates this relationship:

	Accounts Payable		
Cash Payments to Suppliers	→ Payments on Account 547,000	Beg. Bal. 43,000	
		Purchases on Account 554,000*	→ Purchases
		<b>End. Bal. 50,000</b>	

\*Purchases = Cost of Goods Sold (\$520,000) + Increase in Inventory (\$34,000)

Thus, \$7,000 must be added to net income to reconcile net income to net cash flows from operating activities.

### Increase in Current Liabilities—Accrued Liabilities

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$3,000 increase in accrued liabilities.

#### Cash Flow Analysis

Increase in accrued liabilities \$3,000

Using the same logic as with the increase in accounts payable, this amount is added to net income. The increase in accrued liabilities was created by an adjusting entry that also increases expenses but does not use cash in the current period. Since expenses decrease net income, the increase in accrued expenses needs to be added to net income.

### Decrease in Current Liabilities—Income Taxes Payable

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$2,000 decrease in income taxes payable.

#### Cash Flow Analysis

Decrease in income taxes payable (\$2,000)

This amount is deducted from net income because the decrease in income taxes payable means the company paid this year's taxes plus an amount from the prior year, as follows.

$$\begin{aligned} \text{Income Taxes Expense} + \text{Additional Payment} &= \text{Total Income Taxes Payments} \\ \$7,000 + \$2,000 &= \$9,000 \end{aligned}$$

	Income Taxes Payable		
Cash Paid for Income Taxes	→ Income Taxes Payments 9,000	Beg. Bal. 5,000	
		Income Taxes Expense 7,000	→ Income Taxes Expense for the Year
		<b>End. Bal. 3,000</b>	

## Schedule of Cash Flows from Operating Activities

In summary, Exhibit 7 shows that by using the indirect method, net income of \$16,000 has been adjusted by reconciling items totaling \$14,000 to arrive at net cash flows from operating activities of \$30,000:

$$\begin{aligned} \text{Net Income +/- Reconciling Items} &= \text{Cash Flows from Operating Activities} \\ \$16,000 + \$14,000 &= \$30,000 \end{aligned}$$

Although Eureka's net income was \$16,000, the company actually had net cash flows of \$30,000 from operating activities to use for purchasing assets, reducing debts, and paying dividends. The rules for reconciling items from the income statement that do not affect cash flows can be summarized as follows.

	<i>Add to or Deduct from Net Income</i>
Depreciation expense	+ Add
Amortization expense	+ Add
Depletion expense	+ Add
Losses	+ Add
Gains	- Deduct

The following summarizes the adjustments from the balance sheet for increases and decreases in current assets and current liabilities:

	<i>Add to Net Income</i> +	<i>Deduct from Net Income</i> -
Current assets:		
Accounts receivable (net)	▼ Decrease	▲ Increase
Inventory	▼ Decrease	▲ Increase
Prepaid expenses	▼ Decrease	▲ Increase
Current liabilities:		
Accounts payable	▲ Increase	▼ Decrease
Accrued liabilities	▲ Increase	▼ Decrease
Income taxes payable	▲ Increase	▼ Decrease



## Business Perspective

### What Is EBITDA, and Is It Any Good?

Some companies and analysts like to use EBITDA (an acronym for Earnings Before Interest, Taxes, Depreciation, and Amortization) as a shortcut measure of cash flows from operations. But experiences of the past decade have caused many analysts to reconsider this measure of performance. For instance, when **WorldCom** transferred \$3.8 billion from expenses to capital expenditures in one year, it touted its EBITDA. At the time, the firm was, in fact, nearly bankrupt. The demise of **Vivendi**, the big French company that imploded when it did not have enough cash to pay its debts and that also touted its EBITDA, is another reason that analysts have had second thoughts about relying on this measure of performance.

Some analysts are now saying that EBITDA is "to a great extent misleading" and that it "is a confusing metric. . . . Some take it for a proxy for profits and some take it for a proxy for cash flow, and it's neither."<sup>2</sup> Cash flows from operations and free cash flow, both of which take into account interest, taxes, and depreciation, are better and more comprehensive measures of a company's ability to generate sufficient cash flows.



## APPLY IT!

For the year ended June 30, 2015, RAK Corporation's net income was \$7,400. Its depreciation expense was \$2,000. During the year, its accounts receivable increased by \$4,400, inventories increased by \$7,000, prepaid rent decreased by \$1,400, accounts payable increased by \$14,000, salaries payable increased by \$1,000, and income taxes payable decreased by \$600. The company also had an \$1,800 gain on the sale of investments. Use the indirect method to prepare a schedule of cash flows from operating activities.

### SOLUTION

**RAK Corporation**  
**Schedule of Cash Flows from Operating Activities**  
**For the Year Ended June 30, 2015**

Cash flows from operating activities:		
Net income		\$ 7,400
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation	\$ 2,000	
Gain on sale of investments	(1,800)	
Changes in current assets and current liabilities:		
Increase in accounts receivable	(4,400)	
Increase in inventories	(7,000)	
Decrease in prepaid rent	1,400	
Increase in accounts payable	14,000	
Increase in salaries payable	1,000	
Decrease in income taxes payable	(600)	4,600
Net cash flows from operating activities		<u>\$12,000</u>

**TRY IT! SE2, SE3, SE6, E2A, E3A, E4A, E8A, E2B, E3B, E4B, E8B**

### CASH FLOW

## LO 3 Step Two: Determining Cash Flows from Investing Activities

**STUDY NOTE:** Investing activities involve long-term assets and short- and long-term investments. Inflows and outflows of cash are shown in the investing activities section of the statement of cash flows.

Determining cash flows from investing activities is step 2 in preparing the statement of cash flows. In this step, accounts involving cash receipts and cash payments from investing activities are examined individually. The objective is to explain the change in each account balance from one period to the next.

Although investing activities relate mainly to the long-term assets shown on the balance sheet, they also include any short-term investments shown under current assets on the balance sheet and any investment gains and losses on the income statement. The balance sheets in Exhibit 5 show that Eureka had no short-term investments and that its long-term assets consisted of investments and plant assets. The income statement in Exhibit 4 shows that Eureka had a gain on the sale of investments and a loss on the sale of plant assets.

The following transactions pertain to Eureka's investing activities in 2014:

1. Purchased investments in the amount of \$78,000.
2. Sold for \$102,000 investments that cost \$90,000.
3. Purchased plant assets in the amount of \$120,000.
4. Sold for \$5,000 plant assets that cost \$10,000 and that had accumulated depreciation of \$2,000.
5. Issued \$100,000 of bonds at face value in a noncash exchange for plant assets.

In the sections that follow, we explain the effects of these transactions on Eureka's cash flows by analyzing their impact on the accounts related to investing activities.

## Investments

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$12,000 decrease in investments. To explain this decrease and its effects on the statement of cash flows, we will analyze the increases and decreases in Eureka's Investments account.

### Purchase of Investments

**Transaction 1** Purchased investments in the amount of \$78,000.

#### Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+78,000				
-78,000				

	<i>Dr.</i>	<i>Cr.</i>
Investments	78,000	
Cash		78,000
Purchase of investments		

#### Cash Flow Analysis

Purchase of investments	(\$78,000)
-------------------------	------------

### Sale of Investments

**Transaction 2** Sold for \$102,000 investments that cost \$90,000.

#### Journal Entry

<b>A</b>	=	<b>L</b>	+	<b>SE</b>
+102,000				+12,000
-90,000				

	<i>Dr.</i>	<i>Cr.</i>
Cash	102,000	
Investments		90,000
Gain on Sale of Investments		12,000
Sale of Investments for a gain		

#### Cash Flow Analysis

Sale of investments	\$102,000
---------------------	-----------

**STUDY NOTE:** The \$102,000 price obtained, not the \$12,000 gained, constitutes the cash flow.

Note that the gain on the sale is included in the \$102,000. This is the reason we excluded it in computing cash flows from operations. If it had not been excluded in that section, it would have been counted twice.

**Reconciliation** We have now explained the \$12,000 decrease in the Investments account during 2014, as illustrated in the following T account:

Investments			
	<i>Dr.</i>		<i>Cr.</i>
Beg. Bal.	127,000	Sales	90,000
Purchases	78,000		
<b>End. Bal.</b>	<b>115,000</b>		

Purchases and sales are listed separately as cash outflows and inflows to give analysts a complete view of investing activities. However, some companies prefer to list them as a single net amount. If Eureka Corporation had short-term investments or marketable securities, the analysis of cash flows would be the same.

## Plant Assets

**Financial Statement Information** Eureka's balance sheet shows the following:

- \$210,000 increase in plant assets
- \$35,000 increase in accumulated depreciation

### Purchase of Plant Assets

**Transaction 3** Purchased plant assets in the amount of \$120,000.

#### Journal Entry

$$\begin{array}{r} \mathbf{A} = \mathbf{L} + \mathbf{SE} \\ +120,000 \\ -120,000 \end{array}$$

	<i>Dr.</i>	<i>Cr.</i>
Plant Assets	120,000	
Cash		120,000

#### Cash Flow Analysis

Purchase of plant assets (\$120,000)

**Comment** Cash outflows and cash inflows related to plant assets are listed separately, but companies sometimes combine them into a single net amount, called *capital expenditures*, when the cash inflows from sales are immaterial.

### Sale of Plant Assets

**Transaction 4** Sold for \$5,000 plant assets that cost \$10,000 and that had accumulated depreciation of \$2,000.

#### Journal Entry

$$\begin{array}{r} \mathbf{A} = \mathbf{L} + \mathbf{SE} \\ +5,000 \quad +3,000 \\ +2,000 \\ -10,000 \end{array}$$

	<i>Dr.</i>	<i>Cr.</i>
Cash	5,000	
Accumulated Depreciation	2,000	
Loss on Sale of Plant Assets	3,000	
Plant Assets		10,000
Sale of plant assets at a loss		

#### Cash Flow Analysis

Sale of plant assets \$5,000

Note that this transaction results in a positive cash flow of \$5,000, even though the plant assets were sold at a loss of \$3,000. As noted in our analysis of operating activities, the loss on the sale of plant assets is added back to net income. This action avoids counting the loss in two sections of the statement of cash flows.

### Issued Bonds in Exchange for Plant Assets

**Transaction 5** Issued \$100,000 of bonds at face value in a noncash exchange for plant assets.

#### Journal Entry

$$\begin{array}{r} \mathbf{A} = \mathbf{L} + \mathbf{SE} \\ +100,000 \quad +100,000 \end{array}$$

	<i>Dr.</i>	<i>Cr.</i>
Plant Assets	100,000	
Bonds Payable		100,000
Issued bonds at face value for plant assets		

#### Cash Flow Analysis

<b>Schedule of Noncash Investing and Financing Transactions</b>	
Issue of bonds payable for plant assets	\$100,000

Although this transaction does not involve an inflow or outflow of cash, it is a significant transaction involving both an investing activity (the purchase of plant assets) and a financing activity (the issue of bonds payable). Because one purpose of the statement of cash flows is to show important investing and financing activities, the transaction is *disclosed* at the bottom of the statement of cash flows or in a separate schedule.

**STUDY NOTE:** The amount of a loss or gain on the sale of an asset is determined by the amount of cash received and does not represent a cash outflow or inflow.

**Reconciliation** We have now explained all the changes related to Eureka’s Plant Assets account. The following T accounts summarize these changes:

Plant Assets			
<i>Dr.</i>		<i>Cr.</i>	
Beg. Bal.	505,000	Sales	10,000
Cash Purchase	120,000		
Noncash Purchase	100,000		
<b>End. Bal.</b>	<b>715,000</b>		

Accumulated Depreciation			
<i>Dr.</i>		<i>Cr.</i>	
Sale	2,000	Beg. Bal.	68,000
		Depreciation Expense	37,000
		<b>End. Bal.</b>	<b>103,000</b>

Had the balance sheet included specific plant asset accounts (e.g., Equipment and the related accumulated depreciation account) or other long-term asset accounts (e.g., Intangibles), the analysis would have been the same.

## APPLY IT!

The following T accounts show Andre Company’s plant assets and accumulated depreciation at the end of 2015:

Plant Assets				Accumulated Depreciation			
<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>	
Beg. Bal.	65,000	Disposals	23,000	Disposals	14,700	Beg. Bal.	34,500
Purchases	33,600					Depreciation	10,200
<b>End. Bal.</b>	<b>75,600</b>					<b>End. Bal.</b>	<b>30,000</b>

Andre’s income statement shows a \$4,400 gain on the sale of plant assets. Compute the amounts that should be shown as cash flows from investing activities and show how they should appear on Andre’s 2015 statement of cash flows.

### SOLUTION

Cash flows from investing activities:

Purchase of plant assets	\$(33,600)
Sale of plant assets	12,700

The T accounts show total purchases of plant assets of \$33,600, which is an outflow of cash, and the disposal of plant assets that cost \$23,000 and that had accumulated depreciation of \$14,700. The cash inflow from the disposal was as follows.

Plant assets	\$23,000
Less accumulated depreciation	<u>14,700</u>
Book value	\$ 8,300
Add gain on sale	<u>4,400</u>
Cash inflow from sale of plant assets	<u><u>\$12,700</u></u>

Because the gain on the sale is included in the \$12,700 in the investing activities section of the statement of cash flows, it should be deducted from net income in the operating activities section.

### TRY IT! SE4, SE6, E5A, E6A, E8A, E5B, E6B, E8B



## LO 4 Step Three: Determining Cash Flows from Financing Activities

Determining cash flows from financing activities is step 3 in preparing the statement of cash flows. It is very similar to determining cash flows from investing activities, but the accounts analyzed relate to short-term borrowings, long-term liabilities, and stockholders' equity. Because Eureka Corporation does not have short-term borrowings, we deal only with long-term liabilities and stockholders' equity accounts.

The following transactions pertain to Eureka's financing activities in 2014:

1. Issued \$100,000 of bonds at face value in a noncash exchange for plant assets.
2. Repaid \$50,000 of bonds at face value at maturity.
3. Issued 15,200 shares of \$5 par value common stock for \$175,000.
4. Paid cash dividends in the amount of \$7,000.
5. Purchased treasury stock for \$25,000.

### Bonds Payable

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$50,000 increase in Bonds Payable.

#### Issued Bonds

**Transaction 1** Issued \$100,000 of bonds at face value in a noncash exchange for plant assets. We have already analyzed Transaction 1 in connection with plant assets, but we also need to account for the change in the Bonds Payable account. As noted, this transaction is reported on the schedule of noncash investing and financing transactions.

#### Redeemed Bonds

**Transaction 2** Repaid \$50,000 of bonds at face value at maturity.

#### Journal Entry

$$\begin{array}{r} \mathbf{A} \\ -50,000 \end{array} = \begin{array}{r} \mathbf{L} \\ -50,000 \end{array} + \begin{array}{r} \mathbf{SE} \end{array}$$

	<i>Dr.</i>	<i>Cr.</i>
Bonds Payable	50,000	
Cash		50,000
Repayment of bonds at face value at maturity		

#### Cash Flow Analysis

Repayment of bonds (\$50,000)

**Reconciliation** The following T account explains the change in Bonds Payable:

Bonds Payable			
<i>Dr.</i>		<i>Cr.</i>	
Repayment	50,000	Beg. Bal.	245,000
		Noncash Issue	100,000
		<b>End. Bal.</b>	<b>295,000</b>

If Eureka Corporation had any notes payable, the analysis would be the same.

### Common Stock

#### Increase in Common Stock and Additional Paid-in Capital

**Financial Statement Information** Eureka's balance sheet (Exhibit 5) shows a \$76,000 increase in common stock and a \$99,000 increase in additional paid-in capital.

**Transaction 3** Issued 15,200 shares of \$5 par value common stock for \$175,000.

**Journal Entry**

$$\begin{array}{rcl}
 \mathbf{A} & = & \mathbf{L} + \mathbf{SE} \\
 +175,000 & & +76,000 \\
 & & +99,000
 \end{array}$$

	Dr.	Cr.
Cash	175,000	
Common Stock		76,000
Additional Paid-in Capital		99,000
Issued 15,200 shares of \$5 par value common stock		

**Cash Flow Analysis**

Issuance of common stock \$175,000

**Reconciliation** The following analysis of this transaction is all that is needed to explain the changes in the two accounts during 2014:

Common Stock		Additional Paid-in Capital	
Dr.	Cr.	Dr.	Cr.
	Beg. Bal. 200,000		Beg. Bal. 115,000
	Issue 76,000		Issue 99,000
	<b>End. Bal. 276,000</b>		<b>End. Bal. 214,000</b>

**STUDY NOTE:** Dividends paid, not dividends declared, appear on the statement of cash flows.

## Retained Earnings

**Increase in Retained Earnings**

**Financial Statement Information** Eureka’s balance sheet (Exhibit 5) shows a \$9,000 increase in retained earnings.

**Transaction 4** Paid cash dividends in the amount of \$7,000.

**Journal Entry**

$$\begin{array}{rcl}
 \mathbf{A} & = & \mathbf{L} + \mathbf{SE} \\
 & & -7,000 \\
 & & +7,000
 \end{array}$$

	Dr.	Cr.
Retained Earnings	7,000	
Cash Dividends		7,000
To close the Cash Dividends account		

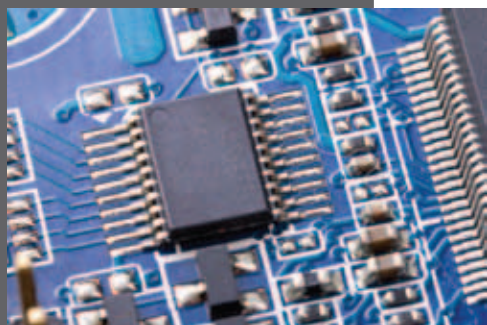
**Cash Flow Analysis**

Payment of dividends (\$7,000)

**Reconciliation** Recall that dividends will reduce Retained Earnings and that net income appears in the operating activities section of the statement of cash flows. Thus, we have now explained all the changes related to Eureka’s Retained Earnings account. This T account shows the change in the Retained Earnings account:

Retained Earnings			
Dr.		Cr.	
Cash Dividends	7,000	Beg. Bal.	132,000
		Net Income	16,000
		<b>End. Bal.</b>	<b>141,000</b>

High-tech companies with large amounts of intangible assets can lose up to 80 percent of their value in times of financial stress. As a hedge against economic downturns, these companies need to build cash reserves and may therefore choose to hoard cash rather than pay dividends.



Patryk Kosmider/Shutterstock.com

## Treasury Stock

**Increase in Treasury Stock**

**Financial Statement Information** Eureka’s balance sheet (Exhibit 5) shows a \$25,000 increase in treasury stock.



**Transaction 5** Purchased treasury stock for \$25,000.

### Journal Entry

$$\begin{array}{r} \mathbf{A} = \mathbf{L} + \mathbf{SE} \\ -25,000 \qquad \qquad -25,000 \end{array}$$

	Dr.	Cr.
Treasury Stock	25,000	
Cash		25,000
Purchased treasury stock		

**STUDY NOTE:** The purchase of treasury stock qualifies as a financing activity, but it is also a cash outflow.

### Cash Flow Analysis

Purchase of treasury stock (\$25,000)

**Reconciliation** The following T account explains the change in Treasury Stock:

Treasury Stock		
	Dr.	Cr.
Purchase	25,000	

## Step 4: Preparing the Statement of Cash Flows

We have now analyzed all of Eureka Corporation's income statement items, explained all balance sheet changes, and taken all additional information into account. Exhibit 8 shows how these data are assembled in Eureka's statement of cash flows.

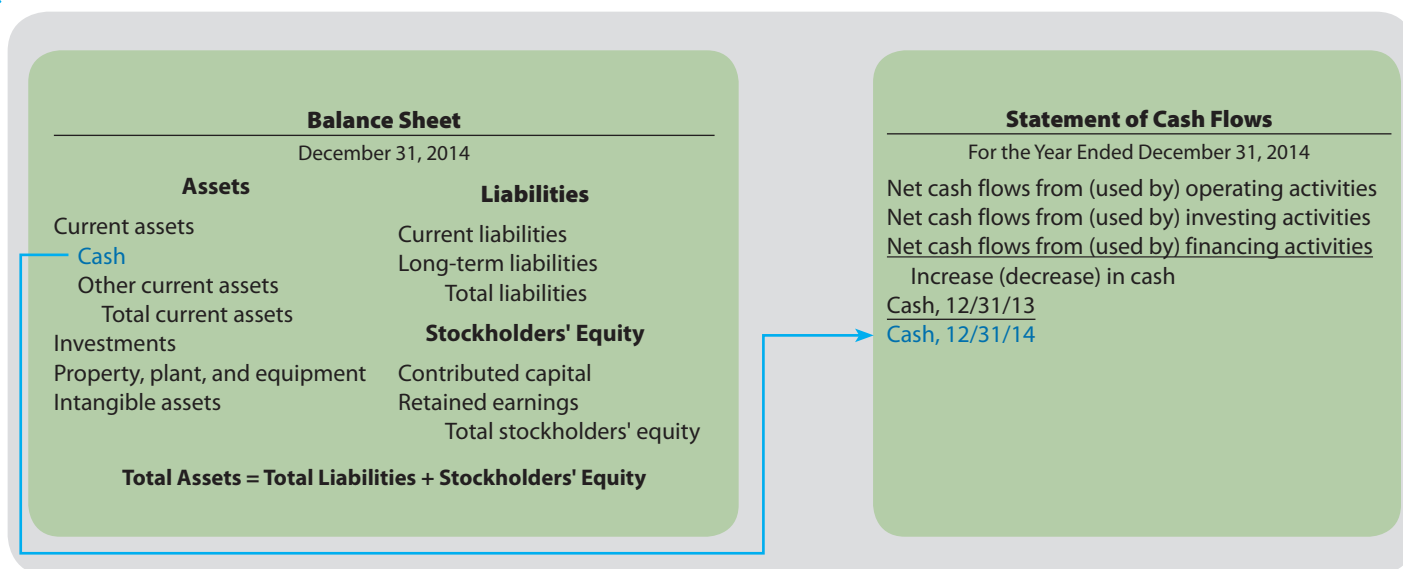
### Exhibit 8 Statement of Cash Flows: Indirect Method

Eureka Corporation Statement of Cash Flows For the Year Ended December 31, 2014		
Cash flows from operating activities:		
Net income		\$ 16,000
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation	\$ 37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Changes in current assets and current liabilities:		
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Decrease in income taxes payable	(2,000)	14,000
Net cash flows from operating activities		\$ 30,000
Cash flows from investing activities:		
Purchase of investments	\$ (78,000)	
Sale of investments	102,000	
Purchase of plant assets	(120,000)	
Sale of plant assets	5,000	
Net cash flows from investing activities		(91,000)
Cash flows from financing activities:		
Repayment of bonds	\$ (50,000)	
Issuance of common stock	175,000	
Payment of dividends	(7,000)	
Purchase of treasury stock	(25,000)	
Net cash flows from financing activities		93,000
Net increase in cash		\$ 32,000
Cash at beginning of year		15,000
Cash at end of year		\$ 47,000
<b>Schedule of Noncash Investing and Financing Transactions</b>		
Issue of bonds payable for plant assets		\$100,000

# Cash Flows and the Financial Statements

As shown in Exhibit 9, the statement of cash flows explains the changes in cash on the balance sheet and reconciles the change in Cash (reported on the Balance Sheet) from one period to the next.

**Exhibit 9**  
Relationship of the Statement of Cash Flows to the Balance Sheet



© Cengage Learning 2014

## APPLY IT!

During 2015, Brown Company issued \$1,000,000 in long-term bonds at par, repaid \$200,000 of notes payable at face value, issued notes payable of \$40,000 for equipment, paid interest of \$40,000, paid dividends of \$25,000, and repurchased common stock in the amount of \$50,000. Prepare the cash flows from financing activities section of the statement of cash flows.

### SOLUTION

Cash flows from financing activities:

Issuance of long-term bonds	\$1,000,000
Repayment of notes payable	(200,000)
Payment of dividends	(25,000)
Purchase of treasury stock	(50,000)
Net cash flows from financing activities	<u>\$ 725,000</u>

Note: Interest is an operating activity. The exchange of the notes payable for equipment is a noncash investing and financing transaction.

**TRY IT! SE5, SE6, E7A, E8A, E7B, E8B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Evaluate a company's cash-generating efficiency
  - Cash flow yield
  - Cash flows to sales
  - Cash flows to assets
  - Free cash flow
- Ethics

## RELEVANT LEARNING OBJECTIVE

- LO 5** Analyze the statement of cash flows.

CASH FLOW

**LO 5** Analyzing Cash Flows

An analysis of the statement of cash flows can reveal significant relationships. One area on which analysts focus is the cash inflows and outflows from operating activities, the first section on the statement of cash flows. Analysts use the information in this section to compute cash flow yield, cash flows to sales, cash flows to assets, and free cash flow.

**Cash Flow Ratios**

Cash flows from operating activities represent the cash generated from current or continuing operations. They are a measure of the ability to pay bills on time and to meet unexpected needs for cash, as well as how management spends the company's cash.

While the level of cash at the bottom of the statement of cash flows is certainly an important consideration, such information can be obtained from the balance sheet. The focal point of cash flow analysis is on cash inflows and outflows from operating activities. These cash flows are used in ratios that measure **cash-generating efficiency**, which is a company's ability to generate cash from its current or continuing operations. The ratios that analysts use to compute cash-generating efficiency are cash flow yield, cash flows to sales, and cash flows to assets.

In this section, we compute these ratios for **Amazon.com** in 2011 using data for net income and net cash flows from Exhibit 1 and the following information from Amazon.com's 2011 annual report (all dollar amounts are in millions):

	2011	2010
Net sales	\$48,077	\$34,204
Total assets	25,278	18,797

**Cash Flow Yield** **Cash flow yield** is the ratio of net cash flows from operating activities to net income. For **Amazon.com**, it is calculated as follows.

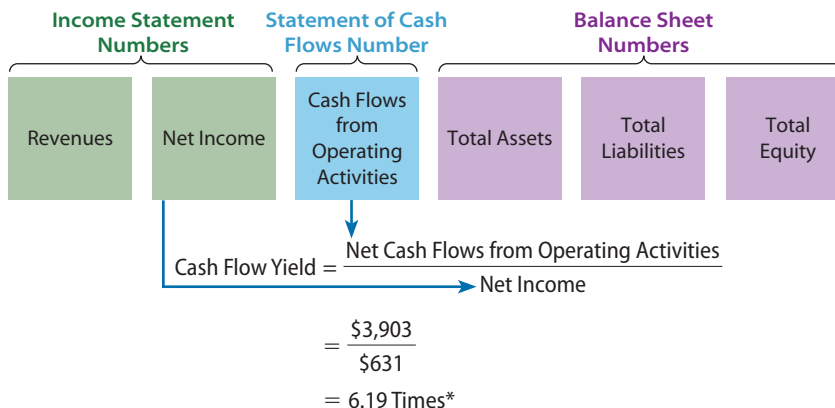
**Business Perspective****Can a Company Have Too Much Cash?**

Having a surplus of cash on hand can be a benefit or a risk. Many companies put their excess cash to good use by investing in productive assets, conducting research and development, paying off debt, buying back stock, or paying dividends. Of course, companies must also keep enough cash on hand for emergencies; but when companies like **ExxonMobil**, **Microsoft**, and **Cisco Systems** accumulated large amounts of cash before the market crash in 2008, some commentators argued that this was poor management. They pointed out that shareholders suffer when executives are too conservative and keep the money in low-paying money market accounts or make unwise acquisitions.<sup>3</sup> However, these companies and others, like **Ford** and **Google**, that had cash reserves not only survived the down years, but also were prospering by 2010.<sup>4</sup> For financial statement users, it is important to look closely at the components of the statement of cash flows.

© Aljja / iStockphoto.com

**RATIO**

**Cash Flow Yield: How Much Operating Cash Did Each Dollar of Net Income Generate?**



\*Rounded

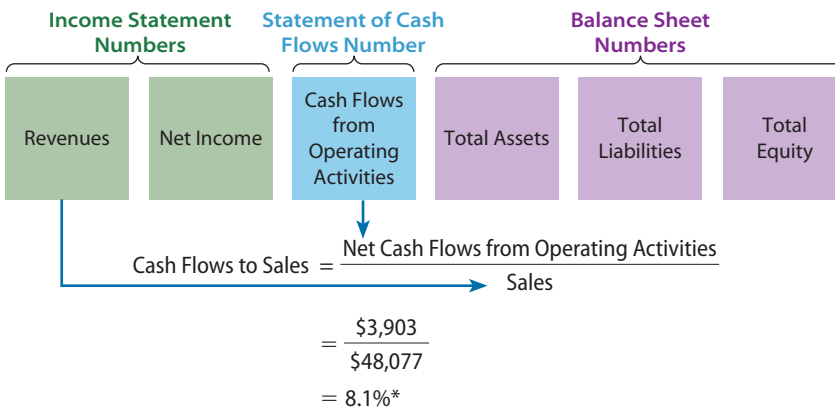
Cash flow yield is an important financial ratio because it shows whether a company is generating sufficient cash flow in relation to its net income or profitability. For most companies, the cash flow yield should exceed 1.0. Amazon.com’s cash flow yield in 2011 was much better than that. With a cash flow yield of 6.19 times, Amazon.com was generating about \$6.19 of cash for every dollar of net income.

The cash flow yield needs to be examined carefully. For instance, a firm with significant depreciable assets should have a cash flow yield greater than 1.0 because depreciation expense is added back to net income to arrive at cash flows from operating activities. If special items, such as discontinued operations, appear on the income statement and are material, income from continuing operations (from the income statement) should be used as the denominator. Also, an artificially high cash flow yield may result because a firm has very low net income, which is the denominator in the ratio.

**Cash Flows to Sales** Cash flows to sales is the ratio of net cash flows from operating activities to net sales. For Amazon.com, it is calculated as follows.

**RATIO**

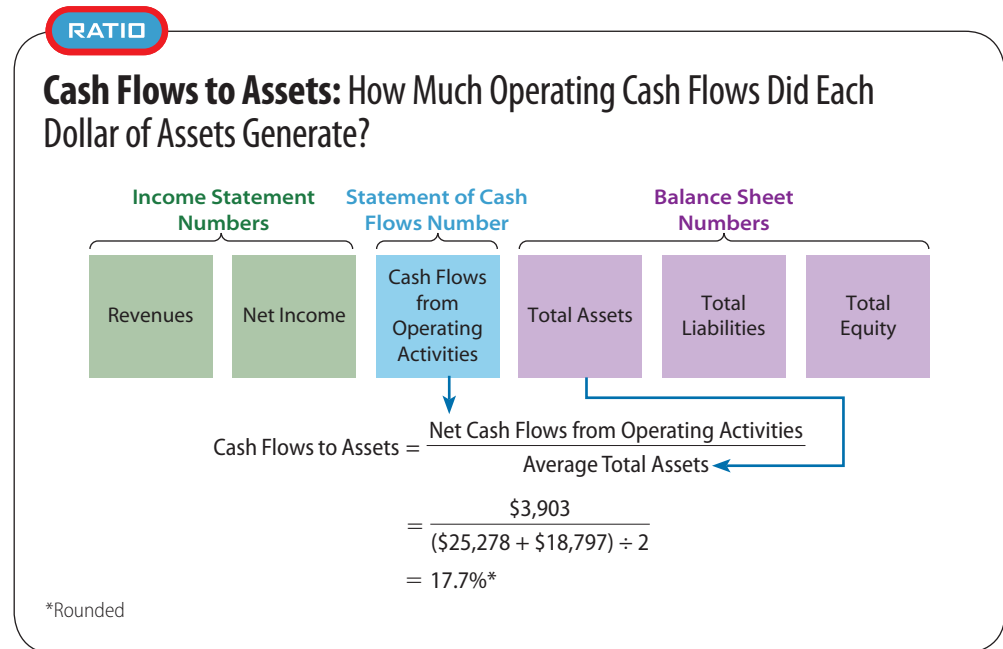
**Cash Flows to Sales: How Much Operating Cash Flows Did Each Dollar of Sales Generate?**



\*Rounded

Amazon.com generated positive cash flows to sales of 8.1 percent. Another way to state this result is that every dollar of sales generated 8.1 cents in cash.

**Cash Flows to Assets** **Cash flows to assets** is the ratio of net cash flows from operating activities to average total assets. **Amazon.com**'s ratio is calculated as follows.



At 17.7 percent, Amazon.com's cash flows to assets ratio indicates that for every dollar of assets, the company generated almost 18 cents. This excellent result is higher than its cash flows to sales ratio because of its good asset turnover ratio:

$$\begin{aligned} \text{Asset Turnover} &= \text{Sales} \div \text{Average Total Assets} \\ 2.2 \text{ Times}^* &= \$48,077 \div \$22,038 \\ &\text{or} \\ \text{Asset Turnover} &= \text{Cash Flows to Assets} \div \text{Cash Flows to Sales} \\ 2.2 \text{ Times}^* &= 17.7\% \div 8.1\% \end{aligned}$$

\* Rounded

Cash flows to sales and cash flows to assets are closely related to the profitability measures of profit margin and return on assets. They exceed those measures by the amount of the cash flow yield ratio because cash flow yield is the ratio of net cash flows from operating activities to net income.

## Free Cash Flow

As noted in an earlier chapter, **free cash flow** is the amount of cash that remains after deducting the funds a company must commit to continue operating at its planned level. Free cash flow is a very useful analytic tool. A study of 100 different measures showed it to be the best predictor of future increases in stock price.<sup>5</sup>

Free cash flow can be positive or negative:

- *Positive free cash flow* means that the company has met all of its planned cash commitments and has cash available to reduce debt or to expand.
- *Negative free cash flow* means that the company will have to sell investments, borrow money, or issue stock in the short term to continue at its planned level. If a company's free cash flow remains negative for several years, it may not be able to raise cash by issuing stocks or bonds. On the statement of cash flows, cash commitments for current and continuing operations, interest, and income taxes are incorporated in cash flows from current operations.

**Amazon.com** has a stated primary financial objective of “long-term sustainable growth in free cash flow.”<sup>6</sup> The company definitely achieved this objective in 2011, as shown in the computation (in millions) that follows.

**STUDY NOTE:** The computation for free cash flow sometimes uses net capital expenditures in place of purchases plus sales of plant assets.

$$\begin{aligned} \text{Free Cash Flow} &= \text{Net Cash Flows from Operating Activities} - \text{Dividends} - \text{Purchases of Plant Assets} + \text{Sales of Plant Assets} \\ &= \$3,903 - \$0 - \$1,811 + \$0 \\ &= \$2,092 \end{aligned}$$

Purchases of plant assets (capital expenditures) and sales (dispositions) of plant assets, if any, appear in the investing activities section of the statement of cash flows. Dividends, if any, appear in the financing activities section. Amazon.com is a growing company and does not have material sales of plant assets and does not pay dividends. The company's positive free cash flow of \$2,092 million was due primarily to its strong operating cash flow of \$3,903 million. Consequently, the company does not have to borrow money to expand.

## Asking the Right Questions About the Statement of Cash Flows

Most readers of financial statements are accustomed to looking at the “bottom line” to get an overview of a company's financial status. They look at total assets on the balance sheet and net income on the income statement. However, the statement of cash flows requires a different approach because changes in the components of the statement during the year are far more revealing.

In interpreting a statement of cash flows, it pays to know the right questions to ask. To illustrate, we will use **Amazon.com** as an example.

**Cash Flows and Net Income** *What are the primary reasons that Amazon.com's cash flows from operating activities differed from net income in 2011?*

For Amazon.com, the largest positive items in 2011 were accounts payable and depreciation. They are added to net income for different reasons. Accounts payable represents



## Business Perspective

### What Do You Mean, “Free Cash Flow”?

Because the statement of cash flows has been around for less than 25 years, no generally accepted analyses have yet been developed. For example, the term *free cash flow* is commonly used in the business press, but there is no agreement on its definition. An article in *Forbes* defines *free cash flow* as “cash available after paying out capital expenditures and dividends, but *before taxes and interest*” [emphasis added].<sup>7</sup> An article in *The Wall Street Journal* defines it as “operating income less maintenance-level capital expenditures.”<sup>8</sup> The definition with which we are most in agreement is the one used in *BusinessWeek*: free cash flow is net cash flows from operating activities less net capital expenditures and dividends. This “measures truly discretionary funds—company money that an owner could pocket without harming the business.”<sup>9</sup>



an increase in the amount owed to creditors, whereas depreciation represents a noncash expense that is deducted in arriving at net income. Amazon.com's two largest negative items were increases in inventories and amortization of unearned revenue. As a growing company, Amazon.com was managing its operating cycle by generating cash from creditors to pay for increases in inventories.

**Investing Activities** *What were Amazon.com's most important investing activities other than capital expenditures?*

Amazon.com was actively buying and selling investments. However, sales of marketable securities and other investments were not sufficient to offset the purchase of marketable securities and other investments and the purchase of various assets.

**Financing Activities** *How did Amazon.com manage its financing activities during 2011?*

Excess tax benefits from stock-based compensation and proceeds from long-term debt provided some funds to buy back treasury stock and pay off some long-term debt, but the inflows were less than the outflows. Because of its good cash flow from operations, Amazon.com did not need long-term financing.

**Cash Flow Trends** *What has been the trend of cash flows for Amazon.com?*

Because cash flows can vary from year to year, analysts should look at trends in cash flow measures over several years. For example, Amazon.com's management states:

*Because of our model we are able to turn our inventory quickly and have a cash-generating operating cycle. On average our high inventory velocity means we generally collect from consumers before our payments to suppliers come due. Inventory turnover was 10, 11, and 12 for 2011, 2010, and 2009. We expect variability in inventory turnover over time since it is affected by several factors, including our product mix, the mix of sales by us and by other sellers, our continuing focus on in-stock inventory availability, our investment in new geographies and product lines, and the extent to which we choose to utilize outsource fulfillment providers. Accounts payable days were 74, 72, and 68 for 2011, 2010, and 2009. We expect some variability in accounts payable days over time since they are affected by several factors, including the mix of product sales, the mix of sales by other sellers, the mix of suppliers, seasonality, and changes in payment terms over time, including the effect of balancing pricing and timing of payment terms with suppliers.<sup>10</sup>*

## Ethical Considerations in Analyzing the Statement of Cash Flows

Although cash inflows and outflows are not as subject to manipulation as earnings are, managers are acutely aware of users' emphasis on cash flows from operations as an important measure of performance. Thus, an incentive exists to overstate these cash flows.

In earlier chapters, we cited an egregious example of earnings management. As you may recall, by treating operating expenses of about \$10 billion over several years as purchases of equipment, **WorldCom** reduced reported expenses and improved reported earnings. In addition, by classifying payments of operating expenses as investments on the statement of cash flows, it was able to show an improvement in cash flows from operations. The inclusion of the expenditures in the investing activities section did not draw special attention because the company normally had large capital expenditures.

Another way a company can show an apparent improvement in its performance is through lack of transparency, or lack of full disclosure, in its financial statements. For instance, securitization—the sale of batches of accounts receivable—is clearly a means of financing, and the proceeds from it should be shown in the financing activities section of the statement of cash flows. However, because the accounting standards are somewhat vague about where these proceeds should go, some companies net the proceeds against the accounts receivable in the operating activities section of the statement and bury the explanation in the notes to the financial statements. By doing so, they make collections of receivables look better than they actually were. It is not illegal to do this; but from an ethical standpoint, it obscures the company's true performance.

## APPLY IT!

In 2015, Benson Corporation had year-end assets of \$2,400,000, sales of \$2,000,000, net income of \$400,000, net cash flows from operating activities of \$360,000, dividends of \$100,000, purchases of plant assets of \$200,000, and sales of plant assets of \$40,000. In 2014, year-end assets were \$2,200,000. Calculate cash flow yield, cash flows to sales, cash flows to assets, and free cash flow.

### SOLUTION

$$\text{Cash Flow Yield} = \frac{\$360,000}{\$400,000} = 0.9 \text{ Time}$$

$$\text{Cash Flows to Sales} = \frac{\$360,000}{\$2,000,000} = 0.18, \text{ or } 18\%$$

$$\text{Cash Flows to Assets} = \frac{\$360,000}{(\$2,400,000 + \$2,200,000) \div 2} = 0.16, \text{ or } 16\% \text{ (rounded)}$$

$$\text{Free Cash Flow} = \$360,000 - \$100,000 - \$200,000 + \$40,000 = \$100,000$$

### TRY IT! SE7, SE8, E9A, E9B

## TriLevel Problem



Deliga Corporation

The beginning of this chapter focused on Deliga Corporation, whose managers were concerned because in 2015, cash flows from operating activities were less than net income, cash and cash equivalents declined during the year, and the company was having trouble paying its bills on time. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*How do relevance and classification apply to the statement of cash flows?*

### Section 2: Accounting Applications

*How is the statement of cash flows prepared using the indirect method?*

Prepare a statement of cash flows using Deliga Corporation's income statement for 2015 and comparative balance sheets for 2015 and 2014 that follow.

	A	B	C	D	E
1	<b>Deliga Corporation</b>				
2	<b>Income Statement</b>				
3	<b>For the Year Ended December 31, 2015</b>				
4					
5	Net sales				\$825,000
6	Cost of goods sold				460,000
7	Gross margin				\$365,000
8	Operating expenses (including depreciation expense of \$6,000				
9	on buildings and \$11,550 on equipment and amortization				
10	expense of \$2,400)				235,000
11	Operating income				\$130,000
12	Other income:				
13	Interest expense			\$(27,500)	
14	Dividend income			1,700	
15	Gain on sale of investments			6,250	
16	Loss on disposal of equipment			(1,150)	(20,700)
17	Income before income taxes				\$109,300
18	Income taxes expense				26,100
19	Net income				\$ 83,200

	A	B	C	D	E	F
1	<b>Deliga Corporation</b>					
2	<b>Comparative Balance Sheets</b>					
3	<b>December 31, 2015 and 2014</b>					
4						<b>Increase or</b>
5			<b>2015</b>	<b>2014</b>	<b>Change</b>	<b>Decrease</b>
6	<b>Assets</b>					
7	Cash		\$ 52,925	\$ 60,925	\$ (8,000)	Decrease
8	Accounts receivable (net)		148,000	157,250	(9,250)	Decrease
9	Inventory		161,000	150,500	10,500	Increase
10	Prepaid expenses		3,900	2,900	1,000	Increase
11	Long-term investments		18,000	43,000	(25,000)	Decrease
12	Land		75,000	62,500	12,500	Increase
13	Buildings		231,000	231,000	—	—
14	Accumulated depreciation—buildings		(45,500)	(39,500)	(6,000)	Increase
15	Equipment		79,865	83,615	(3,750)	Decrease
16	Accumulated depreciation—equipment		(21,700)	(22,800)	1,100	Decrease
17	Intangible assets		9,600	12,000	(2,400)	Decrease
18	Total assets		\$712,090	\$741,390	\$(29,300)	
19						
20	<b>Liabilities and Stockholders' Equity</b>					
21	Accounts payable		\$ 66,875	\$116,875	\$(50,000)	Decrease
22	Notes payable (current)		37,850	72,850	(35,000)	Decrease
23	Accrued liabilities		2,500	—	2,500	Increase
24	Income taxes payable		10,000	—	10,000	Increase
25	Bonds payable		105,000	155,000	(50,000)	Decrease
26	Mortgage payable		165,000	175,000	(10,000)	Decrease
27	Common stock, \$10 par value		200,000	170,000	30,000	Increase
28	Additional paid-in capital		45,000	25,000	20,000	Increase
29	Retained earnings		104,865	46,665	58,200	Increase
30	Treasury stock		(25,000)	(20,000)	(5,000)	Increase
31	Total liabilities and stockholders' equity		\$712,090	\$741,390	\$(29,300)	

The company's records for 2015 provide this additional information:

- a. Sold long-term investments that cost \$35,000 for a gain of \$6,250; made other long-term investments in the amount of \$10,000.
- b. Purchased five acres of land to build a parking lot for \$12,500.
- c. Sold equipment that cost \$18,750 and that had accumulated depreciation of \$12,650 at a loss of \$1,150; purchased new equipment for \$15,000.
- d. Repaid notes payable in the amount of \$50,000; borrowed \$15,000 by signing new notes payable.
- e. Converted \$50,000 of bonds payable into 3,000 shares of common stock.
- f. Reduced the Mortgage Payable account by \$10,000.
- g. Declared and paid cash dividends of \$25,000.
- h. Purchased treasury stock for \$5,000.

### Section 3: Business Applications

*What measures may be used to explain the apparent cause of Deliga's operating cash flow problem and the decline in its cash and cash equivalents?*

Compute the company's cash flow yield, cash flows to sales, cash flows to assets, and free cash flow for 2015. (Round ratios to the nearest decimal point.) What do your results indicate about the company's cash-generating efficiency? What do they indicate about Deliga's need to sell investments, issue stock, or borrow money to maintain current operations or finance future growth?

## SOLUTION

### Section 1: Concepts

The statement of cash flows is *relevant* to management, investors, and creditors for assessing the current and future liquidity of a company, its dividend policy, and its financing needs. Operating activities *classify* inflows and outflows from operating activities and include among other things cash inflows from the sales of goods and services, sale of trading securities, as well as interest and dividends on loans and investments while cash outflows include cash spent for wages, inventory, expenses, interest, taxes, and purchase of trading securities. Investing activities *classify* the acquisition and sale of short-term marketable securities, long-term investments, and property, plant, and equipment and the making and collecting of loans. Financing activities *classify* obtaining resources from stockholders and creditors and show proceeds from stock issues and from short- and long-term borrowings and deductions for repayment of loans, payment of dividends, and purchase of treasury stock. Finally, noncash investing and financing activities are *disclosed* in a separate schedule.

## Section 2: Accounting Applications

	A	B	C	D	E
1	<b>Deliga Corporation</b>				
2	<b>Statement of Cash Flows</b>				
3	<b>For the Year Ended December 31, 2015</b>				
4					
5	Cash flows from operating activities:				
6	Net income				\$83,200
7	Adjustments to reconcile net income to net cash flows				
8	from operating activities:				
9			Depreciation expense—buildings	\$ 6,000	
10			Depreciation expense—equipment	11,550	
11			Amortization expense—intangible assets	2,400	
12			Gain on sale of investments	(6,250)	
13			Loss on disposal of equipment	1,150	
14	Changes in current assets and current liabilities:				
15			Decrease in accounts receivable	9,250	
16			Increase in inventory	(10,500)	
17			Increase in prepaid expenses	(1,000)	
18			Decrease in accounts payable	(50,000)	
19			Increase in accrued liabilities	2,500	
20			Increase in income taxes payable	10,000	(24,900)
21	Net cash flows from operating activities				\$58,300
22	Cash flows from investing activities:				
23	Sale of long-term investments			\$ 41,250 <sup>a</sup>	
24	Purchase of long-term investments			(10,000)	
25	Purchase of land			(12,500)	
26	Sale of equipment			4,950 <sup>b</sup>	
27	Purchase of equipment			(15,000)	
28	Net cash flows from investing activities				8,700
29	Cash flows from financing activities:				
30	Repayment of notes payable			\$(50,000)	
31	Issuance of notes payable			15,000	
32	Reduction in mortgage			(10,000)	
33	Dividends paid			(25,000)	
34	Purchase of treasury stock			(5,000)	
35	Net cash flows from financing activities				(75,000)
36	Net (decrease) in cash				\$ (8,000)
37	Cash at beginning of year				60,925
38	Cash at end of year				\$52,925
39					
40	<b>Schedule of Noncash Investing and Financing Transactions</b>				
41	Conversion of bonds payable into common stock				\$50,000
42					
43	<sup>a</sup> \$35,000 + \$6,250 (gain) = \$41,250				
44	<sup>b</sup> \$18,750 – \$12,650 = \$6,100 (book value) – \$1,150 (loss) = \$4,950				

## Section 3: Business Applications

$$\text{Cash Flow Yield} = \frac{\$58,300}{\$83,200} = 0.7 \text{ Time}^*$$

$$\text{Cash Flows to Sales} = \frac{\$58,300}{\$825,000} = 7.1\%^*$$

$$\text{Cash Flows to Assets} = \frac{\$58,300}{(\$712,090 + \$741,390) \div 2} = 8.0\%^*$$

$$\text{Free Cash Flow} = \$58,300 - \$25,000 - \$12,500 - \$15,000 + \$4,950 = \$10,750$$

\*Rounded

Deliga should generate at least \$1 of net cash flows from operations for each \$1 of net income. However, its cash flow yield shows that it generated only 70 cents for each \$1 of net income. Judging from this result alone, Deliga's cash-generating efficiency is weak, and it seems likely that the company will have to sell investments, borrow money, or issue stock to maintain current operations or finance future growth.

The operating activities section of Deliga's statement of cash flows shows that the company reduced its accounts payable by \$50,000. This one item more than offset the effects of all the other items and accounts for Deliga's operating cash flow problem and the decline in its cash and cash equivalents. Either Deliga unnecessarily paid its creditors a large amount, or its creditors have changed their terms. In the aftermath of the recession of the last few years, it has not been unusual for creditors to give less favorable terms as credit from banks has tightened.

## Chapter Review

**Describe the principal purposes and concepts underlying the statement of cash flows, and identify its components and format.** **LO 1**

The statement of cash flows is relevant to investors and creditors by providing information about a company's cash receipts and cash payments during a period in order to assess the company's cash-generating ability. It is relevant to management to assess liquidity, determine dividend policy, and plan investing and financing activities. Investors and creditors use it to assess the company's cash-generating ability.

The statement of cash flows has three major classifications: (1) operating activities, which involve the cash effects of transactions and other events that enter into the determination of net income; (2) investing activities, which involve the acquisition and sale of marketable securities and long-term assets and the making and collecting of loans; and (3) financing activities, which involve obtaining resources from stockholders and creditors. Noncash investing and financing transactions are also important because they affect future cash flows.

**Use the indirect method to determine cash flows from operating activities.** **LO 2**

The indirect method adjusts net income for all items in the income statement that do not have cash flow effects (such as depreciation, amortization, and gains and losses on sales of assets) and for changes in assets and liabilities that affect operating cash flows. Generally, increases in current assets have a negative effect on cash flows, and decreases have a positive effect. Conversely, increases in current liabilities have a positive effect on cash flows, and decreases have a negative effect.

**Determine cash flows from investing activities.** **LO 3**

Investing activities involve the acquisition and sale of property, plant, and equipment and other long-term assets, including long-term investments. They also involve the acquisition and sale of short-term marketable securities, other than trading securities, and the making and collecting of loans. Cash flows from investing activities are determined by analyzing the cash flow effects of changes in each account related to investing activities. The effects of gains and losses reported on the income statement must also be considered.



Determine cash flows from financing activities. **LO 4**

Determining cash flows from financing activities is almost identical to determining cash flows from investing activities. The difference is that the accounts analyzed relate to short-term borrowings, long-term liabilities, and stockholders' equity. After the changes in the balance sheet accounts from one accounting period to the next have been explained, all the cash flow effects should have been identified, and the statement of cash flows can be prepared.

Analyze the statement of cash flows. **LO 5**

Analysts tend to focus on a firm's degree of liquidity, which is determined by cash inflows and outflows. The ratios used to measure a firm's ability to generate sufficient cash are cash flow yield, cash flows to sales, and cash flows to assets. Free cash flow—the cash that remains after deducting the funds a firm must commit to continue operating at its planned level—is another important measure of the adequacy of cash flow.

## Key Terms and Ratios

**cash** 602 (LO1)  
**cash equivalents** 602 (LO1)  
**direct method** 605 (LO1)  
**financing activities** 603 (LO1)  
**indirect method** 606 (LO1)  
**investing activities** 603 (LO1)

**marketable securities** 602 (LO1)  
**noncash investing and financing transactions** 605 (LO1)  
**operating activities** 603 (LO1)  
**statement of cash flows** 602 (LO1)  
**trading securities** 603 (LO1)

**RATIOS**  
**cash flow yield** 622 (LO5)  
**cash flows to assets** 624 (LO5)  
**cash flows to sales** 623 (LO5)  
**cash-generating efficiency** 622 (LO5)  
**free cash flow** 624 (LO5)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1** **DQ1.** Which statement is more useful—the income statement or the statement of cash flows?
- LO 2** **DQ2.** If a company has positive earnings, can cash flows from operating activities ever be negative?
- LO 2, 3** **DQ3.** Which adjustments to net income in the operating activities section of the statement of cash flows are directly related to cash flows in other sections?
- LO 5** **DQ4.** How would you respond to someone who says that the most important item on the statement of cash flows is the change in the cash balance for the year?
- LO 5** **DQ5. BUSINESS APPLICATION** ► If a company's cash flow yield is less than 1.0, would its cash flows to sales and cash flows to assets be greater or less than profit margin and return on assets, respectively?
- LO 5** **DQ6. BUSINESS APPLICATION** ► In computing free cash flow, what is an argument for treating the purchases of treasury stock like dividend payments?

### SHORT EXERCISES

- LO 1** **Classification of Cash Flow Transactions**
- SE1. CONCEPT** ► The list that follows itemizes Alpha Pro Corporation's transactions. Identify each as (a) an operating activity, (b) an investing activity, (c) a financing activity, (d) a noncash transaction, or (e) none of the above.
- Sold land.
  - Declared and paid a cash dividend.

3. Paid interest.
4. Issued common stock for plant assets.
5. Issued preferred stock.
6. Borrowed cash on a bank loan.

**LO 2 Computing Cash Flows from Operating Activities: Indirect Method**

**SE2.** Stewart Construction Corporation had a net income of \$16,500 during 2014. In that year, the company had depreciation expense of \$7,000. Accounts Receivable increased by \$5,500, and Accounts Payable increased by \$2,500. Those were the company's only current assets and current liabilities. Use the indirect method to determine net cash flows from operating activities.

**LO 2 Computing Cash Flows from Operating Activities: Indirect Method**

**SE3.** During 2014, Cupello Corporation had a net income of \$144,000. Included on its income statement were depreciation expense of \$16,000 and amortization expense of \$1,800. During the year, Accounts Receivable decreased by \$8,200, Inventories increased by \$5,400, Prepaid Expenses decreased by \$1,000, Accounts Payable decreased by \$14,000, and Accrued Liabilities decreased by \$1,700. Use the indirect method to determine net cash flows from operating activities.

**LO 3 Cash Flows from Investing Activities and Noncash Transactions**

**SE4.** During 2014, Fargo Company purchased land for \$375,000. It paid \$125,000 in cash and signed a \$250,000 mortgage for the rest. The company also sold for \$95,000 cash a building that originally cost \$90,000, on which it had \$70,000 of accumulated depreciation, making a gain of \$75,000. Prepare the cash flows from investing activities section and the schedule of noncash investing and financing transactions of the statement of cash flows.

**LO 4 Cash Flows from Financing Activities**

**SE5.** During 2014, North Dakota Company issued \$1,000,000 in long-term bonds at 96, repaid \$150,000 of bonds at face value, paid interest of \$80,000, and paid dividends of \$50,000. Prepare the cash flows from the financing activities section of the statement of cash flows.

**LO 1, 2, 3, 4 Identifying Components of the Statement of Cash Flows**

**SE6. CONCEPT** ▶ Assuming the indirect method is used to prepare the statement of cash flows, tell whether each of the following items would be reported (a) in cash flows from operating activities, (b) in cash flows from investing activities, (c) in cash flows from financing activities, (d) in the schedule of noncash investing and financing transactions, or (e) not on the statement of cash flows at all:

1. Dividends paid
2. Cash receipts from sales
3. Decrease in accounts receivable
4. Sale of plant assets
5. Gain on sale of investments
6. Issue of stock for plant assets
7. Issue of common stock
8. Net income

**LO 5 Cash-Generating Efficiency Ratios and Free Cash Flow**



**SE7. BUSINESS APPLICATION** ▶ In 2014, Melvin Corporation had year-end assets of \$1,100,000, sales of \$1,580,000, net income of \$180,000, net cash flows from operating activities of \$360,000, purchases of plant assets of \$240,000, and sales of plant assets of \$40,000, and it paid dividends of \$80,000. In 2013, year-end assets were \$1,000,000. Calculate the cash-generating efficiency ratios of cash flow yield, cash flows to sales, and cash flows to assets. Also calculate free cash flow. (Round to the nearest tenth of a percent.)

LO 5 **Cash-Generating Efficiency Ratios and Free Cash Flow**

RATIO

**SE8. BUSINESS APPLICATION** ► Examine the cash flow measures in requirement 3 of the TriLevel Problem at the end of this chapter. Discuss the meaning of these ratios.

**EXERCISES: SET A**LO 1 **Classification of Cash Flow Transactions**

**E1A. CONCEPT** ► VIP Corporation engaged in the transactions that follow. Identify each transaction as (a) an operating activity, (b) an investing activity, (c) a financing activity, (d) a noncash transaction, or (e) not on the statement of cash flows. Assume the indirect method is used. (*Hint:* More than one answer may apply.)

1. Paid interest.
2. Increased dividends receivable.
3. Declared and paid a cash dividend.
4. Purchased a long-term investment.
5. Increased accounts receivable.
6. Sold equipment at a loss.
7. Issued long-term bonds for plant assets.
8. Issued common stock.
9. Declared and issued a stock dividend.
10. Decreased wages payable.
11. Purchased a 60-day Treasury bill.
12. Repaid notes payable.
13. Purchased land.

LO 2 **Cash Flows from Operating Activities: Indirect Method**

**E2A.** The condensed single-step income statement for the year ended December 31, 2014, of Conti Chemical Company, a distributor of farm fertilizers and herbicides, follows.

Sales		\$26,000,000
Less: Cost of goods sold	\$15,200,000	
Operating expenses (including depreciation of \$1,640,000)	7,600,000	
Income taxes expense	800,000	23,600,000
Net income		<u>\$ 2,400,000</u>

Selected accounts from Conti Chemical's balance sheets for 2014 and 2013 follow.

	2014	2013
Accounts receivable	\$4,800,000	\$3,400,000
Inventory	1,680,000	2,040,000
Prepaid expenses	520,000	360,000
Accounts payable	1,920,000	1,440,000
Accrued liabilities	120,000	200,000
Income taxes payable	280,000	240,000

Prepare a schedule of cash flows from operating activities using the indirect method.

LO 2 **Computing Cash Flows from Operating Activities: Indirect Method**

**E3A.** During 2014, Ortega Corporation had net income of \$82,000. Included on its income statement were depreciation expense of \$4,600 and amortization expense of \$600. During the year, Accounts Receivable increased by \$6,800, Inventories decreased by \$3,800, Prepaid Expenses decreased by \$400, Accounts Payable increased by \$10,000, and Accrued Liabilities decreased by \$900. Determine net cash flows from operating activities using the indirect method.

**LO 2 Preparing a Schedule of Cash Flows from Operating Activities: Indirect Method**

**E4A.** For the year ended June 30, 2014, net income for Flake Corporation was \$14,800. Depreciation expense was \$4,000. During the year, Accounts Receivable increased by \$8,800, Inventories increased by \$14,000, Prepaid Rent decreased by \$2,800, Accounts Payable increased by \$28,000, Salaries Payable increased by \$2,000, and Income Taxes Payable decreased by \$1,200. Use the indirect method to prepare a schedule of cash flows from operating activities.

**LO 3 Computing Cash Flows from Investing Activities: Investments**

**E5A.** Wilma Company's T account for long-term available-for-sale investments at the end of 2014 follows.

Investments			
<i>Dr.</i>		<i>Cr.</i>	
Beg. Bal.	76,000	Sales of Investments	78,000
Purchases of Investments	116,000		
<b>End. Bal.</b>	<b>114,000</b>		

In addition, Wilma's income statement shows a loss on the sale of investments of \$13,000. Compute the amounts to be shown as cash flows from investing activities, and show how they appear in the statement of cash flows.

**LO 3 Computing Cash Flows from Investing Activities: Plant Assets**

**E6A.** The T accounts for plant assets and accumulated depreciation for Street Company at the end of 2014 follow.

Plant Assets				Accumulated Depreciation			
<i>Dr.</i>		<i>Cr.</i>		<i>Dr.</i>		<i>Cr.</i>	
Beg. Bal.	130,000	Disposals	46,000	Disposals	29,400	Beg. Bal.	69,000
Purchases	67,200					Depreciation	20,400
<b>End. Bal.</b>	<b>151,200</b>					<b>End. Bal.</b>	<b>60,000</b>

In addition, Street's income statement shows a gain on sale of plant assets of \$8,800. Compute the amounts to be shown as cash flows from investing activities, and show how they appear on the statement of cash flows.

**LO 4 Determining Cash Flows from Financing Activities: Notes Payable**

**E7A.** All transactions involving Notes Payable and related accounts of Sally Company during 2014 follow.

Cash	<i>Dr.</i>	36,000	<i>Cr.</i>
Notes Payable			36,000
Bank loan			
	<i>Dr.</i>	<i>Cr.</i>	
Patent	60,000		
Notes Payable			60,000
Purchase of patent by issuing note payable			
	<i>Dr.</i>	<i>Cr.</i>	
Notes Payable	10,000		
Interest Expense	1,000		
Cash			11,000
Repayment of note payable at maturity			

Determine the amounts of the transactions affecting financing activities and show how they appear on the statement of cash flows for 2014.

LO 2, 3, 4 **Preparing the Statement of Cash Flows: Indirect Method**

**E8A.** Keeper Corporation's income statement for the year ended June 30, 2014, and its comparative balance sheets for June 30, 2014 and 2013 follow.

<b>Keeper Corporation</b>	
<b>Income Statement</b>	
<b>For the Year Ended June 30, 2014</b>	
Sales	\$234,000
Cost of goods sold	156,000
Gross margin	<u>\$ 78,000</u>
Operating expenses	45,000
Operating income	<u>\$ 33,000</u>
Interest expense	2,800
Income before income taxes	<u>\$ 30,200</u>
Income taxes expense	12,300
Net income	<u><u>\$ 17,900</u></u>

<b>Keeper Corporation</b>		
<b>Comparative Balance Sheets</b>		
<b>June 30, 2014 and 2013</b>		
	<b>2014</b>	<b>2013</b>
<b>Assets</b>		
Cash	\$ 69,900	\$ 12,500
Accounts receivable (net)	21,000	26,000
Inventory	43,400	48,400
Prepaid expenses	3,200	2,600
Furniture	55,000	60,000
Accumulated depreciation—furniture	(9,000)	(5,000)
Total assets	<u>\$183,500</u>	<u>\$144,500</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 13,000	\$ 14,000
Income taxes payable	1,200	1,800
Notes payable (long-term)	37,000	35,000
Common stock, \$10 par value	115,000	90,000
Retained earnings	17,300	3,700
Total liabilities and stockholders' equity	<u>\$183,500</u>	<u>\$144,500</u>

Keeper issued a \$22,000 note payable for purchase of furniture; sold at carrying value furniture that cost \$27,000 with accumulated depreciation of \$15,300; recorded depreciation on the furniture for the year, \$19,300; repaid a note in the amount of \$20,000; issued \$25,000 of common stock at par value; and paid dividends of \$4,300. Prepare Keeper's statement of cash flows for the year 2014 using the indirect method.

LO 5 **Cash-Generating Efficiency Ratios and Free Cash Flow**

**RATIO**

**E9A. BUSINESS APPLICATION** ▶ In 2014, Andy's Corporation had year-end assets of \$2,400,000, sales of \$3,300,000, net income of \$280,000, net cash flows from operating activities of \$390,000, dividends of \$120,000, purchases of plant assets of \$500,000, and sales of plant assets of \$90,000. In 2013, year-end assets were \$2,100,000. Calculate free cash flow and the cash-generating efficiency ratios of cash flow yield, cash flows to sales, and cash flows to assets. (Round to one decimal point or the nearest tenth of a percent.)

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 1 Classification of Cash Flow Transactions

**P1. CONCEPT** ► Analyze each transaction listed in the table that follows and place X's in the appropriate columns to indicate the transaction's classification and its effect on cash flows using the indirect method.

Transaction	Cash Flow Classification				Effect on Cash Flows		
	Operating Activity	Investing Activity	Financing Activity	Noncash Transaction	Increase	Decrease	No Effect
1. Paid a cash dividend.							
2. Decreased accounts receivable.							
3. Increased inventory.							
4. Incurred a net loss.							
5. Declared and issued a stock dividend.							
6. Retired long-term debt with cash.							
7. Sold available-for-sale securities at a loss.							
8. Issued stock for equipment.							
9. Decreased prepaid insurance.							
10. Purchased treasury stock with cash.							
11. Retired a fully depreciated truck (no gain or loss).							
12. Increased interest payable.							
13. Decreased dividends receivable on investment.							
14. Sold treasury stock.							
15. Increased income taxes payable.							
16. Transferred cash to money market account.							
17. Purchased land and building with a mortgage.							

### LO 1, 5 Interpreting and Analyzing the Statement of Cash Flows

**RATIO**

- ✓ 2: Free cash flow, 2013: (\$183,114)
- ✓ 2: Free cash flow, 2014: \$290,316

**P2.** The comparative statements of cash flows for Wung Corporation, a manufacturer of high-quality suits for men, follow. To expand its markets and familiarity with its brand, the company attempted a new strategic diversification in 2013 by acquiring a chain of retail men's stores in outlet malls. Its plan was to expand in malls around the country, but department stores viewed the action as infringing on their territory.

Wung Corporation Statement of Cash Flows For the Years Ended December 31, 2014 and 2013		
(In thousands)	2014	2013
Cash flows from operating activities:		
Net income (loss)	\$ (43,090)	\$ 76,030
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation	\$ 70,438	\$ 50,036
Loss on closure of retail outlets	70,000	
Changes in current assets and current liabilities:		
Decrease (increase) in accounts receivable	100,000	(89,606)
Decrease (increase) in inventory	120,814	(102,290)
Decrease (increase) in prepaid expenses	2,734	4,492
Increase (decrease) in accounts payable	61,158	2,532
Increase (decrease) in accrued liabilities	3,000	(5,576)
Increase (decrease) in income taxes payable	(16,600)	(12,562)
	<u>\$ 411,544</u>	<u>\$(152,974)</u>

(Continued)



Net cash flows from operating activities	\$ 368,454	\$ (76,944)
Cash flows from investing activities:		
Capital expenditures, net	\$ (32,290)	\$ (66,224)
Purchase of Retail Division, cash portion	—	(402,000)
Net cash flows from investing activities	\$ (32,290)	\$ (468,224)
Cash flows from financing activities:		
Increase (decrease) in notes payable to banks	\$ (247,000)	\$ 456,800
Reduction in long-term debt	(18,476)	(21,622)
Payment of dividends	(45,848)	(39,946)
Purchase of treasury stock	—	(25,000)
Net cash flows from financing activities	\$ (311,324)	\$ 370,232
Net increase (decrease) in cash	\$ 24,840	\$ (174,936)
Cash at beginning of year	32,064	207,000
Cash at end of year	\$ 56,904	\$ 32,064

#### Schedule of Noncash Investing and Financing Transactions

Issue of bonds payable for retail acquisition	\$ 100,000
---	------------

#### REQUIRED

Evaluate the success of the company's strategy by answering the questions that follow.

- ACCOUNTING CONNECTION** ► What are the primary reasons cash flows from operating activities differ from net income in 2013 and in 2014? What is the effect of the acquisition in 2013? What conclusions can you draw from the changes in 2014?
- BUSINESS APPLICATION** ► Compute free cash flow for both years. What was the total cost of the acquisition? Was the company able to finance expansion in 2013 by generating internal cash flow? What was the situation in 2013?
- ACCOUNTING CONNECTION** ► What are the most significant financing activities in 2013? How did the company finance the acquisition? Do you think this is a good strategy? What other issues might you question in financing activities?
- ACCOUNTING CONNECTION** ► Based on results in 2014, what actions was the company forced to take and what is your overall assessment of the company's diversification strategy?

LO 2, 3, 4, 5

RATIO

SPREADSHEET

- ✓ 1: Net cash flows from operating activities: \$23,400
- ✓ 1: Net cash flows from investing activities: (\$7,200)
- ✓ 1: Net cash flows from financing activities: \$51,000

#### Statement of Cash Flows: Indirect Method

**P3.** Chaplin Arts, Inc.'s comparative balance sheets for December 31, 2014 and 2013 follow.

Chaplin Arts, Inc. Comparative Balance Sheets December 31, 2014 and 2013		
Assets	2014	2013
Cash	\$ 94,560	\$ 27,360
Accounts receivable (net)	102,430	75,430
Inventory	112,890	137,890
Prepaid expenses	—	20,000
Land	25,000	—
Building	137,000	—
Accumulated depreciation—building	(15,000)	—
Equipment	33,000	34,000
Accumulated depreciation—equipment	(14,500)	(24,000)
Patents	4,000	6,000
Total assets	<u>\$479,380</u>	<u>\$276,680</u>

**Liabilities and Stockholders' Equity**

Accounts payable	\$ 10,750	\$ 36,750
Notes payable (current)	10,000	—
Accrued liabilities	—	12,300
Mortgage payable	162,000	—
Common stock, \$10 par value	180,000	150,000
Additional paid-in capital	57,200	37,200
Retained earnings	59,430	40,430
Total liabilities and stockholders' equity	<u>\$479,380</u>	<u>\$276,680</u>

The following additional information about Chaplin Arts's operations during 2013 is available: (a) net income, \$28,000; (b) building and equipment depreciation expense amounts, \$15,000 and \$3,000, respectively; (c) equipment that cost \$13,500 with accumulated depreciation of \$12,500 sold at a gain of \$5,300; (d) equipment purchases, \$12,500; (e) patent amortization, \$3,000; purchase of patent, \$1,000; (f) funds borrowed by issuing notes payable, \$25,000; notes payable repaid, \$15,000; (g) land and building purchased for \$162,000 by signing a mortgage for the total cost; (h) 1,500 shares of \$20 par value common stock issued for a total of \$50,000; and (i) paid cash dividends, \$9,000.

**REQUIRED**

- Using the indirect method, prepare a statement of cash flows for Chaplin Arts.
- ACCOUNTING CONNECTION** ► Why did Chaplin Arts have an increase in cash of \$67,200 when it recorded net income of only \$28,000? Discuss and interpret.
- BUSINESS APPLICATION** ► Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.) What is your assessment of Chaplin Arts' cash-generating ability?

LO 2, 3, 4, 5

RATIO

- ✓ 1: Net cash flows from operating activities: (\$106,000)
- ✓ 1: Net cash flows from investing activities: \$34,000
- ✓ 1: Net cash flows from financing activities: \$24,000

**Statement of Cash Flows: Indirect Method**

**P4.** Ben Tools, Inc.'s comparative balance sheets for December 31, 2014 and 2013, follow.

**Ben Tools, Inc.**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$ 257,600	\$ 305,600
Accounts receivable (net)	738,800	758,800
Inventory	960,000	800,000
Prepaid expenses	14,800	26,800
Long-term investments	440,000	440,000
Land	361,200	321,200
Building	1,200,000	920,000
Accumulated depreciation—building	(240,000)	(160,000)
Equipment	480,000	480,000
Accumulated depreciation—equipment	(116,000)	(56,000)
Intangible assets	20,000	40,000
Total assets	<u>\$4,116,400</u>	<u>\$3,876,400</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 470,800	\$ 660,800
Notes payable (current)	40,000	160,000
Accrued liabilities	10,800	20,800
Mortgage payable	1,080,000	800,000
Bonds payable	1,000,000	760,000
Common stock	1,300,000	1,300,000
Additional paid-in capital	80,000	80,000
Retained earnings	254,800	194,800
Treasury stock	(120,000)	(100,000)
Total liabilities and stockholders' equity	<u>\$4,116,400</u>	<u>\$3,876,400</u>

(Continued)

During 2014, the company had net income of \$96,000 and building and equipment depreciation expenses of \$80,000 and \$60,000, respectively. It amortized intangible assets in the amount of \$20,000; purchased investments for \$116,000; sold investments for \$150,000, on which it recorded a gain of \$34,000; issued \$240,000 of long-term bonds at face value; purchased land and a warehouse through a \$320,000 mortgage; paid \$40,000 to reduce the mortgage; borrowed \$60,000 by issuing notes payable; repaid notes payable in the amount of \$180,000; declared and paid cash dividends in the amount of \$36,000; and purchased treasury stock in the amount of \$20,000.

**REQUIRED**

- Using the indirect method, prepare a statement of cash flows for Ben Tools.
- ACCOUNTING CONNECTION** ► Why did Ben Tools experience a decrease in cash in a year in which it had a net income of \$96,000? Discuss and interpret.
- BUSINESS APPLICATION** ► Compute and assess cash flow yield and free cash flow for 2014. Why is each of these measures important in assessing cash-generating ability?

LO 2, 3, 4, 5

RATIO

SPREADSHEET

- ✓ 1: Net cash flows from operating activities: \$126,600
- ✓ 1: Net cash flows from investing activities: (\$25,800)
- ✓ 1: Net cash flows from financing activities: \$14,000

**Statement of Cash Flows: Indirect Method**

**P5.** Yong Company's income statement for the year ended December 31, 2014, and its comparative balance sheets as of December 31, 2014 and 2013, follow.

**Yong Company**  
**Income Statement**  
**For the Year Ended December 31, 2014**

Sales		\$1,609,000
Cost of goods sold		1,127,800
Gross margin		<u>\$ 481,200</u>
Operating expenses (including depreciation expense of \$46,800)		449,400
Income from operations		<u>\$ 31,800</u>
Other income (expenses):		
Gain on sale of furniture and fixtures	\$ 7,000	
Interest expense	<u>(23,200)</u>	<u>(16,200)</u>
Income before income taxes		\$ 15,600
Income taxes expense		4,600
Net income		<u><u>\$ 11,000</u></u>

**Yong Company**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$164,800	\$ 50,000
Accounts receivable (net)	165,200	200,000
Merchandise inventory	350,000	450,000
Prepaid rent	2,000	3,000
Furniture and fixtures	148,000	144,000
Accumulated depreciation—furniture and fixtures	<u>(42,000)</u>	<u>(24,000)</u>
Total assets	<u><u>\$788,000</u></u>	<u><u>\$823,000</u></u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$143,400	\$200,400
Income taxes payable	1,400	4,400
Notes payable (long-term)	40,000	20,000
Bonds payable	100,000	200,000
Common stock, \$20 par value	240,000	200,000
Additional paid-in capital	181,440	121,440
Retained earnings	<u>81,760</u>	<u>76,760</u>
Total liabilities and stockholders' equity	<u><u>\$788,000</u></u>	<u><u>\$823,000</u></u>

During 2014, the company engaged in these transactions:

- Sold at a gain of \$7,000 furniture and fixtures that cost \$35,600, on which it had accumulated depreciation of \$28,800.
- Purchased furniture and fixtures in the amount of \$39,600.
- Paid a \$20,000 note payable and borrowed \$40,000 on a new note.
- Converted bonds payable in the amount of \$100,000 into 4,000 shares of common stock.
- Declared and paid \$6,000 in cash dividends.

#### REQUIRED

- Using the indirect method, prepare a statement of cash flows for Yong. Include a supporting schedule of noncash investing transactions and financing transactions.
- ACCOUNTING CONNECTION** ► What are the primary reasons for Yong's large increase in cash from 2013 to 2014, despite its low net income?
- BUSINESS APPLICATION** ► Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.) Compare and contrast what these two performance measures tell you about Yong's cash-generating ability.

## ALTERNATE PROBLEMS

### LO 1 Classification of Cash Flow Transactions

**P6. CONCEPT** ► Analyze each transaction listed in the table that follows and place X's in the appropriate columns to indicate the transaction's classification and its effect on cash flows using the indirect method.

Transaction	Cash Flow Classification				Effect on Cash Flows		
	Operating Activity	Investing Activity	Financing Activity	Noncash Transaction	Increase	Decrease	No Effect
1. Increased accounts payable.							
2. Decreased inventory.							
3. Increased prepaid insurance.							
4. Earned a net income.							
5. Declared and paid a cash dividend.							
6. Issued stock for cash.							
7. Retired long-term debt by issuing stock.							
8. Purchased a long-term investment with cash.							
9. Sold trading securities at a gain.							
10. Sold a machine at a loss.							
11. Retired fully depreciated equipment.							
12. Decreased interest payable.							
13. Purchased available-for-sale securities (long-term).							
14. Decreased dividends receivable.							
15. Decreased accounts receivable.							
16. Converted bonds to common stock.							
17. Purchased 90-day Treasury bill.							

LO 2, 3, 4, 5

RATIO

SPREADSHEET

- ✓ 1: Net cash flows from operating activities: \$548,000
- ✓ 1: Net cash flows from investing activities: \$6,000
- ✓ 1: Net cash flows from financing activities: (\$260,000)

### Statement of Cash Flows: Indirect Method

**P7.** Reed Corporation's income statement for the year ended June 30, 2014, and its comparative balance sheets as of June 30, 2014 and 2013, follow.

#### Reed Corporation Income Statement For the Year Ended June 30, 2014

Sales		\$8,081,800
Cost of goods sold		7,312,600
Gross margin		<u>\$ 769,200</u>
Operating expenses (including depreciation expense of \$120,000)		378,400
Income from operations		<u>\$ 390,800</u>
Other income (expenses)		
Loss on sale of equipment	\$ (8,000)	
Interest expense	<u>(75,200)</u>	<u>(83,200)</u>
Income before income taxes		\$ 307,600
Income taxes expense		68,400
Net income		<u><u>\$ 239,200</u></u>

#### Reed Corporation Comparative Balance Sheets June 30, 2014 and 2013

	2014	2013
<b>Assets</b>		
Cash	\$ 334,000	\$ 40,000
Accounts receivable (net)	200,000	240,000
Inventory	360,000	440,000
Prepaid expenses	1,200	2,000
Property, plant, and equipment	1,256,000	1,104,000
Accumulated depreciation—property, plant, and equipment	<u>(366,000)</u>	<u>(280,000)</u>
Total assets	<u><u>\$1,785,200</u></u>	<u><u>\$1,546,000</u></u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 128,000	\$ 84,000
Notes payable (due in 90 days)	60,000	160,000
Income taxes payable	52,000	36,000
Mortgage payable	720,000	560,000
Common stock, \$5 par value	400,000	400,000
Retained earnings	<u>425,200</u>	<u>306,000</u>
Total liabilities and stockholders' equity	<u><u>\$1,785,200</u></u>	<u><u>\$1,546,000</u></u>

During 2014, the corporation sold at a loss of \$8,000 equipment that cost \$48,000, on which it had accumulated depreciation of \$34,000. It also purchased land and a building for \$200,000 through an increase of \$200,000 in Mortgage Payable; made a \$40,000 payment on the mortgage; repaid \$160,000 in notes but borrowed an additional \$60,000 through the issuance of a new note payable; and declared and paid a \$120,000 cash dividend.

#### REQUIRED

1. Using the indirect method, prepare a statement of cash flows. Include a supporting schedule of noncash investing and financing transactions.
2. **ACCOUNTING CONNECTION** ► What are the primary reasons for Reed's large increase in cash from 2013 to 2014?
3. **BUSINESS APPLICATION** ► Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.) How would you assess the corporation's cash-generating ability?

LO 2, 3, 4, 5

RATIO

- ✓ 1: Net cash flows from operating activities: \$93,600
- ✓ 1: Net cash flows from investing activities: (\$28,800)
- ✓ 1: Net cash flows from financing activities: \$204,000

**Statement of Cash Flows: Indirect Method**

**P8.** Shah Fabrics, Inc.'s comparative balance sheets for December 31, 2014 and 2013, follow.

<b>Shah Fabrics, Inc.</b>		
<b>Comparative Balance Sheets</b>		
<b>December 31, 2014 and 2013</b>		
	<b>2014</b>	<b>2013</b>
<b>Assets</b>		
Cash	\$ 378,240	\$ 109,440
Accounts receivable (net)	409,720	301,720
Inventory	451,560	551,560
Prepaid expenses	—	80,000
Land	100,000	—
Building	548,000	—
Accumulated depreciation—building	(60,000)	—
Equipment	132,000	136,000
Accumulated depreciation—equipment	(58,000)	(96,000)
Patents	16,000	24,000
Total assets	\$1,917,520	\$1,106,720
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 43,000	\$ 147,000
Notes payable (current)	40,000	—
Accrued liabilities	—	49,200
Mortgage payable	648,000	—
Common stock, \$10 par value	720,000	600,000
Additional paid-in capital	228,800	148,800
Retained earnings	237,720	161,720
Total liabilities and stockholders' equity	\$1,917,520	\$1,106,720

Additional information about Shah Fabrics' operations during 2014 is as follows: (a) net income, \$112,000; (b) building and equipment depreciation expense amounts, \$60,000 and \$12,000, respectively; (c) equipment that cost \$54,000 with accumulated depreciation of \$50,000 sold at a gain of \$21,200; (d) equipment purchases, \$50,000; (e) patent amortization, \$12,000; purchase of patent, \$4,000; (f) funds borrowed by issuing notes payable, \$100,000; notes payable repaid, \$60,000; (g) land and building purchased for \$648,000 by signing a mortgage for the total cost; (h) 6,000 shares of \$40 par value common stock issued for a total of \$200,000; and (i) paid cash dividend, \$36,000.

**REQUIRED**

1. Using the indirect method, prepare a statement of cash flows for Shah Fabrics.
2. **ACCOUNTING CONNECTION** ► Why did Shah Fabrics have an increase in cash of \$268,800 when it recorded net income of only \$112,000? Discuss and interpret.
3. **BUSINESS APPLICATION** ► Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.) What is your assessment of Shah Fabrics' cash-generating ability?



LO 2, 3, 4, 5

RATIO

- ✓ 1: Net cash flows from operating activities: (\$212,000)
- ✓ 1: Net cash flows from investing activities: \$68,000
- ✓ 1: Net cash flows from financing activities: \$48,000

**Statement of Cash Flows: Indirect Method**

**P9.** Kohl Ceramics, Inc.'s comparative balance sheets, for December 31, 2014 and 2013, follow.

<b>Kohl Ceramics, Inc.</b>		
<b>Comparative Balance Sheets</b>		
<b>December 31, 2014 and 2013</b>		
	<b>2014</b>	<b>2013</b>
<b>Assets</b>		
Cash	\$ 515,200	\$ 611,200
Accounts receivable (net)	1,477,600	1,517,600
Inventory	1,920,000	1,600,000
Prepaid expenses	29,600	53,600
Long-term investments	880,000	880,000
Land	722,400	642,400
Building	2,400,000	1,840,000
Accumulated depreciation—building	(480,000)	(320,000)
Equipment	960,000	960,000
Accumulated depreciation—equipment	(232,000)	(112,000)
Intangible assets	40,000	80,000
Total assets	<u>\$8,232,800</u>	<u>\$7,752,800</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 941,600	\$1,321,600
Notes payable (current)	80,000	320,000
Accrued liabilities	21,600	41,600
Mortgage payable	2,160,000	1,600,000
Bonds payable	2,000,000	1,520,000
Common stock	2,600,000	2,600,000
Additional paid-in capital	160,000	160,000
Retained earnings	509,600	389,600
Treasury stock	(240,000)	(200,000)
Total liabilities and stockholders' equity	<u>\$8,232,800</u>	<u>\$7,752,800</u>

During 2014, the company had net income of \$192,000 and building and equipment depreciation expenses of \$160,000 and \$120,000, respectively. It amortized intangible assets in the amount of \$40,000; purchased investments for \$232,000; sold investments for \$300,000, on which it recorded a gain of \$68,000; issued \$480,000 of long-term bonds at face value; purchased land and a warehouse through a \$640,000 mortgage; paid \$80,000 to reduce the mortgage; borrowed \$120,000 by issuing notes payable; repaid notes payable in the amount of \$360,000; declared and paid cash dividends in the amount of \$72,000; and purchased treasury stock in the amount of \$40,000.

**REQUIRED**

1. Using the indirect method, prepare a statement of cash flows for Kohl Ceramics.
2. **ACCOUNTING CONNECTION** ▶ Why did Kohl Ceramics experience a decrease in cash in a year in which it had a net income of \$192,000? Discuss and interpret.
3. **BUSINESS APPLICATION** ▶ Compute and assess cash flow yield and free cash flow for 2014. Why is each of these measures important in assessing cash-generating ability?

LO 2, 3, 4, 5

RATIO

- ✓ 1: Net cash flows from operating activities: \$126,600
- ✓ 1: Net cash flows from investing activities: (\$25,800)
- ✓ 1: Net cash flows from financing activities: \$14,000
- ✓ 3: Free cash flow, 2014: \$94,800

**Statement of Cash Flows: Indirect Method**

**P10.** William Corporation's income statement for the year ended December 31, 2014, and its comparative balance sheets as of December 31, 2014 and 2013, follow.

**William Corporation**  
**Income Statement**  
**For the Year Ended December 31, 2014**

Sales		\$1,609,000
Cost of goods sold		1,127,800
Gross margin		<u>\$ 481,200</u>
Operating expenses (including depreciation expense of \$46,800)		449,400
Income from operations		<u>\$ 31,800</u>
Other income (expenses)		
Gain on sale of furniture and fixtures	\$ 7,000	
Interest expense	<u>(23,200)</u>	(16,200)
Income before income taxes		<u>\$ 15,600</u>
Income taxes expense		4,600
Net income		<u><u>\$ 11,000</u></u>

**William Corporation**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$164,800	\$ 50,000
Accounts receivable (net)	165,200	200,000
Merchandise inventory	350,000	450,000
Prepaid rent	2,000	3,000
Furniture and fixtures	148,000	144,000
Accumulated depreciation—furniture and fixtures	<u>(42,000)</u>	<u>(24,000)</u>
Total assets	<u>\$788,000</u>	<u>\$823,000</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$143,400	\$200,400
Income taxes payable	1,400	4,400
Notes payable (long-term)	40,000	20,000
Bonds payable	100,000	200,000
Common stock, \$20 par value	240,000	200,000
Additional paid-in capital	181,440	121,440
Retained earnings	<u>81,760</u>	<u>76,760</u>
Total liabilities and stockholders' equity	<u>\$788,000</u>	<u>\$823,000</u>

During 2014, William engaged in these transactions:

- a. Sold at a gain of \$7,000 furniture and fixtures that cost \$35,600, on which it had accumulated depreciation of \$28,800.
- b. Purchased furniture and fixtures in the amount of \$39,600.
- c. Paid a \$20,000 note payable and borrowed \$40,000 on a new note.
- d. Converted bonds payable in the amount of \$100,000 into 4,000 shares of common stock.
- e. Declared and paid \$6,000 in cash dividends.

**REQUIRED**

1. Using the indirect method, prepare a statement of cash flows for William. Include a supporting schedule of noncash investing transactions and financing transactions.
2. **ACCOUNTING CONNECTION** ► What are the primary reasons for William's large increase in cash from 2013 to 2014, despite its low net income?
3. **BUSINESS APPLICATION** ► Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.) Compare and contrast what these two performance measures tell you about William's cash-generating ability.

## CASES

### LO 1, 2 Conceptual Understanding: EBITDA and the Statement of Cash Flows

**C1.** When **Fleetwood Enterprises, Inc.**, a large producer of recreational vehicles and manufactured housing, warned that it might not be able to generate enough cash to satisfy debt requirements and could be in default of a loan agreement, its cash flow, defined in the financial press as “EBITDA” (earnings before interest, taxes, depreciation, and amortization), was a negative \$2.7 million. The company would have had to generate \$17.7 million in the next accounting period to comply with the loan terms.<sup>11</sup> To what section of the statement of cash flows does EBITDA most closely relate? Is EBITDA a good approximation for this section of the statement of cash flows? Explain your answer, which should include an identification of the major differences between EBITDA and the section of the statement of cash flows you chose.

### LO 5 Interpreting Financial Reports: Classic Case—Anatomy of a Disaster

**RATIO**

**C2.** On October 16, 2001, Kenneth Lay, chairman and CEO of **Enron Corporation**, announced the company’s earnings for the first nine months of 2001 as follows:

*Our 26 percent increase in recurring earnings per diluted share shows the very strong results of our core wholesale and retail energy businesses and our natural gas pipelines. The continued excellent prospects in these businesses and Enron’s leading market position make us very confident in our strong earnings outlook.<sup>12</sup>*

Less than six months later, the company filed for the biggest bankruptcy in U.S. history. Its stock dropped to less than \$1 per share, and a major financial scandal was underway. Enron’s statement of cash flows for the first nine months of 2001 and 2000 (restated to correct the previous accounting errors) follow. Assume you report to an investment analyst, who has asked you to analyze this statement for clues as to why the company went under.

**Enron Corporation**  
**Statement of Cash Flows**  
**For the Nine Months Ended September 30, 2001 and 2000**

(In millions)	2001	2000
Cash Flows from Operating Activities:		
Reconciliation of net income to net cash provided by operating activities:		
Net income	\$ 225	\$ 797
Cumulative effect of accounting changes, net of tax	(19)	—
Depreciation, depletion and amortization	746	617
Deferred income taxes	(134)	8
Gains on sales of non-trading assets	(49)	(135)
Investment losses	768	0
Changes in components of working capital:		
Receivables	987	(3,363)
Inventories	1	339
Payables	(1,764)	2,899
Other	464	(455)
Trading investments		
Net margin deposit activity	(2,349)	541
Other trading activities	173	(555)
Other, net	198	(566)
Net Cash Provided by (Used in) Operating Activities	<u>\$ (753)</u>	<u>\$ 127</u>

Cash Flows from Investing Activities:		
Capital expenditures	\$(1,584)	\$(1,539)
Equity investments	(1,172)	(858)
Proceeds from sales of non-trading investments	1,711	222
Acquisition of subsidiary stock	0	(485)
Business acquisitions, net of cash acquired	(82)	(773)
Other investing activities	(239)	(147)
Net Cash Used in Investing Activities	<u>\$(1,366)</u>	<u>\$(3,580)</u>
Cash Flows from Financing Activities:		
Issuance of long-term debt	\$ 4,060	\$ 2,725
Repayment of long-term debt	(3,903)	(579)
Net increase in short-term borrowings	2,365	1,694
Issuance of common stock	199	182
Net redemption of company-obligated preferred securities of subsidiaries	0	(95)
Dividends paid	(394)	(396)
Net (acquisition) disposition of treasury stock	(398)	354
Other financing activities	(49)	(12)
Net Cash Provided by Financing Activities	<u>\$ 1,880</u>	<u>\$ 3,873</u>
Increase (Decrease) in Cash and Cash Equivalents	<u>\$ (239)</u>	<u>\$ 420</u>
Cash and Cash Equivalents, Beginning of Period	1,240	333
Cash and Cash Equivalents, End of Period	<u>\$ 1,001</u>	<u>\$ 753</u>

1. **BUSINESS APPLICATION** ► For the two time periods shown, compute the cash-generating efficiency ratios of cash flow yield, cash flows to sales (Enron's revenues were \$133,762 million in 2001 and \$55,494 million in 2000), and cash flows to assets (use total assets of \$61,783 million for 2001 and \$64,926 million for 2000). Also compute free cash flows for the two years. (Round to one decimal place or the nearest tenth of a percent.)
2. Prepare a memorandum to the investment analyst that assesses Enron's cash generating efficiency in light of the chairman's remarks and that evaluates its available free cash flow, taking into account its financing activities. Identify significant changes in Enron's operating items and any special operating items that should be considered. Include your computations as an attachment.

#### LO 5 Ethical Dilemma: Ethics and Cash Flow Classifications

**C3. BUSINESS APPLICATION** ► Precise Metals, Inc., a fast-growing company that makes metals for equipment manufacturers, has an \$800,000 line of credit at its bank. One section in the credit agreement says that the ratio of cash flows from operations to interest expense must exceed 3.0. If this ratio falls below 3.0, the company must reduce the balance outstanding on its line of credit to one-half the total line if the funds borrowed against the line of credit exceed one-half of the total line.

After the end of the fiscal year, the company's controller informs the president: "We will not meet the ratio requirements on our line of credit in 2010 because interest expense was \$1.2 million and cash flows from operations were \$3.2 million. Also, we have borrowed 100 percent of our line of credit. We do not have the cash to reduce the credit line by \$400,000."

The president says, "This is a serious situation. To pay our ongoing bills, we need our bank to increase our line of credit, not decrease it. What can we do?" "Do you recall the \$500,000 two-year note payable for equipment?" replied the controller. "It is now classified as 'Proceeds from Notes Payable' in cash flows provided from financing activities in the statement of cash flows. If we move it to cash flows from operations and call it 'Increase in Payables,' it would increase cash flows from operations to \$3.7 million and put us over the limit." "Well, do it," ordered the president. "It surely doesn't make any

*(Continued)*

difference where it is on the statement. It is an increase in both places. It would be much worse for our company in the long term if we failed to meet this ratio requirement.”

What is your opinion of the controller and president’s reasoning? Is the president’s order ethical? Who benefits and who is harmed if the controller follows the president’s order? What are management’s alternatives? What would you do?

**LO 1, 5** **Conceptual Understanding: Alternative Uses of Cash**

**C4.** Perhaps because of hard times in their start-up years, companies in the high tech sector of American industry seem more prone than those in other sectors to building up cash reserves. For example, companies like **Cisco Systems**, **Intel**, **Dell**, and **Oracle** have amassed large cash balances.

Assume you work for a company in the high-tech industry that has built up a substantial amount of cash. The company is still growing through development of new products, has some debt, and has never paid a dividend or bought treasury stock. The company is doing better than most companies in the current financial crisis but the company’s stock price is lagging. Outline at least four strategies for using the company’s cash to improve the company’s financial outlook.

**LO 1** **Interpreting Financial Reports: Analysis of the Statement of Cash Flows**

**C5.** Refer to the statement of cash flows in the **CVS Corporation** annual report in the Supplement to Chapter 16 to answer the following questions:

1. Does CVS use the indirect method of reporting cash flows from operating activities? Other than net earnings, what are the most important factors affecting the company’s cash flows from operating activities? Explain the trend of each of these factors.
2. Based on the cash flows from investing activities, in 2010 and 2011, would you say that CVS is a contracting or an expanding company? Explain.
3. Has CVS used external financing during 2010 and 2011? If so, where did it come from?

**LO 1, 5** **Interpreting Financial Reports: Cash Flows Analysis**

**RATIO**

**SPREADSHEET**

**C6. BUSINESS APPLICATION** ▶ Refer to the annual report of **CVS Corporation** and the financial statements of **Southwest Airlines** in the Supplement to Chapter 16. Calculate for 2011 and 2010 each company’s cash flow yield, cash flows to sales, cash flows to assets, and free cash flow. (Round to one decimal place or to the nearest tenth of a percent.) At the end of 2009, Southwest’s total assets were \$14,269 million and CVS’s total assets were \$61,641 million.

Discuss and compare the trends of the cash-generating ability of CVS and Southwest. Comment on each company’s change in cash and cash equivalents over the two-year period.

**Continuing Case: Annual Report Project**

**RATIO**

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company’s website, examine the statement of cash flows and accompanying notes of your company. Answer the following questions:

1. Does the company use the direct or indirect method for computing cash flows from operating activities? What effect does depreciation have on cash flows? Have receivables, inventories, and payables had positive or negative effects on cash flows from operating activities?
2. What are the most important investing activities for the company in the most recent year?
3. What are the most important financing activities for the company in the most recent year?
4. **BUSINESS APPLICATION** ▶ Calculate cash flow yield, cash flows to sales, cash flows to assets, and free cash flow for the most recent year.

# SUPPLEMENT TO CHAPTER 15

## The Direct Method of Preparing the Statement of Cash Flows

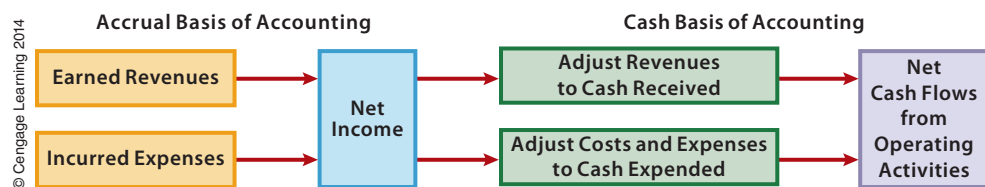
To this point, the indirect method of preparing the statement of cash flows has been used. In this section, the direct method is presented.

### Determining Cash Flows from Operating Activities

The principal difference between the indirect and the direct methods appears in the cash flows from operating activities section of the statement of cash flows.

- The indirect method starts with net income from the income statement and converts it to net cash flows from operating activities by adding or subtracting items that do not affect net cash flows.
- The direct method converts each item on the income statement to its cash equivalent, as illustrated in Exhibit 1. For instance, sales are converted to cash receipts from sales and purchases are converted to cash payments for purchases.

**Exhibit 1**  
Direct Method of  
Determining Net Cash Flows  
from Operating Activities



To illustrate how to determine cash flows from operating activities under the direct method, we will use Eureka Corporation. Eureka's schedule of cash flows from operating activities is presented in Exhibit 2.

**Exhibit 2**  
Schedule of Cash Flows  
from Operating Activities:  
Direct Method

© Cengage Learning 2014

Eureka Corporation Schedule of Cash Flows from Operating Activities For the Year Ended December 31, 2014		
Cash receipts from:		
Sales	\$706,000	
Interest received	6,000	\$712,000
Cash payments for:		
Purchases	\$547,000	
Operating expenses	103,000	
Interest	23,000	
Income taxes	9,000	682,000
Net cash flows from operating activities		\$ 30,000



## CASH FLOW

## Cash Receipts from Sales

Sales result in a positive cash flow for a company. Cash sales are direct cash inflows. Credit sales are not direct cash inflows because some receivables may be uncollectible. For example, you cannot assume that credit sales are automatically inflows of cash, because the collections of accounts receivable in any one accounting period are not likely to equal credit sales. Some receivables may be uncollectible, sales from a prior period may be collected in the current period, or sales from the current period may be collected in the next period.

- ▲ If accounts receivables *increase* from one accounting period to the next, cash receipts from sales will not be as great as sales.
- ▼ If accounts receivable *decrease* from one accounting period to the next, cash receipts from sales will exceed sales.

The relationships among sales, changes in the accounts receivable, and cash receipts from sales are reflected in the formula that follows.

$$\text{Sales} \begin{cases} + \text{ Decrease in Accounts Receivable} \\ \text{or} \\ - \text{ Increase in Accounts Receivable} \end{cases} = \text{Cash Receipts from Sales}$$

Refer to the balance sheets and the income statement for Eureka Corporation in Exhibits 4 and 5 in Chapter 15. Note that sales were \$698,000 in 2014 and that accounts receivable decreased by \$8,000. Thus, cash received from sales is \$706,000:

$$\$698,000 + \$8,000 = \$706,000$$

Collections were \$8,000 more than sales recorded for the year.

## Cash Receipts from Interest and Dividends

Although interest and dividends received are most closely associated with investment activity and are often called *investment income*, the FASB *classifies* the cash received from these items as operating activities. To simplify the examples in this text, it is assumed that interest income equals interest received and that dividend income equals dividends received. Thus, based on Exhibit 4 in Chapter 15, interest received by Eureka Corporation is assumed to equal \$6,000, which is the amount of interest income.

## Cash Payments for Purchases

The cost of goods sold (from the income statement) must be adjusted for changes in two balance sheet accounts to arrive at cash payments for purchases. First, the cost of goods sold must be adjusted for changes in inventory to arrive at net purchases. Then, net purchases must be adjusted for the change in accounts payable to arrive at cash payments for purchases.

- ▲ If inventory has *increased* from one accounting period to another, net purchases will be greater than the cost of goods sold because net purchases during the period have exceeded the dollar amount of the items sold during the period.
- ▼ If inventory has *decreased*, net purchases will be less than the cost of goods sold.
- ▲ If accounts payable have *increased*, cash payments for purchases will be less than net purchases.
- ▼ If accounts payable have *decreased*, cash payments for purchases will be greater than net purchases.

These relationships may be stated in equation form as follows.

$$\text{Cost of Goods Sold} \left\{ \begin{array}{l} + \text{ Increase in Inventory} \\ \text{or} \\ - \text{ Decrease in Inventory} \end{array} \right\} \left\{ \begin{array}{l} + \text{ Decrease in Accounts Payable} \\ \text{or} \\ - \text{ Increase in Accounts Payable} \end{array} \right\} = \text{Cash Payments for Purchases}$$

From Exhibits 4 and 5 in Chapter 15, cost of goods sold is \$520,000, inventory increased by \$34,000, and accounts payable increased by \$7,000. Thus, cash payments for purchases for Eureka are computed as follows.

$$\$520,000 + \$34,000 - \$7,000 = \$547,000$$

Eureka purchased \$34,000 more inventory than it sold and paid out \$7,000 less in cash than it made in purchases. The net result is that cash payments for purchases exceeded the cost of goods sold by \$27,000 (\$547,000 – \$520,000).

### Cash Payments for Operating Expenses

Just as the cost of goods sold does not represent the amount of cash paid for purchases during an accounting period, operating expenses do not match the amount of cash paid to employees, suppliers, and others for goods and services. Three adjustments must be made to operating expenses to arrive at the cash outflows. The first adjustment is for changes in prepaid expenses, such as prepaid insurance or prepaid rent.

- ▲ If prepaid assets *increase* during the accounting period, more cash will have been paid out than appears on the income statement as expenses.
- ▼ If prepaid assets *decrease*, the expenses shown on the income statement will exceed the cash spent.

The second adjustment is for changes in liabilities resulting from accrued expenses, such as wages payable and payroll taxes payable.

- ▲ If accrued liabilities *increase* during the accounting period, operating expenses on the income statement will exceed the cash spent.
- ▼ If accrued liabilities *decrease*, operating expenses will fall short of cash spent.

The third adjustment is made because certain expenses do not require a current outlay of cash; those expenses must be subtracted from operating expense to arrive at cash payments for operating expenses. The most common expenses in this category are depreciation expense, amortization expense, and depletion expense. For example, in 2014, Eureka recorded depreciation expense of \$37,000. No cash payment was made in this transaction. Therefore, to the extent that operating expenses include depreciation and similar items, an adjustment is needed to reduce operating expenses to the amount of cash expended.

The three adjustments to operating expenses are summarized in the equations that follow.

$$\text{Operating Expenses} \left\{ \begin{array}{l} + \text{ Increase in Prepaid Expenses} \\ \text{or} \\ - \text{ Decrease in Prepaid Expenses} \end{array} \right\} \left\{ \begin{array}{l} + \text{ Decrease in Accrued Liabilities} \\ \text{or} \\ - \text{ Increase in Accrued Liabilities} \end{array} \right\} \left\{ \begin{array}{l} - \text{ Depreciation and Other Noncash Expenses} \end{array} \right\} = \text{Cash Payments for Operating Expenses}$$

According to Exhibits 4 and 5 in Chapter 15, Eureka's operating expenses (including depreciation of \$37,000) were \$147,000, prepaid expenses decreased by \$4,000, and accrued liabilities increased by \$3,000. As a result, Eureka's cash payments for operating expenses are computed as follows.

$$\$147,000 - \$4,000 - \$3,000 - \$37,000 = \$103,000$$

If there are prepaid expenses and accrued liabilities that are *not* related to specific operating expenses, they are not included in these computations. One example is income taxes payable, which is the accrued liability related to income taxes expense. The cash payment for income taxes will be discussed shortly.

## Cash Payments for Interest

The FASB classifies cash payments for interest as operating activities. For the sake of simplicity, all examples in this text assume that interest payments are equal to interest expense on the income statement. Thus, based on Exhibit 4 in Chapter 15, Eureka's interest payments are assumed to be \$23,000 in 2014.

## Cash Payments for Income Taxes

The amount of income taxes expense that appears on the income statement rarely equals the amount of income taxes actually paid during the year. To determine cash payments for income taxes, income taxes are adjusted by the change in Income Taxes Payable.

- ▲ If Income Taxes Payable *increased* during the accounting period, cash payments for taxes will be less than the expense shown on the income statement.
- ▼ If Income Taxes Payable *decreased*, cash payments for taxes will exceed income taxes on the income statement.

In other words, the following equation is applicable:

$$\text{Income Taxes} \left\{ \begin{array}{l} + \text{Decrease in Income Taxes Payable} \\ \text{or} \\ - \text{Increase in Income Taxes Payable} \end{array} \right. = \text{Cash Payments for Income Taxes}$$

In 2014, Eureka reported income taxes of \$7,000 on its income statement and a decrease of \$2,000 in Income Taxes Payable on its balance sheets (see Exhibits 4 and 5 in Chapter 15). As a result, cash payments for income taxes for Eureka during 2014 are calculated as follows.

$$\$7,000 + \$2,000 = \$9,000$$

## Compiling the Statement of Cash Flows

Eureka's statement of cash flows under the direct method is presented in Exhibit 3. The only differences between that statement of cash flows and the one based on the indirect method shown in Exhibit 8 in Chapter 15 occur in the first and last sections. The middle sections, which present cash flows from investing activities and financing activities, net increases or decreases in cash, and the schedule of non-cash investing and financing activities, are the same under both methods.

The first section of the statement in Exhibit 3 shows the net cash flows from operating activities on a direct basis, as presented in Exhibit 2. The last section is the same as the cash flows from operating activities section of the statement of cash flows under the indirect method (see Exhibit 8 in Chapter 15). The FASB believes that when the direct method is used, a schedule must be provided that reconciles net income to net cash flows from operating activities. Thus, the statement of cash flows under the direct method includes a section that accommodates the main difference between it and the indirect method.

**Exhibit 3**  
**Statement of Cash**  
**Flows: Direct Method**

<b>Eureka Corporation</b>		
<b>Statement of Cash Flows</b>		
<b>For the Year Ended December 31, 2014</b>		
Cash flows from operating activities:		
Cash receipts from:		
Sales	\$ 706,000	
Interest received	6,000	\$712,000
Cash payments for:		
Purchases	\$ 547,000	
Operating expenses	103,000	
Interest	23,000	
Income taxes	9,000	682,000
Net cash flows from operating activities		<u>\$ 30,000</u>
Cash flows from investing activities:		
Purchase of investments	\$ (78,000)	
Sale of investments	102,000	
Purchase of plant assets	(120,000)	
Sale of plant assets	5,000	
Net cash flows from investing activities		(91,000)
Cash flows from financing activities:		
Repayment of bonds	\$ (50,000)	
Issue of common stock	150,000	
Dividends paid	(7,000)	
Net cash flows from financing activities		93,000
Net increase in cash		<u>\$ 32,000</u>
Cash at beginning of year		15,000
Cash at end of year		<u>\$ 47,000</u>
<b>Schedule of Noncash Investing and Financing Transactions</b>		
Issue of bonds payable for plant assets		<u>\$100,000</u>
Reconciliation of net income to net cash flows from operating activities:		
Net income		\$ 16,000
Adjustments to reconcile net income to net cash flows from operating activities:		
Depreciation	\$ 37,000	
Gain on sale of investments	(12,000)	
Loss on sale of plant assets	3,000	
Changes in current assets and current liabilities:		
Decrease in accounts receivable	8,000	
Increase in inventory	(34,000)	
Decrease in prepaid expenses	4,000	
Increase in accounts payable	7,000	
Increase in accrued liabilities	3,000	
Decrease in income taxes payable	(2,000)	14,000
Net cash flows from operating activities		<u>\$ 30,000</u>
Cash flows from investing activities:		
Purchase of investments	\$ (78,000)	
Sale of investments	102,000	
Purchase of plant assets	(120,000)	
Sale of plant assets	5,000	
Net cash flows from investing activities		(91,000)
Cash flows from financing activities:		
Repayment of bonds	\$ (50,000)	
Issuance of common stock	175,000	
Payment of dividends	(7,000)	
Purchase of treasury stock	(25,000)	
Net cash flows from financing activities		93,000
Net increase in cash		<u>\$ 32,000</u>
Cash at beginning of year		15,000
Cash at end of year		<u>\$ 47,000</u>

## Assignments

### SHORT EXERCISES

#### SE1. Cash Receipts from Sales and Cash Payments for Purchases: Direct Method

During 2014, Nebraska Wheat Company, a maker of whole-grain products, had sales of \$426,500. The ending balance of accounts receivable was \$127,400 in 2013 and \$96,200 in 2014. Also, during 2014, Nebraska Wheat had cost of goods sold of \$294,200. The ending balance of inventory was \$36,400 in 2013 and \$44,800 in 2014. The ending balance of accounts payable was \$28,100 in 2013 and \$25,900 in 2014. Using the direct method, calculate cash receipts from sales and cash payments for purchases in 2014.

#### SE2. Cash Payments for Operating Expenses and Income Taxes: Direct Method

During 2014, Nebraska Wheat Company had operating expenses of \$79,000 and income tax expense of \$12,500. Depreciation expense of \$20,000 for 2014 was included in operating expenses. The ending balance of prepaid expenses was \$3,600 in 2013 and \$2,300 in 2014. The ending balance of accrued liabilities (excluding income taxes payable) was \$3,000 in 2013 and \$2,000 in 2014. The ending balance of income taxes payable was \$4,100 in 2013 and \$3,500 in 2014. Calculate cash payments for operating expenses and income taxes in 2014 using the direct method.

### EXERCISES

#### E1. Computing Cash Flows from Operating Activities: Direct Method

Vlieg Corporation engaged in the transactions that follow in 2014. Using the direct method, compute the various cash flows from operating activities as required.

- During 2014, Vlieg had cash sales of \$41,300 and sales on credit of \$123,000. During the same year, accounts receivable decreased by \$18,000. Determine the cash receipts from sales during 2014.
- During 2014, Vlieg's cost of goods sold was \$119,000. During the same year, merchandise inventory increased by \$12,500 and accounts payable decreased by \$4,300. Determine the cash payments for purchases during 2014.
- During 2014, Vlieg had operating expenses of \$45,000, including depreciation of \$15,600. Also during 2014, related prepaid expenses decreased by \$3,100 and relevant accrued liabilities increased by \$1,200. Determine the cash payments for operating expenses to suppliers of goods and services during 2014.
- Vlieg's income tax expense for 2014 was \$4,300. Income taxes payable decreased by \$230 that year. Determine the cash payments for income taxes during 2014.

#### E2. Preparing a Schedule of Cash Flows from Operating Activities: Direct Method

Vasquez Corporation's income statement follows.

<b>Vasquez Corporation</b>		
<b>Income Statement</b>		
<b>For the Year Ended June 30, 2014</b>		
Sales		\$122,000
Cost of goods sold		<u>60,000</u>
Gross margin		\$ 62,000
Operating expenses:		
Salaries expense	\$32,000	
Rent expense	16,800	
Depreciation expense	<u>2,000</u>	<u>50,800</u>
Income before income taxes		\$ 11,200
Income taxes		<u>2,400</u>
Net income		<u>\$ 8,800</u>

Additional information: (a) Accounts receivable increased by \$4,400 during the year; (b) inventories increased by \$7,000, and accounts payable increased by \$14,000 during the year; (c) prepaid rent decreased by \$1,400, while salaries payable increased by \$1,000; and (d) income taxes payable decreased by \$600 during the year.

Using the direct method, prepare a schedule of cash flows from operating activities.

## PROBLEMS

### P1. Cash Flows from Operating Activities: Direct Method

✓ Total operating activities:  
\$47,600 inflows

Tanucci Clothing Store's income statement follows.

Net sales		\$4,900,000
Cost of goods sold:		
Beginning inventory	\$1,240,000	
Net cost of purchases	<u>3,040,000</u>	
Goods available for sale	\$4,280,000	
Ending inventory	<u>1,400,000</u>	
Cost of goods sold		<u>2,880,000</u>
Gross margin		\$2,020,000
Operating expenses:		
Sales and administrative salaries expense	\$1,112,000	
Other sales and administrative expenses	<u>624,000</u>	
Total operating expenses		<u>1,736,000</u>
Income before income taxes		\$ 284,000
Income taxes		<u>78,000</u>
Net income		<u>\$ 206,000</u>

Additional information: (a) other sales and administrative expenses include depreciation expense of \$104,000 and amortization expense of \$36,000; (b) accrued liabilities for salaries were \$24,000 less than the previous year, and prepaid expenses were \$40,000 more than the previous year; and (c) during the year accounts receivable (net) increased by \$288,000, accounts payable increased by \$228,000, and income taxes payable decreased by \$14,400.

#### REQUIRED

Using the direct method, prepare a schedule of cash flows from operating activities.

### P2. Statement of Cash Flows: Direct Method

RATIO

SPREADSHEET

✓ 1: Total operating activities:  
\$548,000 inflows  
✓ 1: Total financing activities:  
\$260,000 outflows

Flanders Corporation's 2014 income statement and comparative balance sheet as of June 30, 2014 and 2013 follow.

Sales		\$2,081,800
Cost of goods sold		<u>1,312,600</u>
Gross margin		\$ 769,200
Operating expenses (including depreciation expense of \$120,000)		<u>378,400</u>
Income from operations		\$ 390,800
Other income (expenses):		
Loss on disposal of equipment	\$ 8,000	
Interest expense	<u>75,200</u>	<u>83,200</u>
Income before income taxes		\$ 307,600
Income taxes		<u>68,400</u>
Net income		<u>\$ 239,200</u>



**Flanders Corporation**  
**Comparative Balance Sheets**  
**For Years Ended June 30, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$ 334,000	\$ 40,000
Accounts receivable (net)	200,000	240,000
Inventory	360,000	440,000
Prepaid expenses	1,200	2,000
Property, plant, and equipment	1,256,000	1,104,000
Accumulated depreciation—property, plant, and equipment	(366,000)	(280,000)
Total assets	<u>\$1,785,200</u>	<u>\$1,546,000</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 128,000	\$ 84,000
Notes payable (due in 90 days)	60,000	160,000
Income taxes payable	52,000	36,000
Mortgage payable	720,000	560,000
Common stock, \$5 par value	400,000	400,000
Retained earnings	425,200	306,000
Total liabilities and stockholder's equity	<u>\$ 1,785,200</u>	<u>\$1,546,000</u>

The following is additional information about 2014: (a) equipment that cost \$48,000 with accumulated depreciation of \$34,000 was sold at a loss of \$8,000; (b) land and building were purchased in the amount of \$200,000 through an increase of \$200,000 in the mortgage payable; (c) a \$40,000 payment was made on the mortgage; (d) the notes were repaid, but the company borrowed an additional \$60,000 through the issuance of a new note payable; and (e) a \$120,000 cash dividend was declared and paid.

**REQUIRED**

1. Use the direct method to prepare a statement of cash flows. Include a supporting schedule of noncash investing and financing transactions. Do not include a reconciliation of net income to net cash flows from operating activities.
2. What are the primary reasons for Flanders' large increase in cash from 2013 to 2014?
3. Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.)

**P3. Statement of Cash Flows: Direct Method**

Saudade Corporation's 2014 income statement and comparative balance sheet as of June 30, 2014 and 2013 follow.

RATIO

SPREADSHEET

- ✓ 1: Total operating activities:  
\$638,400 inflows
- ✓ 1: Total financing activities:  
\$303,000 outflows

**Saudade Corporation**  
**Income Statement**  
**For the Year Ended June 30, 2014**

Sales	\$2,252,700
Cost of goods sold	<u>1,451,200</u>
Gross margin	\$ 801,500
Operating expenses (including depreciation expense of \$140,000)	<u>397,300</u>
Income from operations	\$ 404,200
Other income (expenses):	
Loss on disposal of equipment	\$ 7,500
Interest expense	<u>74,800</u>
Income before income taxes	\$ 321,900
Income taxes	<u>69,200</u>
Net income	<u>\$ 252,700</u>

**Saudade Corporation**  
**Comparative Balance Sheets**  
**For Years Ended June 30, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$ 393,900	\$ 50,000
Accounts receivable (net)	180,000	250,000
Inventory	330,000	420,000
Prepaid expenses	1,400	2,300
Property, plant, and equipment	1,365,000	1,213,000
Accumulated depreciation—property, plant, and equipment	(404,000)	(297,000)
Total assets	<u>\$1,866,300</u>	<u>\$1,638,300</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 148,000	\$ 85,000
Notes payable (due in 90 days)	75,000	150,000
Income taxes payable	53,300	39,000
Mortgage payable	740,000	587,000
Common stock, \$5 par value	415,000	415,000
Retained earnings	435,000	362,300
Total liabilities and stockholders' equity	<u>\$1,866,300</u>	<u>\$1,638,300</u>

The following is additional information about 2014: (a) equipment that cost \$49,000 with accumulated depreciation of \$33,000 was sold at a loss of \$7,500; (b) land and building were purchased in the amount of \$201,000 through an increase of \$201,000 in the mortgage payable; (c) a \$48,000 payment was made on the mortgage; (d) the notes were repaid, but the company borrowed an additional \$75,000 through the issuance of a new note payable; and (e) a \$180,000 cash dividend was declared and paid.

**REQUIRED**

1. Use the direct method to prepare a statement of cash flows. Include a supporting schedule of noncash investing and financing transactions. Do not include a reconciliation of net income to net cash flows from operating activities.
2. What are the primary reasons for Saudade's large increase in cash from 2013 to 2014?
3. Compute and assess cash flow yield and free cash flow for 2014. (Round to one decimal place.)



# CHAPTER 16

## Financial Statement Analysis

### BUSINESS INSIGHT

#### Medal Investments

Having studied the eating habits of Americans for several months, Kate Medal, president of Medal Investments, has concluded that there is a trend toward eating out and that the trend will continue. She is, therefore, planning to invest in a fast-food restaurant chain, and she has narrowed her choice to two companies: Fast Burger and Tasty Steak. She is now thinking about how she should evaluate these companies and arrive at her final decision.

In this chapter, we discuss the various analytical tools and standards that Kate can use to measure and compare the financial performance of the two companies.

- 1. CONCEPT** ► *What concepts underlie the standards that Kate can use to compare the performance of the two companies?*
- 2. ACCOUNTING APPLICATION** ► *What analytical tools can Kate use to measure the financial performance of Fast Burger and Tasty Steak?*
- 3. BUSINESS APPLICATION** ► *In what ways would having access to prior years' information aid this analysis? Why is earnings management important in your assessment?*

### LEARNING OBJECTIVES

- LO 1** Describe the concepts, standards of comparison, and sources of information used in measuring financial performance.
- LO 2** Apply horizontal analysis, trend analysis, vertical analysis, and ratio analysis to financial statements.
- LO 3** Apply financial ratio analysis in a comprehensive evaluation of a company's financial performance.
- LO 4** Define *quality of earnings*, and identify the factors that affect quality of earnings and related management compensation issues.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Relevance
- Predictive value
- Comparability
- Timeliness

RELEVANT  
LEARNING OBJECTIVE

**LO 1** Describe the concepts, standards of comparison, and sources of information used in measuring financial performance.

## LO 1 Concepts Underlying Financial Performance Measurement

**Financial statement analysis** (or *financial performance measurement*) is used to show how items in a company's financial statements relate to the company's financial performance objectives. Users of accounting information interested in measuring a company's financial performance fall into two groups:

- A company's top managers, who set and strive to achieve financial performance objectives; middle-level managers of business processes; and lower-level employees who own stock in the company
- Creditors and investors, as well as customers who have cooperative agreements with the company

Both these groups of users want measures of financial performance that meet these underlying concepts:

- **Relevance:** The measures need to make a difference in the analysis of a company's performance.
- **Predictive value:** The users want measures that will help them make decisions about future actions.
- **Comparability:** The users want measures that make useful comparison of one period of the company's performance with another and of the company's performance to other companies.
- **Timeliness:** The users want measures that enable them to make decisions made in time to have the desired effects.

In the analysis of accounting information, managers, creditors, and investors want measures that relate to the following objectives:

- **Profitability:** To continue operating, a company must earn a satisfactory net income. Management is responsible for monitoring and measuring net income, determining the causes of any deviations from financial performance plans, and correcting the deviations. Creditors and investors look at a company's past and present net income to identify trends and to judge potential earnings ability.
- **Total Asset Management:** A company uses its assets to generate revenues. These assets are part of the cost of operating a business. To maximize net income, management must use all of the company's assets in a way that maximizes revenues while minimizing the investment in these assets.
- **Liquidity:** A company must be able to pay its bills when they come due and meet unexpected needs for cash. Management must use cash, like other assets, to fund operations that generate maximum revenues. Creditors focus on liquidity because they expect to be paid what they are owed at the appropriate time.
- **Financial Risk:** Management must use debt and stockholders' investments effectively without jeopardizing the company's future. Creditors and stockholders judge the risk involved in making a loan or an investment by looking at a company's past performance and current position. The more difficult it is to predict future profitability and liquidity, the greater the risk.
- **Operating Asset Management:** Managing operating assets is much like managing total assets. Managers must use current assets and current liabilities in a way that supports revenue growth and minimizes investment.



## Standards of Comparison

When analyzing financial statements, decision makers must judge whether the relationships they find in the statements are favorable or unfavorable. Three standards of comparison that they commonly use are rule-of-thumb measures, a company's past performance, and industry norms.

**Rule-of-Thumb Measures** Many financial analysts, investors, and lenders apply general standards, or *rule-of-thumb measures*, to key financial ratios. For example, the credit-rating firm of **Dun & Bradstreet** offers the following rules of thumb:

- **Current Ratio:** The higher the ratio, the more likely the company will be able to meet its liabilities. A ratio of 2 to 1 (2.0) or higher is desirable.
- **Current Liabilities to Net Worth Ratio (%):** Normally a business starts to have trouble when this relationship exceeds 80%.<sup>1</sup>

**Past Performance** Comparing financial measures or ratios of the same company over time is an improvement over using rule-of-thumb measures. Such a comparison gives the analyst some basis for judging whether the measure or ratio is getting better or worse. Thus, it may be helpful in showing future trends. However, such projections must be made with care. Trends reverse over time, and a company's needs may change. For example, even if a company improves its return on investment from 3 percent in one year to 4 percent the next year, the 4 percent return may not be adequate for the company's current needs. In addition, using a company's past performance as a standard of comparison is not helpful in judging its performance relative to that of other companies.

**Industry Norms** Using industry norms as a standard of comparison overcomes some of the limitations of comparing a company's measures over time. Industry norms show how a company compares with other companies in the same industry. For example, if companies in a particular industry have an average rate of return on investment of 8 percent, a 3 or 4 percent rate of return is probably not adequate. Using industry norms as standards has the following limitations:

- **Comparability:** Companies in the same industry may not be strictly comparable. For example, one company in the oil industry purchases oil products and markets them through service stations. The other, an international company, discovers, produces, refines, and markets its own oil products. Because of the disparity in their operations, these two companies cannot be directly compared.
- **Accounting differences:** Companies in the same industry with similar operations may not use the same accounting procedures. For example, they may use different methods of valuing inventories and of depreciating assets.
- **Diversity: Diversified companies** (or *conglomerates*) are large companies that have multiple segments and operate in more than one industry. They may not be comparable to any other company.



## International Perspective

IFRS

### The Use and Evaluation of Performance Measures Must Change When Using IFRS

Financial statement users must carefully consider evaluations and comparisons of historical performance under IFRS for a variety of reasons. When a company switches from U.S. GAAP to IFRS, prior years' performance measures will not likely be comparable. In fact, 80 percent of companies surveyed in a research study of European companies reported higher net income for the same operations under IFRS than under U.S. GAAP. When this occurs, an IFRS profit margin will likely provide a more optimistic evaluation when compared with pre-IFRS results or with a U.S. GAAP-based competitor. Further, the definitions of assets, liabilities, and equity differ under IFRS. The combined effect is that debt to equity, return on equity, and return on assets ratios may not exhibit historical trends. Contracts and management compensation based on these IFRS measures also require a closer look.



**STUDY NOTE:** Each segment of a diversified company represents an investment that the home office or parent company evaluates and reviews frequently.

**Exhibit 1**  
Selected Segment  
Information for Goodyear  
Tire & Rubber Company

The FASB provides a partial solution to the limitation posed by diversified companies. It requires a diversified company to report profit or loss, certain revenue and expense items, and assets for each of its segments. Segment information may be reported for operations in different industries or different geographical areas or for major customers.<sup>2</sup> Exhibit 1 shows how **Goodyear Tire & Rubber Company** reports data on sales, income, and assets for its tire products segments. These data allow the analyst to compute measures of profitability, such as profit margin, asset turnover, and return on assets, for each segment and to compare them with industry norms.

(In millions)	2011	2010	2009
<b>Sales:</b>			
North American Tire	\$ 9,859	\$ 8,205	\$ 6,977
Europe, Middle East and Africa Tire	8,040	6,407	5,801
Latin American Tire	2,472	2,158	1,814
Asia Pacific Tire	2,396	2,062	1,709
<b>Net Sales</b>	<b>\$22,767</b>	<b>\$18,832</b>	<b>\$16,301</b>
<b>Segment Operating Income:</b>			
North American Tire	\$ 276	\$ 18	\$ (305)
Europe, Middle East and Africa Tire	627	319	166
Latin American Tire	231	330	301
Asia Pacific Tire	234	250	210
<b>Total Segment Operating Income</b>	<b>\$ 1,368</b>	<b>\$ 917</b>	<b>\$ 372</b>
<b>Assets:</b>			
North American Tire	\$ 5,744	\$ 5,243	\$ 4,836
Europe, Middle East and Africa Tire	5,915	5,266	5,144
Latin American Tire	2,141	1,809	1,672
Asia Pacific Tire	2,482	2,150	1,548
<b>Total Segment Assets</b>	<b>\$16,282</b>	<b>\$14,468</b>	<b>\$13,200</b>
Corporate	1,347	1,162	1,210
<b>Total Assets</b>	<b>\$17,629</b>	<b>\$15,630</b>	<b>\$14,410</b>

Source: The Goodyear Tire & Rubber Company, Form 10-K, For the Fiscal Year Ended 2011 (adapted).

Despite these limitations, if little information about a company's past performance is available, industry norms probably offer the best available standards for judging current performance—as long as they are used with care.

## Sources of Information

The major sources of information about public corporations follow.

- **Reports published by a corporation:** A public corporation's annual report is an important source of financial information. Most public corporations also publish **interim financial statements** each quarter and sometimes each month. These reports, which present limited information in the form of condensed financial statements, are not subject to a full audit by an independent auditor. The financial community watches interim statements closely for early signs of change in a company's earnings trend.
- **Reports filed with the Securities and Exchange Commission (SEC):** Public corporations in the United States must file annual reports (**Form 10-K**), quarterly reports (**Form 10-Q**), and current reports (**Form 8-K**) with the SEC. If they have more than \$10 million in assets and more than 500 shareholders, they must file these reports electronically at <http://www.sec.gov/edgar/searchedgar/webusers.htm>, where anyone can access them free of charge.

**STUDY NOTE:** Publishers often redefine the content of the ratios that companies provide. While the general content is similar, variations occur. Be sure to ascertain and evaluate the information that a published source uses to calculate ratios.

- **Business periodicals and credit and investment advisory services:** Financial analysts must keep up with current events in the financial world. One leading source of financial news is *The Wall Street Journal*. It is the most complete financial newspaper in the United States and is published every business day. Credit and investment advisory services such as **Moody's Investors Service**, **Standard & Poor's**, and **Dun and Bradstreet** provide useful information, including details about a company's financial history, industry data, and credit ratings.

## APPLY IT!

Identify each of the following as (a) an underlying concept, (b) an objective of financial statement analysis, (c) a standard for financial statement analysis, or (d) a source of information for financial statement analysis:

1. A company's past performance
2. Investment advisory services
3. Assessment of a company's future potential
4. Relevance
5. Industry norms
6. Annual report
7. Form 10-K
8. Timeliness

### SOLUTION

1. c; 2. d; 3. b; 4. a; 5. c; 6. d; 7. d; 8. a

### TRY IT! SE1, SE2, E1A, E1B

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Analyzing financial statements
  - Horizontal analysis
  - Trend analysis
  - Vertical analysis
  - Ratio analysis
- Evaluating profitability and total asset management
  - Profit margin
  - Asset turnover
  - Return on assets
- Evaluating liquidity
  - Cash flow yield
  - Cash flows to sales
  - Cash flows to assets
  - Free cash flow
- Evaluating financial risk
  - Debt to equity ratio
  - Return on equity
  - Interest coverage ratio
- Evaluating operating asset management
  - Inventory turnover
  - Days' inventory on hand
  - Receivable turnover
  - Days' sales uncollected
  - Payables turnover
  - Days' payable
  - Financing period
  - Current ratio
  - Quick ratio
- Evaluating market strength
  - Price/earnings (P/E)
  - Dividend yield

## RELEVANT LEARNING OBJECTIVES

**LO 2** Apply horizontal analysis, trend analysis, vertical analysis, and ratio analysis to financial statements.

**LO 3** Apply financial ratio analysis in a comprehensive evaluation of a company's financial performance.

## LO 2 Tools and Techniques of Financial Analysis

To gain insight into a company's financial performance, one must look beyond the individual numbers to the relationship between the numbers and their change from one period to another. The tools of financial analysis—horizontal analysis, trend analysis, vertical analysis, and ratio analysis—are intended to show these relationships and changes.

### Horizontal Analysis

Comparative financial statements provide financial information for the current year and the previous year. To gain insight into year-to-year changes, analysts use **horizontal analysis**, in which changes from the previous year to the current year are computed in both dollar amounts and percentages. The percentage change relates the size of the change to the size of the dollar amounts involved. Note that it is important to ascertain the base amount used when a percentage describes an item. For example, inventory may be 50 percent of total current assets but only 10 percent of total assets.

Exhibits 2 and 3 present **Starbucks Corporation's** comparative balance sheets and income statements and show both the dollar and percentage changes.

The percentage change is computed as follows.

$$\text{Percentage Change} = 100 \times \frac{\text{Comparative Year Amount} - \text{Base Year Amount}}{\text{Base Year Amount}}$$

The **base year** is the first year considered in any set of data. For example, when comparing data for 2010 and 2011, 2010 is the base year. As the balance sheets in Exhibit 2 show, between 2010 and 2011, Starbucks' total current assets increased by \$1,038.5 million, from \$2,756.4 million to \$3,794.9 million, or by 37.7 percent, computed as follows.

$$\text{Percentage Change} = 100 \times \frac{\$1,038.5 \text{ million}}{\$2,756.4 \text{ million}} = 37.7\%$$

When examining such changes, it is important to consider the dollar amount of the change as well as the percentage change in each component. For example, the difference between the percentage increase in accounts receivable, net (27.7 percent) and total current assets (37.7 percent) is 10 percent. However, the dollar increase in total current assets is more than twelve times the dollar increase in accounts receivable (\$1,038.5 million versus \$83.8 million). Thus, even though the percentage changes differ by 10 percent, current assets require much more cash than accounts receivable.

Starbucks' balance sheets for 2010 and 2011 also show the following:

- ▲ Total assets *increased* by \$974.5 million, or 15.3 percent.
- ▲ Shareholders' equity *increased* by \$710.2 million, or 19.3 percent.

Starbucks' income statements in Exhibit 3 show the following:

- ▲ Net revenues *increased* by \$993.0 million, or 9.3 percent.
- ▲ Gross margin *increased* by \$502.3 million, or 8.0 percent.

This indicates that the cost of sales grew faster than net revenues. In fact, the cost of sales increased 11.0 percent compared with the 9.3 percent increase in net revenues.

In addition,

- ▲ Total operating expenses *increased* by \$249 million, or 5.0 percent, which is lower than the 9.3 percent increase in net revenues.
- ▲ Operating income *increased* by \$309.1 million, or 21.8 percent.
- ▲ Net income *increased* by \$299.7 million, or 31.6 percent.

## Exhibit 2

### Comparative Balance Sheets with Horizontal Analysis

**Starbucks Corporation**  
**Consolidated Balance Sheets**  
**For the Years Ended October 2, 2011 and October 3, 2010**

(Dollar amounts in millions)	2011	2010	Increase (Decrease)	
			Amount*	Percentage*
<b>Assets</b>				
Current assets:				
Cash and cash equivalents	\$1,148.1	\$1,164.0	\$(15.9)	(1.4)
Short-term investments – available-for-sale securities	855.0	236.5	618.5	261.5
Short-term investments – trading securities	47.6	49.2	(1.6)	(3.3)
Accounts receivable, net	386.5	302.7	83.8	27.7
Inventories	965.8	543.3	422.5	77.8
Prepaid and other current assets	161.5	156.5	5.0	3.2
Deferred income taxes, net	230.4	304.2	(73.8)	(24.3)
Total current assets	<u>\$3,794.9</u>	<u>\$2,756.4</u>	<u>\$1,038.5</u>	<u>37.7</u>
Long-term investments – available-for-sale securities	107.0	191.8	(84.8)	(44.2)
Equity and cost investments	372.3	341.5	30.8	9.0
Property, plant, and equipment, net	2,355.0	2,416.5	(61.5)	(2.5)
Other assets	297.7	346.5	(48.8)	(14.1)
Other intangible assets	111.9	70.8	41.1	58.1
Goodwill	321.6	262.4	59.2	22.6
Total assets	<u>\$7,360.4</u>	<u>\$6,385.9</u>	<u>\$ 974.5</u>	<u>15.3</u>
<b>Liabilities and Shareholders' Equity</b>				
Current liabilities:				
Accounts payable	540.0	282.6	257.4	91.1
Accrued compensation and related costs	364.4	400.0	(35.6)	(8.9)
Accrued occupancy costs	148.3	173.2	(24.9)	(14.4)
Accrued taxes	109.2	100.2	9.0	9.0
Insurance reserves	145.6	146.2	(0.6)	(0.4)
Other accrued liabilities	319.0	262.8	56.2	21.4
Deferred revenue	449.3	414.1	35.2	8.5
Total current liabilities	<u>\$2,075.8</u>	<u>\$1,779.1</u>	<u>\$ 296.7</u>	<u>16.7</u>
Long-term debt	549.5	549.4	0.1	0.0
Other long-term liabilities	347.8	375.1	(27.3)	(7.3)
Total liabilities	<u>2,973.1</u>	<u>2,703.6</u>	<u>269.5</u>	<u>10.0</u>
Total shareholders' equity	<u>4,384.9</u>	<u>3,674.7</u>	<u>710.2</u>	<u>19.3</u>
Noncontrolling interests	2.4	7.6	(5.2)	(68.4)
Total equity	<u>4,387.3</u>	<u>3,682.3</u>	<u>705.0</u>	<u>19.1</u>
Total liabilities and shareholders' equity	<u>\$7,360.4</u>	<u>\$6,385.9</u>	<u>\$ 974.5</u>	<u>15.3</u>

\*Rounded

Source: Data from Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011.

**Exhibit 3****Comparative Income Statements with Horizontal Analysis**

**Starbucks Corporation**  
**Consolidated Income Statements**  
**For the Years Ended October 2, 2011 and October 3, 2010**

(Dollar amounts in millions except per share amounts)	2011	2010	Increase (Decrease)	
			Amount*	Percentage*
Net revenues	\$11,700.4	\$10,707.4	\$993.0	9.3
Cost of sales, including occupancy costs	4,949.3	4,458.6	490.7	11.0
Gross margin	\$ 6,751.1	\$ 6,248.8	\$502.3	8.0
Operating expenses				
Store operating expenses	\$ 3,665.1	\$ 3,551.4	\$113.7	3.2
Other operating expenses	402.0	293.2	108.8	37.1
Depreciation and amortization expenses	523.3	510.4	12.9	2.5
General and administrative expenses	636.1	569.5	66.6	11.7
Restructuring charges	—	53.0	(53.0)	(100.0)
Total operating expenses	\$ 5,226.5	\$ 4,977.5	\$249.0	5.0
Gain on sale of properties	30.2	—	30.2	—
Income from equity investees	173.7	148.1	25.6	17.3
Operating income	\$ 1,728.5	\$ 1,419.4	\$309.1	21.8
Interest income and other, net	115.9	50.3	65.6	130.4
Interest expense	(33.3)	(32.7)	(0.6)	1.8
Income before taxes	\$ 1,811.1	\$ 1,437.0	\$374.1	26.0
Income taxes	563.1	488.7	74.4	15.2
Net income	\$ 1,248.0	\$ 948.3	\$299.7	31.6

\*Rounded

Source: Data from Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011.

The primary reason for the increases in operating income and net income is that operating expenses increased at a slower rate (5.0 percent) than net revenues (9.3 percent).

## Trend Analysis

**STUDY NOTE:** To reflect the general five-year economic cycle of the U.S. economy, trend analysis usually covers a five-year period.

**Trend analysis** is a variation of horizontal analysis. With this tool, the analyst calculates percentage changes for several successive years instead of for just two years. Because of its long-term view, trend analysis can highlight basic changes in the nature of a business.

Exhibit 4 shows a trend analysis of **Starbucks'** five-year summary of net revenues and operating income.

Trend analysis uses an **index number** to show changes in related items over time. For an index number, the base year is set at 100 percent. Other years are measured in relation to that amount. For example, the 2011 index for Starbucks' net revenues is figured as follows (dollar amounts are in millions).

### Exhibit 4 Trend Analysis

Starbucks Corporation Net Revenues and Operating Income Trend Analysis					
	2011	2010	2009	2008	2007
<b>Dollar values (In millions)</b>					
Net revenues	\$11,700.4	\$10,707.4	\$9,774.6	\$10,383.0	\$9,411.5
Operating income	1,728.5	1,419.4	562.0	390.3	945.9
<b>Trend analysis (In percentages)</b>					
Net revenues	124.3	113.8	103.9	110.3	100.0
Operating income	182.7	150.1	59.4	41.3	100.0

Source: Data from Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011.

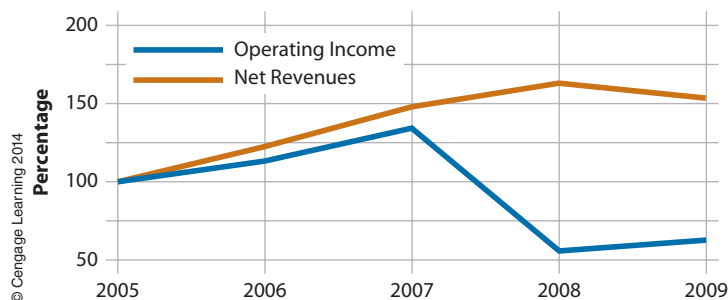
$$\text{Index} = 100 \times \frac{\$11,700.4}{\$9,411.5} = 124.3\%$$

The trend analysis in Exhibit 4 shows the following:

- ▲ Net revenues *increased* over the five-year period.
- ▲ Overall, revenue *increased* 24.3 percent.

Net revenues grew faster than operating income in 2008 and 2009; however, operating income grew faster than net revenues in 2010 and 2011. Exhibit 5 illustrates these trends.

### Exhibit 5 Graph of Trend Analysis Shown in Exhibit 4

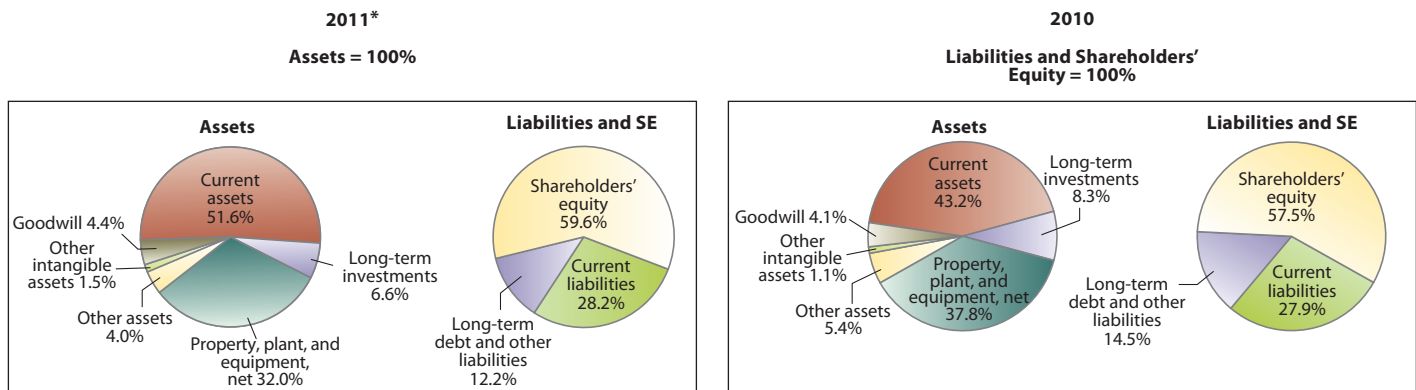


## Vertical Analysis

**Vertical analysis** shows how the different components of a financial statement relate to a total figure in the statement. On the balance sheet, the figure would be total assets or total liabilities and stockholders' equity, and on the income statement, it would be net revenues or net sales. The analyst sets the total figure at 100 percent and computes each component's percentage of that total. The resulting financial statement, which is expressed entirely in percentages, is called a **common-size statement**. Common-size balance sheets and common-size income statements for **Starbucks** are shown in pie-chart form in Exhibits 6 and 8 and in financial statement form in Exhibits 7 and 9.



### Exhibit 6 Common-Size Balance Sheets Presented Graphically



\*Rounding causes some additions not to total precisely.

### Exhibit 7 Common-Size Balance Sheets

#### Starbucks Corporation Common-Size Balance Sheets October 2, 2011, and October 3, 2010

	2011	2010
<b>Assets</b>		
Current assets	51.6%	43.2%
Long-term investments	6.6	8.3
Property, plant, and equipment, net	32.0	37.8
Other assets	4.0	5.4
Other intangible assets	1.5	1.1
Goodwill	4.4	4.1
Total assets	<u>100.0%</u>	<u>100.0%</u>
<b>Liabilities and Shareholders' Equity</b>		
Current liabilities	28.2%	27.9%
Long-term debt and other liabilities	12.2	14.5
Shareholders' equity	59.6	57.5
Total liabilities and shareholders' equity	<u>100.0%</u>	<u>100.0%</u>

Note: Amounts do not precisely total 100 percent in all cases due to rounding.

Source: Data from Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011.

Vertical analysis and common-size statements are useful in comparing the importance of specific components in the operation of a business and in identifying important changes in the components from one year to the next. The main conclusions to be drawn from our analysis of Starbucks are the following:

- Starbucks' assets consist largely of current assets and property, plant, and equipment.
- Starbucks finances assets primarily through equity and current liabilities.
- Starbucks has few long-term liabilities.

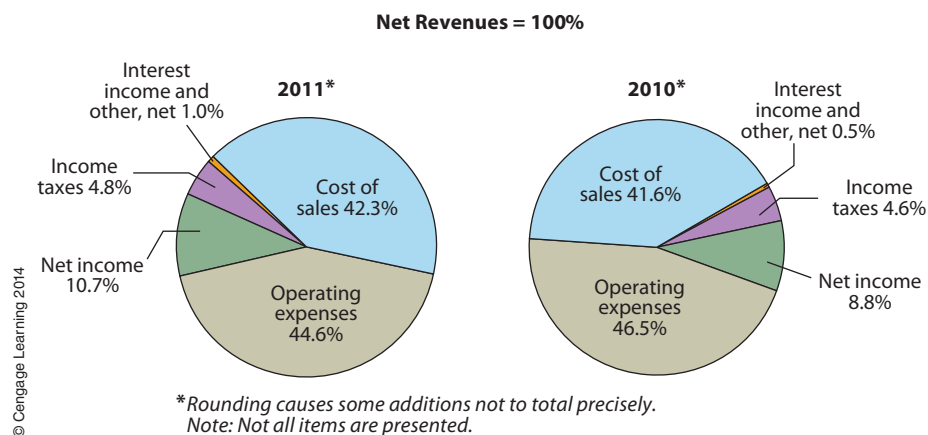
Looking at the pie charts in Exhibit 6 and the common-size balance sheets in Exhibit 7, you can see the following:

- The composition of Starbucks' assets shifted from property, plant, and equipment (declined from 37.8% to 32.0%), long-term investments (from 8.3% to 6.6%), and other assets (from 5.4% to 4.0%) to current assets (from 43.2% to 51.6%).

- The proportion of long-term debt and other liabilities decreased (from 14.5% to 12.2%) while current liabilities increased (from 27.9% to 28.2%) and shareholders' equity increased (from 57.5% to 59.6%).

The common-size income statements in Exhibit 9, illustrated as pie charts in Exhibit 8, show that Starbucks decreased its operating expenses from 2010 to 2011 by 1.9 percent of revenues (46.5% vs. 44.6%). In other words, revenues grew faster than operating expenses.

**Exhibit 8**  
Common-Size Income  
Statements Presented  
Graphically



**Exhibit 9**  
Common-Size  
Income Statements

<b>Starbucks Corporation</b>		
<b>Common-Size Income Statements</b>		
<b>For the Years Ended October 2, 2011, and October 3, 2010</b>		
	<b>2011</b>	<b>2010</b>
Net revenues	100.0%	100.0%
Cost of sales, including occupancy costs	42.3	41.6
Gross margin	57.7%	58.4%
Operating expenses:		
Store operating expenses	31.3%	33.2%
Other operating expenses	3.4	2.7
Depreciation and amortization expenses	4.5	4.8
General and administrative expenses	5.4	5.3
Restructuring charges	—	0.5
Total operating expenses	44.6%	46.5%
Gain on sales of properties	0.3%	—%
Income from equity investees	1.5	1.4
Operating income	14.9%	13.3%
Interest income and other, net	1.0	0.5
Interest expense	(0.3)	(0.3)
Income before taxes	15.5%	13.4%
Income taxes	4.8	4.6
Net income	10.7%	8.9%

Note: Amounts do not precisely total 100 percent in all cases due to rounding.  
Source: Data from Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011.

Common-size statements are often used to make comparisons between companies. They allow an analyst to compare the operating and financing characteristics of two companies of different size in the same industry. For example, the analyst might want to compare Starbucks with other specialty retailers in terms of percentage of total assets

financed by debt or in terms of operating expenses as a percentage of net revenues. Common-size statements would show those and other relationships. These statements can also be used to compare the characteristics of companies that report in different currencies.

## RATIO

## Financial Ratio Analysis

**Financial ratio analysis** identifies key relationships between the components of the financial statements. Ratios are useful tools for evaluating a company's financial position and operations and may reveal areas that need further investigation. To interpret ratios correctly, the analyst must have:

- A general understanding of the company and its environment
- Financial data for several years or for several companies
- An understanding of the data underlying the numerator and denominator

Ratios can be expressed in several ways. For example, a ratio of net income of \$100,000 to sales of \$1,000,000 can be stated as follows.

- Net income is 1/10, or 10 percent, of sales.
- The ratio of sales to net income is 10 to 1 (10:1), or sales are 10 times net income.
- For every dollar of sales, the company has an average net income of 10 cents.

## APPLY IT!

Using 2012 as the base year, prepare a trend analysis for the data that follows, and tell whether the results suggest a favorable or unfavorable trend. (Round to one decimal place.)

	2014	2013	2012
Net sales	\$216,000	\$152,000	\$100,000
Accounts receivable (net)	40,000	29,000	20,000

### SOLUTION

	2014	2013	2012
Net sales	216.0%	152.0%	100.0%
Accounts receivable (net)	200.0%	145.0%	100.0%

These results show favorable trends because the company is increasing sales at a faster pace than the amount of resources tied up in accounts receivable.

**TRY IT! SE3, SE4, SE5, E2A, E3A, E4A, E2B, E3B, E4B**

## RATIO

## LO 3

## Comprehensive Illustration of Financial Ratio Analysis

In this section, we perform a comprehensive financial ratio analysis of **Starbucks'** performance in 2010 and 2011. The following excerpt from the Management's Discussion and Analysis of Financial Condition section of Starbucks' 2011 annual report provides the context for our evaluation:

*Starbucks results for fiscal 2011 reflect the strength and resiliency of our business model, the global power of our brand and the talent and dedication of our employees. Our business has performed well this year despite significant headwinds from commodity costs and a continually challenging consumer environment. Strong global comparable stores sales growth of 8% for the full year (US*

8% and International 5%) drove increased sales leverage and resulted in higher operating margins and net earnings. This helped mitigate the impact of higher commodity costs, which negatively impacted EPS by approximately \$0.20 per share for the year, equivalent to approximately 220 basis points of operating margin. Most of the commodity pressure was related to coffee, with dairy, cocoa, sugar and fuel accounting for the rest. . . .

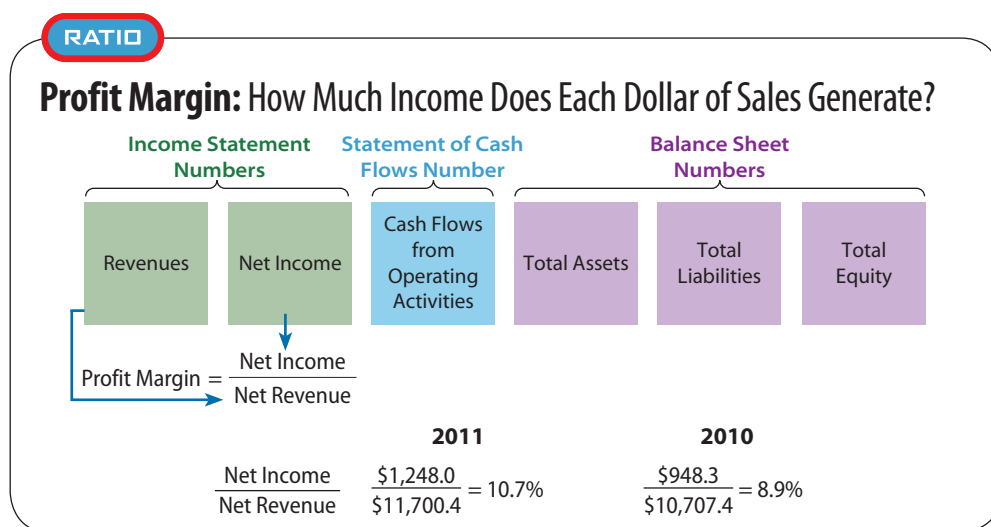
We are aggressively pursuing the profitable expansion opportunities that exist outside the US, including disciplined growth and scale in our more mature markets, and faster expansion in key emerging markets like China.

We will use the ratios introduced earlier in the text, as well as some commonly used supplemental financial ratios, to evaluate Starbucks' performance in relation to the five concepts: profitability, total asset management, liquidity, financial risk, and operating asset management. We will also evaluate Starbucks' market strength. The data that we use in computing all ratios are from Starbucks' Form 10-K, 2011, and Form 10-K, 2010. All dollar amounts shown in the computations are in millions.

## Evaluating Profitability and Total Asset Management

Investors and creditors use profit margin to evaluate a company's ability to earn a satisfactory income (*profitability*). They use asset turnover to determine whether the company uses assets in a way that maximizes revenue (*total asset management*). These two ratios require only three numbers: revenue (or net revenue),\* net income, and average total assets. Their combined effect is overall earning power—that is, return on assets.

**Profit Margin** Profit margin measures the net income produced by each dollar of sales. Starbucks' profit margins in 2011 and 2010 are computed as follows.

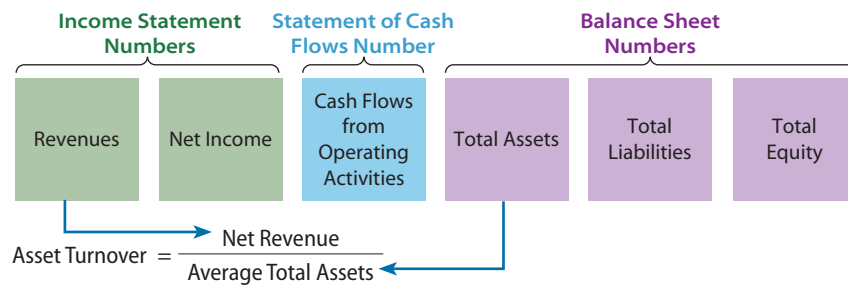


Starbucks' profit margin increased from 8.9 to 10.7 percent between 2011 and 2010 because as a percentage of revenue, operating expenses decreased, as shown in Exhibit 9.

**Asset Turnover** Asset turnover measures how efficiently assets are used to produce sales. Starbucks' asset turnover ratios in 2011 and 2010 are computed as follows.

\* Starbucks refers to revenue as *net revenue*, and we use that term throughout our examples.

## RATIO

**Asset Turnover:** How Much Revenue Is Generated by Each Dollar of Assets?

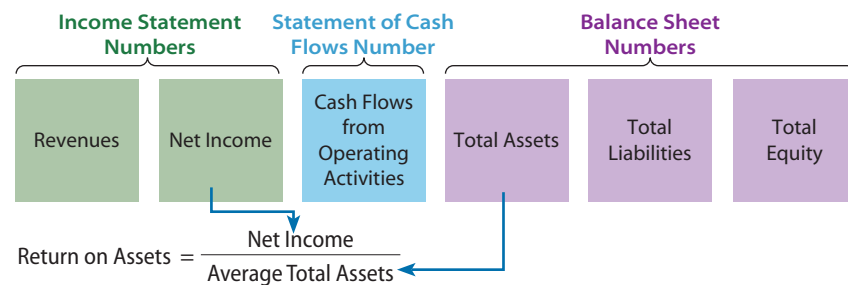
	2011	2010
$\frac{\text{Net Revenue}}{\text{Average Total Assets}}$	$\frac{\$11,700.4}{(\$7,360.4 + \$6,385.9) \div 2}$ $= \frac{\$11,700.4}{\$6,873.2} = 1.7 \text{ Times}$	$\frac{\$10,707.4}{(\$6,385.9 + \$5,576.8^*) \div 2}$ $= \frac{\$10,707.4}{\$5,981.4} = 1.8 \text{ Times}$

\*Total assets from Starbucks' 2009 consolidated balance sheet.

Starbucks' asset turnover decreased slightly to 1.7 times from 1.8 times because net sales increased slightly less in relation to average total assets.

**Return on Assets** Return on assets measures a company's overall earning power, or profitability. Starbucks' return on assets ratios in 2011 and 2010 are computed as follows.

## RATIO

**Return on Assets:** How Much Income Did Each Dollar of Assets Generate?

	2011	2010
$\frac{\text{Net Income}}{\text{Average Total Assets}}$	$\frac{\$1,248.0}{(\$7,360.4 + \$6,385.9) \div 2}$ $= \frac{\$1,248.0}{\$6,873.2} = 18.2\%$	$\frac{\$948.3}{(\$6,385.9 + \$5,576.8) \div 2}$ $= \frac{\$948.3}{\$5,981.4} = 15.9\%$

Starbucks' return on assets increased from 15.9 percent in 2010 to 18.2 percent in 2011 because net income increased more in relation to average total assets.

**Profitability Ratio Relationships** The relationships of the three financial ratios for profitability are as follows.

	<i>Profit Margin</i>		<i>Asset Turnover</i>		<i>Return on Assets</i>
	$\frac{\text{Net Income}}{\text{Net Sales}}$	×	$\frac{\text{Net Sales}}{\text{Average Total Assets}}$	=	$\frac{\text{Net Income}}{\text{Average Total Assets}}$
<b>2010</b>	8.9%	×	1.8	=	16.0%
<b>2011</b>	10.7%	×	1.7	=	18.2%

**Starbucks'** return on assets increased in 2011 because of an increase in profit margin. Although Starbucks' profitability and total asset management ratios were relatively low, Starbucks is very good at generating cash from these returns on assets.

It is important to note that net income is sometimes not as useful in computing profitability ratios as it is for Starbucks. If a company has one-time items on its income statement, such as gains, or losses on the sale or disposal of discontinued operations, income from continuing operations may be a better measure of sustainable earnings than net income. Some analysts like to use earnings before interest and taxes (EBIT) for the earnings measure because it excludes the effects of the company's borrowings and the tax rates from the analysis. Whatever figure one uses for earnings, it is important to try to determine the effects of various components on future operations.

**STUDY NOTE:** The analysis of both asset turnover and return on assets is improved if only productive assets are used in the calculations. For example, when investments in unfinished new plant construction or in nonoperating plants are removed from the asset base, the result is a better picture of the productivity of assets.



## Evaluating Liquidity

As mentioned, *liquidity* is a company's ability to pay bills when they are due and to meet unexpected needs for cash. Analysts compute cash flow yield, cash flows to sales, cash flows to assets, and free cash flow to evaluate a company's liquidity.

**Cash Flow Yield** **Cash flow yield** is the most important liquidity ratio because it measures a company's ability to generate operating cash flows in relation to net income. **Starbucks'** cash flow yields in 2011 and 2010 are computed as follows.

**RATIO**

### Cash Flow Yield: How Much Operating Cash Did Each Dollar of Net Income Generate?

**Income Statement Numbers**

Revenues

Net Income

**Statement of Cash Flows Number**

Cash Flows from Operating Activities

**Balance Sheet Numbers**

Total Assets

Total Liabilities

Total Equity

Cash Flow Yield =  $\frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Income}}$

	<b>2011</b>	<b>2010</b>
$\frac{\text{Net Cash Flows from Operating Activities}}{\text{Net Income}}$	$\frac{\$1,612.4}{\$1,248.0} = 1.3 \text{ Times}$	$\frac{\$1,704.9}{\$948.3} = 1.8 \text{ Times}$

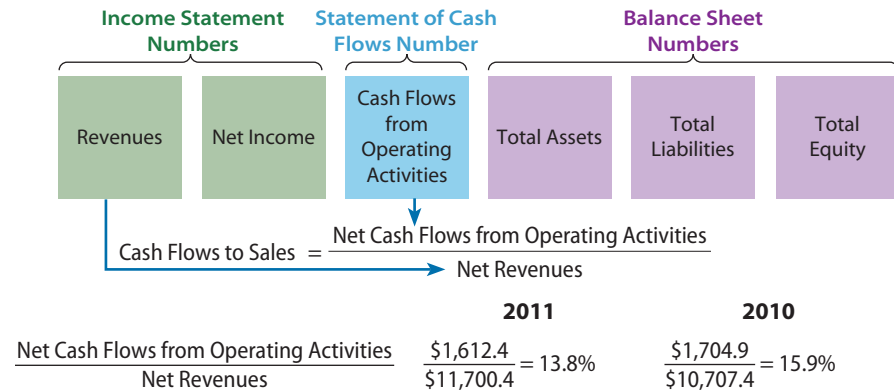
Starbucks' cash flow yield decreased from 1.8 times in 2010 to 1.3 times in 2011 because net cash flows from operating activities decreased while net income increased.

**Cash Flows to Sales** **Cash flows to sales** refers to the ability of sales to generate operating cash flows. **Starbucks'** cash flows to sales ratios in 2011 and 2010 are computed as follows.



## RATIO

### Cash Flows to Sales: How Much Operating Cash Flows Did Each Dollar of Sales Generate?

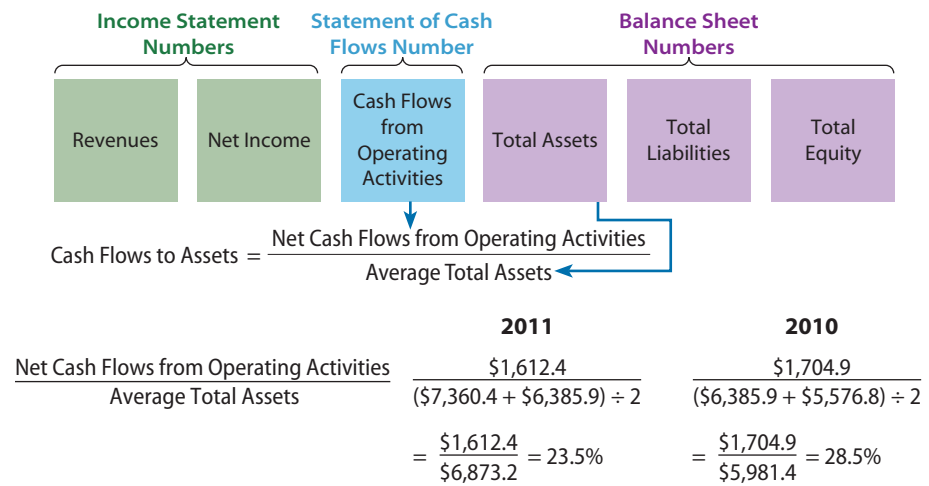


Starbucks' cash flows to sales decreased from 15.9 to 13.8 percent because the company's cash flows provided by its operations decreased while net revenues increased.

**Cash Flows to Assets** Cash flows to assets measures the ability of assets to generate operating cash flows. Starbucks' cash flows to assets ratios in 2011 and 2010 are computed as follows.

## RATIO

### Cash Flows to Assets: How Much Operating Cash Flows Did Each Dollar of Assets Generate?



Starbucks' cash flows to assets decreased from 28.5 to 23.5 percent. The cash flows provided by the company's operations decreased, while the average total assets increased.

**Free Cash Flow** Free cash flow is a measure of the cash remaining after providing for commitments. Starbucks' free cash flows in 2010 and 2011 are computed as follows.

	2011	2010
Net Cash Flows from Operating Activities	\$1,612.4	\$1,704.9
– Dividends	– 389.5	– 171.0
– Net Capital Expenditures*	– 531.9	– 440.7
	= \$691.0	= \$1,093.2

\*From the consolidated statements of cash flows.

Starbucks' free cash flow decreased. While the company's net capital expenditures (the difference between purchases and sales of plant assets) increased by \$91.2 million (\$531.9 - \$440.7), the net cash provided by operating activities decreased by \$92.5 million (\$1,612.4 - \$1,704.9). Another unfavorable factor in Starbucks' free cash flow is that the company paid dividends in the past two years. In sum, Starbucks is very proficient in turning its income into cash. It has very good cash flow returns and strong free cash flow.

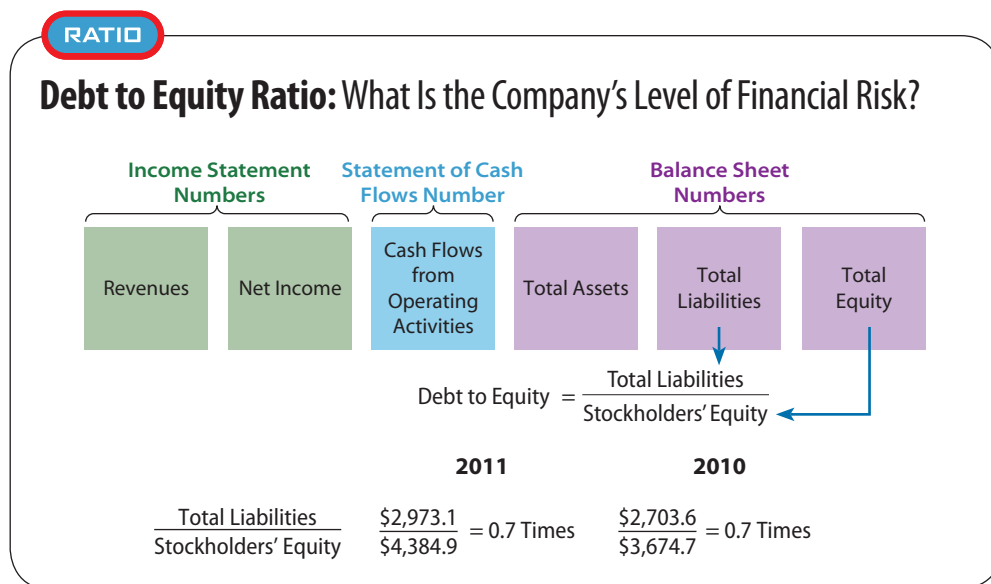
## Evaluating Financial Risk

Financial risk refers to a company's ability to survive in good times and bad. The aim of evaluating financial risk is to detect early signs that a company is headed for financial difficulty through its use of debt, or *financial leverage*, to finance part of the company. Many companies use financial leverage positively. They take advantage of the fact that interest paid on debt is tax-deductible, whereas dividends on stock are not. Because debt usually carries a fixed interest charge and the cost of financing can be limited, leverage can be used to advantage. If a company can earn a return on assets greater than the cost of interest, it increases the return to its stockholders. However, increasing amounts of debt in a company's capital structure can mean that the company is becoming more heavily leveraged. When this occurs, the company runs the risk of not earning a return on assets equal to the cost of financing the assets, thereby incurring a loss. This condition has a negative effect because it represents increasing legal obligations to pay interest periodically and the principal at maturity. Failure to make those payments can result in bankruptcy.

Declining profitability and liquidity ratios together with increased leverage are key indicators of possible failure. Ratios related to financial risk include debt to equity, return on equity, and interest coverage.

**STUDY NOTE:** Because of innovative financing plans and other means of acquiring assets, lease payments and similar types of fixed obligations should be considered when evaluating financial risk.

**Debt to Equity Ratio** The **debt to equity ratio** measures financial risk by showing the amount of assets provided by creditors in relation to the amount provided by stockholders. A higher ratio indicates more financial risk because it indicates the company is relying more heavily on debt financing. **Starbucks'** debt to equity ratios in 2010 and 2011 are computed as follows.



Starbucks' debt to equity ratio was stable at 0.7 times in both 2010 and 2011. Recall from Exhibit 2 that the company increased both its liabilities and its stockholders' equity from 2010 to 2011.

**Return on Equity** Return on equity measures the return to stockholders, or the profitability of stockholders' investments. Starbucks' return on equity ratios in 2010 and 2011 are computed as follows.

**RATIO**

**Return on Equity: How Much Net Income Does a Company Make for Each Dollar Invested by the Owner?**

**Income Statement Numbers**

Revenues

Net Income

**Statement of Cash Flows Number**

Cash Flows from Operating Activities

**Balance Sheet Numbers**

Total Assets

Total Liabilities

Total Equity

Return on Equity =  $\frac{\text{Net Income}}{\text{Average Stockholders' Equity}}$

	2011	2010
Net Income	\$1,248.0	\$948.3
Average Stockholders' Equity	$(\$4,384.9 + \$3,674.7) \div 2$	$(\$3,674.7 + \$3,045.7^*) \div 2$
	$= \frac{\$1,248.0}{\$4,029.8} = 31.0\%$	$= \frac{\$948.3}{\$3,360.2} = 28.2\%$

\*Figures for 2009 are from Starbucks' Form 10-K, 2010.

Starbucks' return on equity increased from 28.2 percent in 2010 to 31.0 percent in 2011. These are excellent returns compared to return on assets of 15.8 percent in 2010 and 18.1 percent in 2011. Note that both the overall profitability (return on assets) and the return to stockholders (return on equity) increased. The reason for this is that Starbucks' net income increased proportionally more than average stockholders' equity.

**Interest Coverage** The **interest coverage ratio** is a supplementary ratio that measures the degree of protection creditors have from default on interest payments. Analysts use this ratio to determine whether a company's interest payments are in peril. Starbucks' interest coverage ratios in 2010 and 2011 are computed as follows.

**RATIO**

**Interest Coverage Ratio: How Many Times Did the Income Exceed Interest Expense?**

	2011	2010
Income Before Income Taxes + Interest Expense	$\$1,811.1 + \$33.3$	$\$1,437.0 + \$32.7$
Interest Expense	\$33.3	\$32.7
	$= \frac{\$1,844.4}{\$33.3} = 55.4 \text{ Times}$	$= \frac{\$1,469.7}{\$32.7} = 44.9 \text{ Times}$

Starbucks' interest coverage increased from 44.9 times to 55.4 times, due to an increase in income before income taxes. Therefore, the interest coverage is at a very safe level.

## Evaluating Operating Asset Management

Research has shown that successful companies carefully manage the operating assets and payables in the **operating cycle**.<sup>3</sup> As discussed in an earlier chapter, the operating cycle involves inventories, accounts receivable, and accounts payable. It spans the time it takes to purchase inventory, sell it, and collect for it. The **financing period**—the period between the time a supplier must be paid and the end of the operating cycle—defines how much additional financing the company must have to support its operations. Because additional debt increases a company's financial risk, it is important to keep the financing period at a manageable level.

The financial ratios that measure operating asset management include inventory turnover, days' inventory on hand, receivables turnover, days' sales uncollected, payables turnover, and days' payable. To determine the days in each component of the cash cycle, the turnover must first be computed by relating the average for each balance sheet account—inventory, accounts receivable, and accounts payable—to the respective income statement account for the period—cost of goods sold and net sales or revenues. The average number of days of each component is then determined by dividing the turnover into 365 days.

**Inventory Turnover** **Inventory turnover** measures the relative size of inventories. **Starbucks'** inventory turnover ratios in 2010 and 2011 are computed as follows.

### RATIO

#### Inventory Turnover: How Many Times Did the Company Sell Its Inventory During an Accounting Period?

	2011	2010
$\frac{\text{Cost of Goods Sold}^*}{\text{Average Inventory}}$	$\frac{\$4,949.3}{(\$965.8 + \$543.3) \div 2}$	$\frac{\$4,458.6}{(\$543.3 + \$664.9^{**}) \div 2}$
	$= \frac{\$4,949.3}{\$754.6} = 6.6 \text{ Times}$	$= \frac{\$4,458.6}{\$604.1} = 7.4 \text{ Times}$

\*Starbucks refers to Cost of Goods Sold as Cost of Sales.

\*\*Inventory from Starbucks' 2009 consolidated balance sheet.

Starbucks' inventory turnover decreased from 7.4 times in 2010 to 6.6 times in 2011 because the average inventory increased more in relation to the cost of goods sold.

**Days' Inventory on Hand** **Days' inventory on hand** measures the average number of days that it takes to sell inventory. **Starbucks'** days' inventory on hand ratios in 2010 and 2011 are computed as follows.

### RATIO

#### Days' Inventory on Hand: How Many Days Did It Take the Company to Sell Its Inventory?

	2011	2010
$\frac{\text{Days in Accounting Period}}{\text{Inventory Turnover}}$	$\frac{365 \text{ Days}}{6.6 \text{ Times}} = 55.3 \text{ Days}$	$\frac{365 \text{ Days}}{7.4 \text{ Times}} = 49.3 \text{ Days}$

Starbucks' days' inventory on hand increased from 49.3 days in 2010 to 55.3 days in 2011 due to the decrease in the inventory turnover.

**Receivables Turnover** **Receivables turnover** measures the relative size of accounts receivable and the effectiveness of credit policies. **Starbucks'** receivables turnover ratios in 2010 and 2011 are computed as follows.

## RATIO

### Receivables Turnover: How Many Times Did the Company Collect Its Accounts Receivable During an Accounting Period?

	2011	2010
$\frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$	$\frac{\$11,700.4}{(\$386.5 + \$302.7) \div 2}$	$\frac{\$10,707.4}{(\$302.7 + \$271.0^*) \div 2}$
	$= \frac{\$11,700.4}{\$344.6} = 34.0 \text{ Times}$	$= \frac{\$10,707.4}{\$286.9} = 37.3 \text{ Times}$

\*Accounts receivable from Starbucks' 2009 consolidated balance sheet.

Because most of Starbucks' sales are for cash or credit card, receivables are not a significant asset for Starbucks. Thus, its receivables turnover is very high. However, it declined slightly, from 37.3 times in 2010 to 34.0 times in 2011.

**Days' Sales Uncollected** **Days' sales uncollected** measures the average number of days it takes to collect receivables. **Starbucks'** days' sales uncollected ratios in 2010 and 2011 are computed as follows.

## RATIO

### Days' Sales Uncollected: How Many Days Does It Take to Collect Accounts Receivables?

	2011	2010
$\frac{\text{Days in Accounting Period}}{\text{Receivables Turnover}}$	$\frac{365 \text{ Days}}{34.0 \text{ Times}} = 10.7 \text{ Days}$	$\frac{365 \text{ Days}}{37.3 \text{ Times}} = 9.8 \text{ Days}$

Starbucks' high receivables turnover ratios resulted in an increase in days' sales uncollected from 9.8 days in 2010 to 10.7 days in 2011.

**Payables Turnover** **Payables turnover** measures the relative size of accounts payable and the credit terms extended to a company. **Starbucks'** payables turnover ratios in 2010 and 2011 are computed as follows.

## RATIO

### Payables Turnover: How Many Times Does a Company Pay Its Accounts Payable During an Accounting Period?

	2011	2010
$\frac{\text{Costs of Goods Sold +/- Change in Inventory}}{\text{Average Accounts Payable}}$	$\frac{\$4,949.3 + \$422.5}{(\$540.0 + \$282.6) \div 2}$	$\frac{\$4,458.6 - \$121.6}{(\$282.6 + \$267.1^*) \div 2}$
	$= \frac{\$5,371.8}{\$411.3} = 13.1 \text{ Times}$	$= \frac{\$4,337.0}{\$274.9} = 15.8 \text{ Times}$

\*Accounts Payable from Starbucks' 2009 consolidated balance sheet.

Starbucks' payables turnover decreased from 15.8 times in 2010 to 13.1 times in 2011.

**Days' Payable** *Days' payable* measures the average number of days it takes to pay accounts payable. Starbucks' days' payable ratios in 2010 and 2011 are computed as follows.

**RATIO**

### Days' Payable: How Many Days Did It Take to Pay Accounts Payable?

	2011	2010
$\frac{\text{Days in Accounting Period}}{\text{Payables Turnover}}$	$\frac{365 \text{ Days}}{13.1 \text{ Times}} = 27.9 \text{ Days}$	$\frac{365 \text{ Days}}{15.8 \text{ Times}} = 23.1 \text{ Days}$

Starbucks' decrease in payables turnover resulted in an increase in days' payable from 23.1 days in 2010 to 27.9 days in 2011.

**Financing Period** We can now assess **Starbucks'** overall operating asset management by computing the financing period—the number of days of financing that must be provided. The financing period is computed by deducting the days' payable from the operating cycle (days' inventory on hand + days' sales uncollected). Starbucks' financing periods in 2010 and 2011 are computed as follows.

**2011:** 55.3 Days + 10.7 Days – 27.9 Days = 38.1 Days  
**2010:** 49.3 Days + 9.8 Days – 23.1 Days = 36.0 Days

Since both days' inventory on hand and days' sales uncollected increased and days' payable increased, Starbucks had to provide 2.1 (38.1 – 36.0) more days of financing for its operating assets in 2011 than in 2010.

## Supplemental Financial Ratios for Assessing Operating Asset Management and Liquidity

In evaluating operating asset management and liquidity, many analysts also consider two supplemental financial ratios: the current ratio and the quick ratio.

### Current Ratio

The **current ratio** measures short-term debt-paying ability by comparing current assets with current liabilities. **Starbucks'** current ratios in 2010 and 2011 are computed as follows.

**RATIO**

### Current Ratio: How Did Current Assets Compare to Current Liabilities?

**Income Statement Numbers**

Revenues

Net Income

**Statement of Cash Flows Number**

Cash Flows from Operating Activities

**Balance Sheet Numbers**

Total Assets

Total Liabilities

Total Equity

Current =  $\frac{\text{Current Assets}}{\text{Current Liabilities}}$

	2011	2010
$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	$\frac{\$3,794.9}{\$2,075.8} = 1.8 \text{ Times}$	$\frac{\$2,756.4}{\$1,779.1} = 1.5 \text{ Times}$



Starbucks' current ratio was increased from 1.5 times in 2010 to 1.8 times in 2011. From 2010 to 2011, its current assets grew faster than its current liabilities.

**Quick Ratio** The **quick ratio**, another measure of short-term debt-paying ability, differs from the current ratio in that the numerator of the quick ratio excludes inventories and prepaid expenses. Inventories and prepaid expenses take longer to convert to cash than the current assets included in the numerator of the quick ratio. **Starbucks'** quick ratios in 2010 and 2011 are computed as follows.

**RATIO**

### Quick Ratio: How Did Current Assets Compare to Current Liabilities?

	2011	2010
Cash + Marketable Securities + Receivables	\$1,148.1 + \$855.0 + \$47.6 + \$386.5	\$1,164.0 + \$236.5 + \$49.2 + \$302.7
Current Liabilities	\$2,075.8	\$1,779.1
	$= \frac{\$2,437.2}{\$2,075.8} = 1.2 \text{ Times}$	$= \frac{\$1,752.4}{\$1,779.1} = 1.0 \text{ Time}$

Starbucks' quick ratio increased from 1.0 time in 2010 to 1.2 times in 2011.

## Evaluating Market Strength with Financial Ratios

Market price is the price at which a company's stock is bought and sold. It indicates how investors view the potential return and risk connected with owning the stock. Market price by itself is not very informative, however, because companies have different numbers of shares outstanding, different earnings, and different dividend policies. Thus, market price must be related to earnings by considering the price/earnings (P/E) ratio and the dividend yield.

**Price/Earnings (P/E)** **Price/earnings (P/E)**, which measures investors' confidence in a company, is the ratio of the market price per share to earnings per share. The P/E ratio is useful in comparing the earnings of different companies and the value of a company's shares in relation to values in the overall market. With a higher P/E ratio, the investor obtains less earnings per dollar invested. **Starbucks'** P/E ratios in 2010 and 2011 are computed as follows.

**RATIO**

### Price/Earnings (P/E): What Value Does the Market Place on the Company's Earnings?

	2011	2010
Market Price per Share Earnings per Share**	$\frac{\$37.86^*}{\$1.66} = 22.8 \text{ Times}$	$\frac{\$24.79^*}{\$1.27} = 19.5 \text{ Times}$

\*Market price is the average for the fourth quarter reported in Starbucks' 2010 and 2011 annual reports.

\*\*Earnings per share is Starbucks' basic EPS.

Starbucks' P/E ratio increased from 19.5 times in 2010 to 22.8 times in 2011 because the market value of its stock increased at a faster rate (from about \$25 to about \$38) than its earnings per share. The implication is that investors are confident that Starbucks' earnings will grow as fast in the future as it did in the past.

**Dividend Yield** **Dividend yield** measures a stock's current return to an investor in the form of dividends. **Starbucks'** dividend yields in 2010 and 2011 are computed as follows.

**RATIO**

**Dividend Yield: What Is the Return from Dividends on Each Share of Stock?**

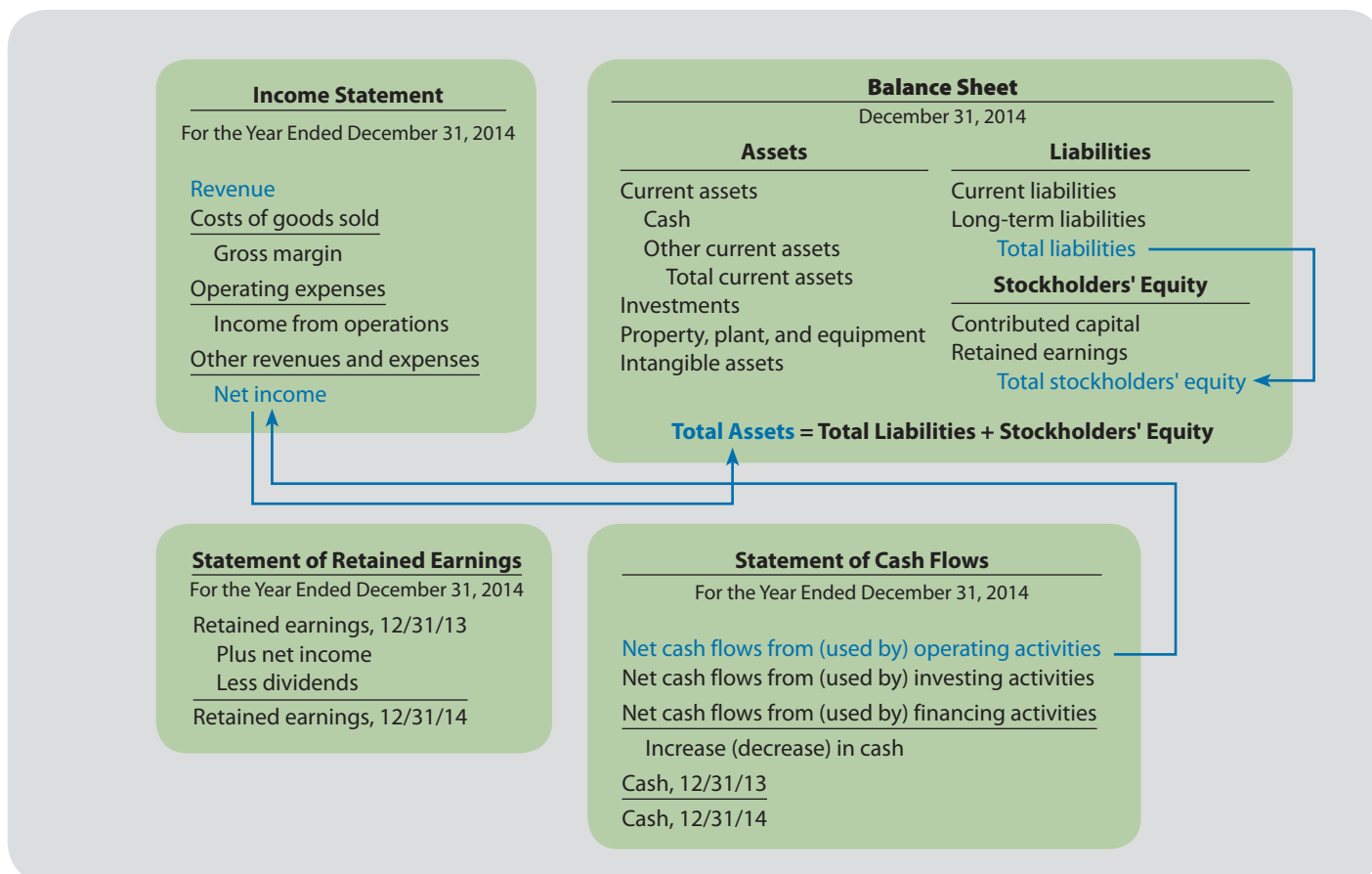
	<b>2011</b>	<b>2010</b>
$\frac{\text{Dividends per Share}}{\text{Market Price per Share}}$	$\frac{\$0.56}{\$37.86} = 1.5\%$	$\frac{\$0.36}{\$24.79} = 1.5\%$

Starbucks's dividend yield was steady and rather low at 1.5 percent for both years 2010 and 2011. Because the dividend yield was rather low, we can conclude that those who invest in the company expect their return to come from increases in the stock's market value.

## Financial Statement Analysis and Performance Assessment

The relationships of key financial ratios help the users of financial statements assess financial performance. These relationships are shown in Exhibit 10.

**Exhibit 10**  
Relationships of Financial Ratios



## APPLY IT!

Kora's, a retail company, engaged in the transactions that follow. Opposite each transaction is a ratio and space to mark the effect of each transaction on the ratio. Show that you understand the effect of business activities on performance measures by placing an X in the appropriate column to show whether the transaction increased, decreased, or had no effect on the ratio.

Transaction	Ratio	Effect		
		Increase	Decrease	None
a. Accrued salaries.	Current ratio			
b. Purchased inventory.	Quick ratio			
c. Increased allowance for uncollectible accounts.	Receivables turnover			
d. Purchased inventory on credit.	Payables turnover			
e. Sold treasury stock.	Profit margin			
f. Borrowed cash by issuing bond payable.	Asset turnover			
g. Paid wages expense.	Return on assets			
h. Repaid bond payable.	Debt to equity ratio			
i. Accrued interest expense.	Interest coverage ratio			
j. Sold merchandise on account.	Return on equity			
k. Recorded depreciation expense.	Cash flow yield			
l. Sold equipment.	Free cash flow			

### SOLUTION

Transaction	Ratio	Effect		
		Increase	Decrease	None
a. Accrued salaries.	Current ratio		X	
b. Purchased inventory.	Quick ratio		X	
c. Increased allowance for uncollectible accounts.	Receivables turnover	X		
d. Purchased inventory on credit.	Payables turnover		X	
e. Sold treasury stock.	Profit margin			X
f. Borrowed cash by issuing bond payable.	Asset turnover		X	
g. Paid wages expense.	Return on assets		X	
h. Repaid bond payable.	Debt to equity ratio	X		
i. Accrued interest expense.	Interest coverage ratio		X	
j. Sold merchandise on account.	Return on equity	X		
k. Recorded depreciation expense.	Cash flow yield	X		
l. Sold equipment.	Free cash flow	X		

**TRY IT! SE6, SE7, SE8, SE9, SE10, E5A, E6A, E7A, E8A, E9A, E5B, E6B, E7B, E8B, E9B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Evaluating quality of earnings
  - Accounting methods
  - Accounting estimates
  - One-time items
- Determining management compensation

## RELEVANT LEARNING OBJECTIVE

**LO 4** Define *quality of earnings*, and identify the factors that affect quality of earnings and related management compensation issues.

**LO 4** Evaluating Quality of Earnings

Net income (net earnings) is the measure most commonly used to evaluate a company's profitability. In fact, one survey indicated that the two important measures in evaluating common stocks were expected changes in earnings per share and return on assets.<sup>4</sup> Net income is a key component of both measures.

Because of the importance of net income, or the "bottom line," in measuring a company's prospects, there is significant interest in evaluating the quality of the net income. The **quality of earnings** refers to the substance of earnings and their sustainability into future periods. Quality of earnings is affected by the following:

- Accounting methods
- Accounting estimates
- One-time items

**Accounting Methods**

The accounting methods a firm uses affect its operating income. Generally accepted accounting methods include:

- Uncollectible receivables methods (percentage of net sales and aging of accounts receivable)
- Inventory methods (LIFO, FIFO, and average cost)
- Depreciation methods (accelerated, production, and straight-line)
- Revenue recognition methods

All these methods are designed to *match* revenues and expenses. However, the expenses are estimates, and the period or periods benefited cannot be demonstrated conclusively. In practice, it is hard to justify one method of estimation over another.

Different accounting methods have different effects on net income. Some methods are more conservative than others because they tend to produce a lower net income in the current period. For example, suppose that Rudy Company and Kanya Company have similar operations, but Rudy uses FIFO for inventory costing and the straight-line (SL) method for computing depreciation. Kanya uses LIFO for inventory costing and the double-declining-balance (DDB) method for computing depreciation. The income statements of the two companies might appear as shown in Exhibit 11.

**Exhibit 11**  
Effects of Different Accounting Methods

	<b>Rudy Company (FIFO and SL)</b>	<b>Kanya Company (LIFO and DDB)</b>
Net sales	\$462,500	\$462,500
Cost of goods available for sale	\$200,000	\$200,000
Less ending inventory	30,000	25,000
Cost of goods sold	\$170,000	\$175,000
Gross margin	\$292,500	\$287,500
Less depreciation expense	\$ 20,000	\$ 40,000
Less other expenses	85,000	85,000
Total operating expenses	\$105,000	\$125,000
Income from continuing operations before income taxes	\$187,500	\$162,500

**STUDY NOTE:** To assess the quality of a company's reported earnings, you must know the estimates and methods it uses to compute income.

### CASH FLOW

**Impact of Different Accounting Methods on Income** The income from continuing operations before income taxes for the firm that uses LIFO and DDB is lower because in periods of rising prices, the LIFO method produces a higher cost of goods sold. Also, in the early years of an asset's useful life, accelerated depreciation yields a higher depreciation expense. The result is lower operating income. However, future operating income should be higher.

**Impact of Different Accounting Methods on Cash Flows** Although the choice of accounting method does not affect cash flows except for possible differences in income taxes, the \$25,000 difference in operating income stems solely from the choice of accounting methods. Estimates of the useful lives and residual values of plant assets could lead to an even greater difference. In practice, of course, differences in net income occur for many reasons; but the user of financial statements must be aware of the discrepancies that can occur as a result of the accounting methods used. In general, an accounting method or estimate that results in lower current earnings produces a better quality of operating income.

**Impact of Different Accounting Methods on Financial Statements** The latitude that companies have in their choice of accounting methods could cause problems in the interpretation of financial statements were it not for the conventions of *full disclosure* and *consistency*. As noted in an earlier chapter, **full disclosure** requires management to explain, in a note to the financial statements, the significant accounting policies used. For instance, in a note to its financial statements, **Starbucks** discloses that it uses the straight-line method for depreciation of property, plant, and equipment.<sup>5</sup> **Consistency** requires that the same accounting procedures be used from year to year. If a company changes its accounting procedure, it must explain the nature of the change and its monetary effect in a note to its statements.

## Accounting Estimates

Users of financial statements also need to be aware of the impact that accounting estimates have on reported income. To comply with *accrual accounting* (the *matching rule*), accountants must assign revenues and expenses to the periods in which they occur. If they cannot establish a direct relationship between revenues and expenses, they systematically allocate the expenses among the periods that benefit from them. In doing so, they must make estimates and exercise judgment, based on realistic assumptions. However, there is latitude in making the estimate, and the final judgment will affect net income.

For example, when a company acquires an asset, the accountant must estimate the asset's useful life. Technological obsolescence could shorten the asset's expected useful life, and regular maintenance and repairs could lengthen it. Although the actual useful life cannot be known with certainty until some future date, the accountant's estimate of it affects both current and future operating income. Other areas that require accounting estimates include:

- Residual value of assets
- Uncollectible accounts receivable
- Sales returns
- Total units of production
- Total recoverable units of natural resources
- Amortization periods
- Warranty claims
- Environmental cleanup costs

The importance of accounting estimates depends on the industry in which a firm operates. For example, estimated uncollectible receivables for a credit card firm, such as **American Express**, or for a financial services firm, such as **Bank of America**, can have

a material impact on earnings; but estimated useful life may be less important because depreciable assets represent a small percentage of the firm's total assets. **Starbucks** has few receivables, but it has major investments in depreciable assets. Thus, estimates of useful life and residual value are more important to Starbucks than an estimate of uncollectible accounts receivable. The company depreciates its equipment over 2 to 15 years and its buildings over 30 to 40 years.<sup>6</sup>

## One-Time Items

If earnings increase because of one-time items, that portion of earnings will not be sustained in the future. In contrast, one-time decreases in earnings may not indicate that earnings will be poor in the future. Examples of one-time items include:

- Gains and losses
- Write-downs and restructurings
- Nonoperating items

Because management has choices in the content and positioning of these income statement components, there is a potential for managing earnings to achieve specific income targets. It is, therefore, critical for users of income statements to understand these factors and take them into consideration when evaluating a company's performance.

Exhibit 12 shows the components of a typical income statement. Net income or loss (the "bottom line" of the income statement) includes all revenues, expenses, gains, and losses over the period. When a company has both continuing and discontinued operations, the operating income section is called *income from continuing operations*. Income

**Exhibit 12**  
Corporate Income Statement

<b>Dingo Corporation</b> <b>Income Statement</b> <b>For the Year Ended December 31, 2014</b>			
Operating items before income taxes	Revenues		\$ 1,850,000
	Costs and expenses		(1,100,000)
	Gain on sale of assets		300,000
	Write-downs of assets		(50,000)
	Restructurings		<u>(150,000)</u>
	Income from continuing operations before income taxes		\$ 850,000
Income taxes	Income taxes expense		<u>289,000</u>
	Income from continuing operations		\$ 561,000
Nonoperating items	Discontinued operations:		
	Income from operations of discontinued segment (net of taxes, \$70,000)	\$ 180,000	
	Loss on disposal of segment (net of taxes, \$84,000)	<u>(146,000)</u>	<u>34,000</u>
	Net income		<u>\$ 595,000</u>
Earnings per share information	Earnings per common share:		
	Income from continuing operations		\$2.81
	Discontinued operations (net of taxes) Net income		<u>0.17</u> <u>\$2.98</u>



## Business Perspective

### Beware of the “Bottom Line!”

© Aljia / iStockphoto.com

In the second quarter of 2007, **McDonald's** posted its second-ever loss: \$711.7 million. Should this have been cause for concern? The answer is no because the loss resulted from a one-time noncash impairment (decline in value) of \$1.6 billion related to investments in Latin America; the company was actually in a period of rapidly growing revenues and profits. In another example, **Campbell Soup** showed unrealistically positive results. Its income jumped by 31 percent due to a tax settlement and an accounting restatement. Without these items, its revenue and income would have been up less than 1 percent; soup sales—its main product—actually dropped by 6 percent. The lesson to be learned is to look beyond the “bottom line” to the components of the income statement when evaluating a company’s performance.<sup>7</sup>

from continuing operations before income taxes may include gains or losses on the sale of assets, write-downs, and restructurings.

As you can see in Exhibit 12, the section of the income statement that follows income taxes may contain such nonoperating items as **discontinued operations**—segments that are no longer part of a company’s operations—and gains (or losses) on the sale or disposal of these segments. Another item that may appear in this section is the write-off of goodwill when its value has been impaired. Earnings per share information appears at the bottom of the statement

**Gains and Losses** When a company sells or otherwise disposes of operating assets or marketable securities, a gain or loss generally results. Although these gains or losses appear in the operating section of the income statement, they usually represent one-time events. However, management often has some choice as to their timing. Thus, from an analyst’s point of view, they should be ignored when considering operating income.

**Write-Downs and Restructurings** When management decides that an asset is no longer of value to the company, a write-down or restructuring occurs.

- A **write-down** (or *write-off*) is a reduction in the value of an asset below its carrying value on the balance sheet.
- A **restructuring** is the estimated cost of a change in a company’s operations. It usually involves the closing of facilities and the laying off of personnel.

Both write-downs and restructurings reduce current operating income and boost future income by shifting future costs to the current period. They are often an indication of poor management decisions in the past, such as paying too much for the assets of another company or making operational changes that do not work out. Companies sometimes take all possible losses in the current year so that future years will be “clean” of these costs. Such “big baths,” as they are called, commonly occur when a company is having a bad year. They also often occur in years when there is a change in management. The new management takes a “big bath” in the current year so it can show improved results in future years.

In a recent year, 34 percent of 500 large companies had write-downs of tangible assets, and 41 percent had restructurings. Another 19 percent had write-downs or charges related to intangible assets, often involving goodwill. In 2011, **Starbucks** did not have any restructuring costs, but in 2009 its restructuring costs were \$332.4 million (compared with net income of only \$390.8 million) in connection with the closing of a number of its stores.<sup>8</sup>

**Nonoperating Items** The nonoperating items that appear on the income statement include discontinued operations and gains or losses on the sale or disposal of these segments. These items can significantly affect net income. For example, in Exhibit 12, earnings per common share for income from continuing operations are \$2.81; but when all the nonoperating items are taken into consideration, net income per share is \$2.98. To





## Business Perspective

### Look Carefully at the Numbers

In recent years, companies have increasingly used pro forma statements—statements as they would appear without certain items—as a way of presenting a better picture of their operations than would be the case in reports prepared under GAAP. For example, in the first quarter of 2012, **GEO Group, Inc.**, reported pro forma net income of \$18.8 million, even though its actual net income was \$15.1 million. The higher pro forma figure came about by not deducting certain expenses which are required under GAAP. In addition, a common practice used by such companies as **Google**, **eBay**, and **Starbucks** is to provide in the notes to the financial statements income as it would be without the expense related to compensation for stock options.<sup>9</sup> Pro forma statements, which are unaudited, have come to mean whatever a company's management wants them to mean. As a result, the SEC issued rules that prohibit companies from giving more prominence to non-GAAP measures and from using terms that are similar to GAAP measures.<sup>10</sup> Nevertheless, companies still report pro forma results. Analysts should rely exclusively on financial statements that are prepared using GAAP and that are audited by an independent CPA.

© Allija / iStockphoto.com

make it easier to evaluate a company's ongoing operations, generally accepted accounting principles require that gains and losses from discontinued operations be reported separately on the income statement.

In Exhibit 12, the *disclosure* of discontinued operations has two parts:

- One part shows that after the decision to discontinue, the income from operations of the disposed segment was \$180,000 (net of \$70,000 taxes).
- The other part shows that the loss from the disposal of the segment was \$146,000 (net of \$84,000 tax savings). (The computation of the gains or losses involved in discontinued operations is covered in more advanced accounting courses.)

## Management Compensation

Knowledge of performance measurement not only is important for evaluating a company, but also leads to an understanding of the criteria by which a board of directors evaluates and compensates management. Members of management are often paid based on the earnings of the company. As noted earlier, one intent of the Sarbanes-Oxley Act of 2002 was to strengthen the corporate governance of public corporations. Under this act, a public corporation's board of directors must establish a **compensation committee** made up of independent directors to determine how the company's top executives will be compensated. The company must file documents with the SEC, *disclosing* the components of compensation and the criteria used to remunerate top executives.

The components of **Starbucks'** compensation of executive officers are typical of those used by many companies. They include the following:

- Annual base salary
- Annual incentive bonuses
- Long-term incentive compensation (stock option awards)<sup>11</sup>

Incentive bonuses are based on financial performance measures that the compensation committee identifies as important to the company's long-term success, especially in terms of increasing the value of shareholders' investments in the company. Many companies tie incentive bonuses to measures such as growth in revenues and return on assets or return on equity. Starbucks bases 50 percent of its incentive bonus on an "adjusted consolidated operating income or adjusted business unit operating income," 30 percent on "adjusted earnings per share target approved by the compensation committee," and 20 percent on the executive's "specific individual performance goals."<sup>12</sup>

Stock option awards are usually based on how well the company is achieving its long-term strategic goals. In 2011, Starbucks' CEO received a base salary of \$1,382,692 and a non-equity incentive plan compensation of \$2,982,000. He also received a stock option awards of \$11,479,494.<sup>13</sup>

From one vantage point, earnings per share is a “bottom-line” number that encompasses all the other performance measures. However, using a single performance measure as the basis for determining compensation has the potential of leading to practices that are not in the best interests of a company or its stockholders. For instance, management could boost earnings per share by reducing the number of shares outstanding (the denominator in the earnings per share equation) while not improving earnings. It could accomplish this by using cash to repurchase shares of the company’s stock (treasury stock), rather than investing the cash in more profitable operations.

## APPLY IT!

The following data apply to Kawa, Inc.: net sales, \$180,000; cost of goods sold, \$87,500; loss from discontinued operations (net of income tax benefit of \$17,500), \$50,000; loss on disposal of discontinued operations (net of income tax benefit of \$4,000), \$12,500; operating expenses, \$32,500; income taxes expense on continuing operations, \$18,000. Prepare the company’s income statement for the year ended December 31, 2014. (*Note:* Ignore earnings per share information.)

### SOLUTION

**Kawa, Inc.**  
**Income Statement**  
**For the Year Ended December 31, 2014**

Net sales		\$180,000
Cost of goods sold		<u>87,500</u>
Gross margin		\$ 92,500
Operating expenses		<u>32,500</u>
Income from continuing operations before income taxes		\$ 60,000
Income taxes expense		<u>18,000</u>
Income from continuing operations		\$ 42,000
Discontinued operations		
Loss from discontinued operations (net of income tax benefit of \$17,500)	\$(50,000)	
Loss on disposal of discontinued operations (net of income tax benefit of \$4,000)	<u>(12,500)</u>	<u>(62,500)</u>
Net loss		<u>\$ (20,500)</u>

**TRY IT! SE11, SE12, E10A, E11A, E12A, E10B, E11B, E12B**

## TriLevel Problem



Monkey Business Images/Shutterstock.com

The beginning of this chapter focused on Kate Medal, the president of Medal Investments, who was planning to invest in either Fast Burger or Tasty Steak. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*What concepts underlie the standards that Kate can use to compare the performance of the two companies?*

### Section 2: Accounting Applications

*What analytical tools can Kate use to measure the financial performance of Fast Burger and Tasty Steak?*

### Medal Investments

The 2014 income statements and balance sheets of the two companies follow.

	A	B	C	D	E
1	<b>Income Statements</b>				
2	<b>For the Year Ended December 31, 2014</b>				
3	(in thousands, except per share amounts)				
4				<b>Fast Burger</b>	<b>Tasty Steak</b>
5	Net sales			\$53,000	\$86,000
6	Costs and expenses:				
7	Cost of goods sold			\$37,000	\$61,000
8	Selling expenses			7,000	10,000
9	Administrative expenses			4,000	5,000
10			Total costs and expenses	\$48,000	\$76,000
11	Income from operations			\$ 5,000	\$10,000
12	Interest expense			1,400	3,200
13	Income before income taxes			\$ 3,600	\$ 6,800
14	Income taxes expense			1,800	3,400
15	Net income			\$ 1,800	\$ 3,400
16	Earnings per share			\$ 1.80	\$ 1.13
17					

	A	B	C	D	E
1	<b>Balance Sheets</b>				
2	<b>December 31, 2014</b>				
3	(in thousands)				
4				<b>Fast Burger</b>	<b>Tasty Steak</b>
5	<b>Assets</b>				
6	Cash			\$ 2,000	\$ 4,500
7	Accounts receivable (net)			2,000	6,500
8	Inventory			2,000	5,000
9	Property, plant, and equipment (net)			20,000	35,000
10	Other assets			4,000	5,000
11			Total assets	\$30,000	\$56,000
12					
13	<b>Liabilities and Stockholders' Equity</b>				
14	Accounts payable			\$ 2,500	\$ 3,000
15	Notes payable			1,500	4,000
16	Bonds payable			10,000	30,000
17	Common stock, \$1 par value			1,000	3,000
18	Additional paid-in capital			9,000	9,000
19	Retained earnings			6,000	7,000
20			Total liabilities and stockholders' equity	\$30,000	\$56,000
21					

The following information pertaining to 2014 is also available to Kate:

- Fast Burger's statement of cash flows shows that it had net cash flows from operations of \$2,200,000. Tasty Steak's statement of cash flows shows that its net cash flows from operations were \$3,000,000.
- Net capital expenditures were \$2,100,000 for Fast Burger and \$1,800,000 for Tasty Steak.
- Fast Burger paid dividends of \$500,000, and Tasty Steak paid dividends of \$600,000.
- The market prices of the stocks of Fast Burger and Tasty Steak were \$30 and \$20, respectively.
- Kate does not have financial information pertaining to prior years. Thus, she used year-end amounts, rather than average amounts.

Perform a comprehensive ratio analysis of both Fast Burger and Tasty Steak using the steps that follow. Assume that all notes payable of the two companies are current liabilities and that all their bonds payable are long-term liabilities. Show dollar amounts in thousands, use end-of-year balances for averages, assume no change in inventory, and round all ratios and percentages to one decimal place.

1. Prepare an analysis of profitability and total asset management.
2. Prepare an analysis of liquidity.
3. Prepare an analysis of financial risk.
4. Prepare an analysis of operating asset management.
5. Prepare an analysis of market strength.
6. In each analysis, indicate which company apparently had the more favorable ratio. (Consider differences of 0.1 or less to be neutral.)

### Section 3: Business Applications

*In what ways would having access to prior years' information aid this analysis? Why is earnings management important in your assessment?*

## SOLUTION

### Section 1: Concepts

Kate can use rule-of-thumb measures, a company's past performance, and industry norms as standards to compare financial performance of the two companies. Rule-of-thumb measures are weak because they often lack *relevance*. A company's past performance is more reliable and it can be used for measuring the improvement (or lack thereof) in a particular ratio, but can be lacking in *predictive value* and *timeliness* because past performance is not a guarantee of future performance and a company's past performance is not helpful in judging its performance relative to the performance of other companies. Finally, Kate can use industry norms to *compare* the financial performance of two companies, but she needs to remember that firms even in the same industry are not always *comparable* because of having different accounting procedures and diversity issues.

### Section 2: Accounting Applications

- 1.

Ratio Name	Fast Burger	Tasty Steak	6. Company with More Favorable Ratio
Profit margin	$\frac{\$1,800}{\$53,000} = 3.4\%$	$\frac{\$3,400}{\$86,000} = 4.0\%$	Tasty Steak
Asset turnover	$\frac{\$53,000}{\$30,000} = 1.8 \text{ Times}$	$\frac{\$86,000}{\$56,000} = 1.5 \text{ Times}$	Fast Burger
Return on assets	$\frac{\$1,800}{\$30,000} = 6.0\%$	$\frac{\$3,400}{\$56,000} = 6.1\%$	Tasty Steak



4.

Ratio Name	Fast Burger	Tasty Steak	6. Company with More Favorable Ratio
Inventory turnover	$\frac{\$37,000}{\$2,000} = 18.5 \text{ Times}$	$\frac{\$61,000}{\$5,000} = 12.2 \text{ Times}$	Fast Burger
Days Inventory on hand	$\frac{365 \text{ Days}}{18.5 \text{ Times}} = 19.7 \text{ Days}$	$\frac{365 \text{ Days}}{12.2 \text{ Times}} = 29.9 \text{ Days}$	Fast Burger
Receivable turnover	$\frac{\$53,000}{\$2,000} = 26.5 \text{ Times}$	$\frac{\$86,000}{\$6,500} = 13.2 \text{ Times}$	Fast Burger
Days sales uncollected	$\frac{365 \text{ Days}}{26.5 \text{ Times}} = 13.8 \text{ Days}$	$\frac{365 \text{ Days}}{13.2 \text{ Times}} = 27.7 \text{ Days}$	Fast Burger
Payables turnover	$\frac{\$37,000}{\$2,500} = 14.8 \text{ Times}$	$\frac{\$61,000}{\$3,000} = 20.3 \text{ Times}$	Tasty Steak
Days payable	$\frac{365 \text{ Days}}{14.8 \text{ Times}} = 24.7 \text{ Days}$	$\frac{365 \text{ Days}}{20.3 \text{ Times}} = 18.0 \text{ Days}$	Fast Burger

**Financing period****Fast Burger:** 19.7 Days + 13.8 Days – 24.7 Days = 8.8 Days**Tasty Steak:** 29.9 Days + 27.7 Days – 18.0 Days = 39.6 Days

Fast Burger's financing period of only 8.8 days is more favorable.

Current ratio	$\frac{\$2,000 + \$2,000 + \$2,000}{\$2,500 + \$1,500}$ $\frac{\$6,000}{\$4,000} = 1.5 \text{ Times}$	$\frac{\$4,500 + \$6,500 + \$5,000}{\$3,000 + \$4,000}$ $\frac{\$16,000}{\$7,000} = 2.3 \text{ Times}$	Tasty Steak
Quick ratio	$\frac{\$2,000 + \$2,000}{\$2,500 + \$1,500}$ $\frac{\$4,000}{\$4,000} = 1.0 \text{ Time}$	$\frac{\$4,500 + \$6,500}{\$3,000 + \$4,000}$ $\frac{\$11,000}{\$7,000} = 1.6 \text{ Times}$	Tasty Steak

*Note:* This analysis indicates the company with the apparently more favorable ratio.

5.

Ratio Name	Fast Burger	Tasty Steak	6. Company with More Favorable Ratio
Price/earnings ratio	$\frac{\$30}{\$1.80} = 16.7 \text{ Times}$	$\frac{\$20}{\$1.13} = 17.7 \text{ Times}$	Tasty Steak
Dividend yield	$\frac{\$500,000 \div 1,000,000}{\$30}$ $= \frac{\$0.50}{\$30} = 1.7\%$	$\frac{\$600,000 \div 3,000,000}{\$20}$ $= \frac{\$0.20}{\$20} = 1.0\%$	Fast Burger

**Section 3: Business Applications**

Prior years' information would be helpful in two ways. First, turnover, return, and cash flows to assets ratios could be based on average amounts. Second, a trend analysis could be performed for each company. Earnings management is important because it can be used to make a company look as if it is performing better than it is in reality.

**Chapter Review**

Describe the concepts, standards of comparison, and sources of information used in measuring financial performance. **LO 1**

Important to measuring financial performance are the concepts of relevance, predictive value, comparability, and timeliness, which underlie the objectives of profitability, total asset management, liquidity, financial risk, and operating asset management. Creditors and investors use financial performance measurement to judge a company's past performance and current position, as well as its future potential and the risk associated with it. Creditors use the information from their analyses to make reliable loans that will be repaid with interest. Investors use the information to make investments that will provide a return that is worth the risk.

Three standards of comparison commonly used in evaluating financial performance are rule-of-thumb measures, a company's past performance, and industry norms. Rule-of-thumb measures are weak because of a lack of evidence that they can be widely applied and that they have predictive value. A company's past performance can offer a guideline for measuring improvement, but it is not helpful in judging performance relative to the performance of other companies. Although the use of industry norms overcomes this last problem, firms are not always comparable, even in the same industry.

The main sources of information about public corporations are annual reports and interim financial statements, reports filed with the SEC, business periodicals, and credit and investment advisory services.

Apply horizontal analysis, trend analysis, vertical analysis, and ratio analysis to financial statements. **LO 2**

Horizontal analysis involves the computation of changes in both dollar amounts and percentages from year to year.

Trend analysis calculates percentage changes for several years. The analyst computes the changes by setting a base year equal to 100 and calculating the results for subsequent years as percentages of the base year.

Vertical analysis uses percentages to show the relationship of the component parts of a financial statement to a total figure in the statement. The resulting financial statements, which are expressed entirely in percentages, are called common-size statements.

Financial ratio analysis identifies key relationships between the components of the financial statements. To interpret ratios correctly, the analyst must have a general understanding of the company and its environment, financial data for several years or for several companies, and an understanding of the data underlying the numerators and denominators.

Apply financial ratio analysis in a comprehensive evaluation of a company's financial performance. **LO 3**

A comprehensive ratio analysis includes the evaluation of a company's profitability, total asset management, liquidity, financial risk, operating asset management, and market strength.

Define quality of earnings, and identify the factors that affect quality of earnings and related management compensation issues. **LO 4**

The quality of earnings refers to the substance of earnings and their sustainability into future accounting periods. The quality of a company's earnings may be affected by the accounting methods and estimates it uses and by one-time items that it reports on its income statement. One-time items include gains and losses, write-downs and restructurings, and nonoperating items.



When a company has both continuing and discontinued operations, the operating income section of its income statement is called income from continuing operations. Income from continuing operations before income taxes is affected by choices of accounting methods and estimates and may contain gains and losses on the sale of assets, write-downs, and restructurings. The lower part of the income statement may contain such nonoperating items as discontinued operations. Earnings per share information appears at the bottom of the statement.

In public corporations, a committee made up of independent directors appointed by the board of directors determines the compensation of top executives. Although earnings per share can be regarded as a “bottom-line” number that encompasses all the other performance measures, using it as the sole basis for determining executive compensation may lead to management practices that are not in the best interests of the company or its stockholders.

## Key Terms and Ratios

**base year** 664 (LO2)  
**common-size statement** 667 (LO2)  
**compensation committee** 687 (LO4)  
**consistency** 684 (LO4)  
**discontinued operations** 686 (LO4)  
**diversified companies** 661 (LO1)  
**financial ratio analysis** 670 (LO2)  
**financial statement analysis** 660 (LO1)  
**financing period** 677 (LO3)  
**Form 8-K** 662 (LO1)  
**Form 10-K** 662 (LO1)  
**Form 10-Q** 662 (LO1)  
**full disclosure** 684 (LO4)  
**horizontal analysis** 664 (LO2)  
**index number** 666 (LO2)

**interim financial statements** 662 (LO1)  
**operating cycle** 677 (LO3)  
**quality of earnings** 683 (LO4)  
**restructuring** 686 (LO4)  
**trend analysis** 666 (LO2)  
**vertical analysis** 667 (LO2)  
**write-down** 686 (LO4)

### RATIOS

**asset turnover** 671 (LO3)  
**cash flow yield** 673 (LO3)  
**cash flows to assets** 674 (LO3)  
**cash flows to sales** 673 (LO3)  
**current ratio** 679 (LO3)  
**days' inventory on hand** 677 (LO3)

**days' payable** 679 (LO3)  
**days' sales uncollected** 678 (LO3)  
**debt to equity ratio** 675 (LO3)  
**dividend yield** 681 (LO3)  
**free cash flow** 674 (LO3)  
**interest coverage ratio** 676 (LO3)  
**inventory turnover** 677 (LO3)  
**payables turnover** 678 (LO3)  
**price/earnings (P/E)** 680 (LO3)  
**profit margin** 671 (LO3)  
**quick ratio** 680 (LO3)  
**receivables turnover** 678 (LO3)  
**return on assets** 672 (LO3)  
**return on equity** 676 (LO3)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1.** How are past performance and industry norms useful in evaluating a company's performance? What are their limitations?
- LO 2 **DQ2.** In a five-year trend analysis, why do the dollar values remain the same for their respective years while the percentages usually change when a new five-year period is chosen?
- LO 3 **DQ3.** Why does a decrease in receivables turnover create the need for cash from operating activities?
- RATIO**
- LO 3 **DQ4.** Why would ratios that include one balance sheet account and one income statement account, such as receivables turnover or return on assets, be questionable if they came from quarterly or other interim financial reports?
- RATIO**

## CASH FLOW

- LO 3 **DQ5.** What is a limitation of free cash flow in comparing one company to another?
- LO 4 **DQ6. BUSINESS APPLICATION** ▶ In what way is selling an investment for a gain potentially a negative in evaluating quality of earnings?
- LO 4 **DQ7. BUSINESS APPLICATION** ▶ Is it unethical for new management to take an extra large write-off (a “big bath”) in order to reduce future costs? Why or why not?
- LO 4 **DQ8. BUSINESS APPLICATION** ▶ Why is it useful to disclose discontinued operations separately on the income statement?
- LO 4 **DQ9. BUSINESS APPLICATION** ▶ Why is it essential that management compensation, including bonuses, be linked to financial goals and strategies that achieve shareholder value?
- LO 4 **DQ10. BUSINESS APPLICATION** ▶ What is one way a company can improve its earnings per share without improving its earnings or net income?

## SHORT EXERCISES

### LO 1 Objectives and Standards of Financial Performance Evaluation

**SE1. CONCEPT** ▶ Indicate whether each of the following items is (a) an underlying concept, (b) an objective or (c) a standard of comparison of financial statement analysis:

1. Industry norms
2. Assessment of a company’s past performance
3. Comparability
4. The company’s past performance
5. Assessment of future potential and related risk
6. Predictive value

### LO 1 Sources of Information

**SE2.** For each piece of information in the list that follows, indicate whether the best source would be (a) reports published by the company, (b) SEC reports, (c) business periodicals, or (d) credit and investment advisory services.

1. Current market value of a company’s stock
2. Management’s analysis of the past year’s operations
3. Objective assessment of a company’s financial performance
4. Most complete body of financial disclosures
5. Current events affecting the company

### LO 2 Trend Analysis

**SE3. ACCOUNTING CONNECTION** ▶ Using 2012 as the base year, prepare a trend analysis for the data that follow, and tell whether the results suggest a favorable or unfavorable trend. (Round to one decimal place.)

	2014	2013	2012
Net sales	\$316,000	\$272,000	\$224,000
Accounts receivable (net)	86,000	64,000	42,000

### LO 2 Horizontal Analysis

**SE4. ACCOUNTING CONNECTION** ▶ Vision, Inc.’s comparative income statements follow. Compute the amount and percentage changes for the income statements, and comment on the changes from 2013 to 2014. (Round the percentage changes to one decimal place.)

(Continued)

**Vision, Inc.**  
**Comparative Income Statements**  
**For the Years Ended December 31, 2014 and 2013**

	2014	2013
Net sales	\$360,000	\$290,000
Cost of goods sold	<u>224,000</u>	<u>176,000</u>
Gross margin	\$136,000	\$114,000
Operating expenses	<u>80,000</u>	<u>60,000</u>
Operating income	\$ 56,000	\$ 54,000
Interest expense	<u>14,000</u>	<u>10,000</u>
Income before income taxes	\$ 42,000	\$ 44,000
Income taxes expense	<u>14,000</u>	<u>16,000</u>
Net income	<u>\$ 28,000</u>	<u>\$ 28,000</u>
Earnings per share	<u>\$ 2.80</u>	<u>\$ 2.80</u>

**LO 2 Vertical Analysis**

**SE5. ACCOUNTING CONNECTION** ► Vision, Inc.'s comparative balance sheets follow. Prepare common-size statements and comment on the changes from 2013 to 2014. (Round to one decimal place.)

**Vision, Inc.**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Current assets	\$ 48,000	\$ 40,000
Property, plant, and equipment (net)	<u>260,000</u>	<u>200,000</u>
Total assets	<u>\$308,000</u>	<u>\$240,000</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities	\$ 36,000	\$ 44,000
Long-term liabilities	180,000	120,000
Stockholders' equity	<u>92,000</u>	<u>76,000</u>
Total liabilities and stockholders' equity	<u>\$308,000</u>	<u>\$240,000</u>

**LO 3 Operating Asset Management Analysis**

**RATIO**

**SE6. ACCOUNTING CONNECTION** ► Using the information for Vision, Inc., in **SE4** and **SE5**, compute the current ratio, quick ratio, receivables turnover, days' sales uncollected, inventory turnover, days' inventory on hand, payables turnover, days' payable, and financing period for 2013 and 2014. Inventories were \$8,000 in 2012, \$10,000 in 2013, and \$14,000 in 2014. Accounts receivable were \$12,000 in 2012, \$16,000 in 2013, and \$20,000 in 2014. Accounts payable were \$18,000 in 2012, \$20,000 in 2013, and \$24,000 in 2014. The company had no marketable securities or prepaid assets. Comment on the results. (Round to one decimal place.)

**LO 3 Profitability and Total Asset Management Analysis**

**RATIO**

**SE7. ACCOUNTING CONNECTION** ► Using the information for Vision, Inc., in **SE4** and **SE5**, compute the profit margin, asset turnover, and return on assets for 2013 and 2014. In 2012, total assets were \$200,000. Comment on the results. (Round to one decimal place.)

**LO 3 Financial Risk Analysis**

**RATIO**

**SE8. ACCOUNTING CONNECTION** ► Using the information for Vision, Inc., in **SE4** and **SE5**, compute the debt to equity ratio, return on equity, and the interest coverage ratio for 2013 and 2014. In 2012 total stockholders' equity was \$60,000. Comment on the results. (Round to one decimal place.)

LO 3

**Liquidity Analysis**

RATIO

CASH FLOW

**SE9. ACCOUNTING CONNECTION** ► Using the information for Vision, Inc., in SE4, SE5, and SE7, compute the cash flow yield, cash flows to sales, cash flows to assets, and free cash flow for 2013 and 2014. Net cash flows from operating activities were \$42,000 in 2013 and \$32,000 in 2014. Net capital expenditures were \$60,000 in 2013 and \$80,000 in 2014. Cash dividends were \$12,000 in both years. Comment on the results. (Round to one decimal place.)

LO 3

**Market Strength Analysis**

RATIO

**SE10. ACCOUNTING CONNECTION** ► Using the information for Vision, Inc., in SE4, SE5, and SE9, compute the price/earnings (P/E) ratio and dividend yield for 2013 and 2014. The company had 10,000 shares of common stock outstanding in both years. The price of Vision's common stock was \$60 in 2013 and \$40 in 2014. Comment on the results. (Round to one decimal place.)

LO 4

**Quality of Earnings**

**SE11. BUSINESS APPLICATION** ► Each of the items that follow is a quality of earnings issue. Indicate whether the item is (a) an accounting method, (b) an accounting estimate, or (c) a nonoperating item. For any item for which the answer is (a) or (b), indicate which alternative is usually the more conservative choice.

1. LIFO versus FIFO
2. Extraordinary loss
3. 10-year useful life versus 15-year useful life
4. Straight-line versus accelerated method
5. Discontinued operations
6. Immediate write-off versus amortization
7. Increase versus decrease in percentage of uncollectible accounts

LO 4

**Corporate Income Statement**

**SE12. BUSINESS APPLICATION** ► Assume that Karib Corporation's chief financial officer gave you the following information: net sales, \$720,000; cost of goods sold, \$350,000; loss from discontinued operations (net of income tax benefit of \$70,000), \$200,000; loss on disposal of discontinued operations (net of income tax benefit of \$16,000), \$50,000; operating expenses, \$130,000; income taxes expense on continuing operations, \$100,000. Prepare the company's income statement for the year ended June 30, 2014. (Ignore earnings per share information.)

**EXERCISES: SET A**

LO 1

**Issues in Financial Performance Evaluation: Objectives, Standards, Sources of Information, and Executive Compensation**

**E1A. CONCEPT** ► Identify each of the following as (a) an underlying concept, (b) an objective of financial statement analysis, (c) a standard for financial statement analysis, (d) a source of information for financial statement analysis, or (e) an executive compensation issue:

1. Past ratios of the company
2. Linking performance to shareholder value
3. Average ratios of other companies in the same industry
4. Assessment of the future potential of an investment
5. Timeliness
6. Interim financial statements
7. SEC Form 10-K
8. Assessment of risk
9. Comparability
10. A company's annual report

LO 2 **Trend Analysis**

**E2A. ACCOUNTING CONNECTION** ► Using 2010 as the base year, prepare a trend analysis of the data that follow, and tell whether the situation shown by the trends is favorable or unfavorable. (Round to one decimal place.)

	2014	2013	2012	2011	2010
Net sales	\$51,040	\$47,960	\$48,400	\$45,760	\$44,000
Cost of goods sold	34,440	30,800	31,080	29,400	28,000
General and administrative expenses	10,560	10,368	10,176	9,792	9,600
Operating income	6,040	6,792	7,144	6,568	6,400

LO 2 **Horizontal Analysis**

**E3A. ACCOUNTING CONNECTION** ► Compute the amount and percentage changes for Rivera Company's comparative balance sheets, and comment on the changes from 2013 to 2014. (Round the percentage changes to one decimal place.)

<b>Rivera Company</b> <b>Comparative Balance Sheets</b> <b>December 31, 2014 and 2013</b>		
	2014	2013
<b>Assets</b>		
Current assets	\$ 37,200	\$ 25,600
Property, plant, and equipment (net)	218,928	194,400
Total assets	<u>\$256,128</u>	<u>\$220,000</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities	\$ 22,400	\$ 6,400
Long-term liabilities	70,000	80,000
Stockholders' equity	163,728	133,600
Total liabilities and stockholders' equity	<u>\$256,128</u>	<u>\$220,000</u>

LO 2 **Vertical Analysis**

**E4A. ACCOUNTING CONNECTION** ► Express Rivera Company's partial comparative income statements as common-size statements, and comment on the changes from 2013 to 2014.

<b>Rivera Company</b> <b>Partial Comparative Income Statements</b> <b>For the Years Ended December 31, 2014 and 2013</b>		
	2014	2013
Net sales	\$424,000	\$368,000
Cost of goods sold	254,400	239,200
Gross margin	<u>\$169,600</u>	<u>\$128,800</u>
Selling expenses	\$106,000	\$ 73,600
General expenses	50,880	36,800
Total operating expenses	<u>\$156,880</u>	<u>\$110,400</u>
Operating income	<u>\$ 12,720</u>	<u>\$ 18,400</u>

LO 3 **Operating Asset Management Analysis**

**E5A. ACCOUNTING CONNECTION** ► Partial comparative balance sheet and income statement information for Posad Company follows.

	<b>2014</b>	<b>2013</b>
Cash	\$ 13,600	\$ 10,400
Marketable securities	7,200	17,200
Accounts receivable (net)	44,800	35,600
Inventory	54,400	49,600
Total current assets	<u>\$120,000</u>	<u>\$112,800</u>
Accounts payable	<u>\$ 40,000</u>	<u>\$ 28,200</u>
Net sales	\$322,560	\$220,720
Cost of goods sold	217,600	203,360
Gross margin	<u>\$104,960</u>	<u>\$ 17,360</u>

In 2012, the year-end balances for Accounts Receivable and Inventory were \$32,400 and \$51,200, respectively. Accounts Payable was \$30,600 in 2012 and is the only current liability. Compute the current ratio, quick ratio, receivables turnover, days' sales uncollected, inventory turnover, days' inventory on hand, payables turnover, days' payable for each year, and financing period. (Round to one decimal place.) Comment on the change in the company's liquidity position, including its operating cycle and required days of financing from 2013 to 2014.

LO 3

**Turnover Analysis**

RATIO

CASH FLOW

**E6A. ACCOUNTING CONNECTION** ► Designer Suits Rental has been in business for four years. Because the company has recently had a cash flow problem, management wonders whether there is a problem with receivables or inventories. Selected figures from the company's financial statements (in thousands) follow.

	<b>2014</b>	<b>2013</b>	<b>2012</b>	<b>2011</b>
Net sales	\$144.0	\$112.0	\$96.0	\$80.0
Cost of goods sold	90.0	72.0	60.0	48.0
Accounts receivable (net)	24.0	20.0	16.0	12.0
Merchandise inventory	28.0	22.0	16.0	10.0
Accounts payable	13.0	10.0	8.0	5.0

Compute the receivables turnover, inventory turnover, and payables turnover for each of the four years, and comment on the results relative to the cash flow problem that the firm has been experiencing. Merchandise inventory was \$11,000, accounts receivable were \$11,000, and accounts payable were \$4,000 in 2010. (Round to one decimal place.)

LO 3

**Profitability and Total Asset Management Analysis**

RATIO

**E7A. ACCOUNTING CONNECTION** ► Elm Company had total assets of \$640,000 in 2012, \$680,000 in 2013, and \$760,000 in 2014. In 2013, Elm had net income of \$77,112 on revenues of \$1,224,000. In 2014, it had net income of \$98,952 on revenues of \$1,596,000. Compute the profit margin, asset turnover, and return on assets for 2013 and 2014. Comment on the apparent cause of the increase or decrease in profitability. (Round to one decimal place.)

LO 3

**Financial Risk and Market Strength Ratios**

RATIO

**E8A. ACCOUNTING CONNECTION** ► An investor is considering investing in the long-term bonds and common stock of Companies A and B. Both firms operate in the same industry. Both also pay a dividend per share of \$8 and have a yield of 10 percent on their long-term bonds. Other data for the two firms follow.

*(Continued)*

	Company A	Company B
Total assets	\$4,800,000	\$2,160,000
Total liabilities	2,160,000	1,188,000
Prior year stockholders' equity	2,120,000	750,000
Income before income taxes	576,000	259,200
Interest expense	194,400	106,920
Net income	136,800	74,800
Earnings per share	6.40	10.00
Market price of common stock	80.00	95.00

Compute the debt to equity ratio, return on equity ratio, interest coverage ratio, and price/earnings (P/E) ratio, as well as the dividend yield, and comment on the results. (Round to one decimal place.)

## LO 3

**Liquidity Analysis**

RATIO

CASH FLOW

**E9A.** Using the data from the financial statements of Stanford, Inc., that follow, compute the company's cash flow yield, cash flows to sales, cash flows to assets, and free cash flow. (Round to one decimal place.)

Net sales	\$3,200,000
Net income	352,000
Net cash flows from operating activities	456,000
Total assets, beginning of year	2,890,000
Total assets, end of year	3,120,000
Cash dividends	120,000
Net capital expenditures	298,000

## LO 4

**Effect of Alternative Accounting Methods**

**E10A. BUSINESS APPLICATION** ► At the end of its first year of operations, a company calculated its ending merchandise inventory according to three different accounting methods, as follows: FIFO, \$47,500; average-cost, \$45,000; LIFO, \$43,000. If the company used the average-cost method, its net income for the year would be \$17,000.

- Determine net income if the company used the FIFO method.
- Determine net income if the company used the LIFO method.
- Which method is more conservative?
- CONCEPT** ► Will the consistency convention be violated if the company chooses to use the LIFO method? Why or why not?
- CONCEPT** ► Does the full-disclosure convention require disclosure of the inventory method used in the financial statements?

## LO 4

**Corporate Income Statement**

**E11A. BUSINESS APPLICATION** ► Assume that Stream Toy Corporation's chief financial officer gave you the following information: net sales, \$3,800,000; cost of goods sold, \$2,100,000; extraordinary gain (net of income taxes of \$7,000), \$25,000; loss from discontinued operations (net of income tax benefit of \$60,000), \$100,000; loss on disposal of discontinued operations (net of income tax benefit of \$26,000), \$70,000; selling expenses, \$100,000; administrative expenses, \$80,000; income taxes expense on continuing operations, \$600,000. Prepare the company's income statement for the year ended June 30, 2014. (Ignore earnings per share information.)



LO 4 **Corporate Income Statement**

**E12A. BUSINESS APPLICATION** ► Components of Van Corporation's income statement for the year ended December 31, 2014 follow. Recast the income statement in multi-step form, including allocating income taxes to appropriate items (assume a 30 percent income tax rate) and showing earnings per share figures (200,000 shares outstanding). (Round earnings per share figures to the nearest cent.)

Sales	\$1,110,000
Cost of goods sold	(550,000)
Operating expenses	(225,000)
Restructuring	(110,000)
Total income taxes expense for period	(179,100)
Income from discontinued operations	160,000
Gain on disposal of discontinued operations	140,000
Extraordinary gain	72,000
Net income	<u>\$ 417,900</u>
Earnings per share	<u>\$ 2.09</u>

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS**LO 2 **Horizontal and Vertical Analysis****SPREADSHEET**

- ✓ 1: Net income: 34.9% increase
- ✓ 1: Total assets: 3.6% increase
- ✓ 2: 2014 Net income: 4.2%

**P1.** Obras Corporation's condensed comparative income statements and comparative balance sheets for 2014 and 2013 follow.

<b>Obras Corporation</b>		
<b>Comparative Income Statements</b>		
<b>For the Years Ended December 31, 2014 and 2013</b>		
	<b>2014</b>	<b>2013</b>
Net sales	\$3,276,800	\$3,146,400
Cost of goods sold	<u>2,088,800</u>	<u>2,008,400</u>
Gross margin	<u>\$1,188,000</u>	<u>\$1,138,000</u>
Operating expenses:		
Selling expenses	\$ 476,800	\$ 518,000
Administrative expenses	447,200	423,200
Total operating expenses	<u>\$ 924,000</u>	<u>\$ 941,200</u>
Income from operations	\$ 264,000	\$ 196,800
Interest expense	<u>65,600</u>	<u>39,200</u>
Income before income taxes	\$ 198,400	\$ 157,600
Income taxes expense	<u>62,400</u>	<u>56,800</u>
Net income	<u>\$ 136,000</u>	<u>\$ 100,800</u>
Earnings per share	<u>\$ 3.40</u>	<u>\$ 2.52</u>

(Continued)

**Obras Corporation**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$ 81,200	\$ 40,800
Accounts receivable (net)	235,600	229,200
Inventory	574,800	594,800
Property, plant, and equipment (net)	750,000	720,000
Total assets	<u>\$1,641,600</u>	<u>\$1,584,800</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 267,600	\$ 477,200
Notes payable (short-term)	200,000	400,000
Bonds payable	400,000	—
Common stock, \$10 par value	400,000	400,000
Retained earnings	374,000	307,600
Total liabilities and stockholders' equity	<u>\$1,641,600</u>	<u>\$1,584,800</u>

**REQUIRED**

1. Prepare schedules showing the amount and percentage changes from 2013 to 2014 for the comparative income statements and the balance sheets. (Round to one decimal place.)
2. Prepare common-size income statements and balance sheets for 2013 and 2014. (Round to one decimal place.)
3. **ACCOUNTING CONNECTION** ► Comment on the results in requirements 1 and 2 by identifying favorable and unfavorable changes in the components and composition of the statements.

**LO 3****Effects of Transactions on Ratios****RATIO**

**P2.** Davis Corporation, a clothing retailer, engaged in the transactions that follow. Opposite each transaction is a ratio and space to mark the effect of each transaction on the ratio.

Transaction	Ratio	Effect		
		Increase	Decrease	None
a. Issued common stock for cash.	Asset turnover	—	—	—
b. Declared cash dividend.	Current ratio	—	—	—
c. Sold treasury stock.	Return on equity	—	—	—
d. Borrowed cash by issuing note payable.	Debt to equity ratio	—	—	—
e. Paid salaries expense.	Inventory turnover	—	—	—
f. Purchased merchandise for cash.	Current ratio	—	—	—
g. Sold equipment for cash.	Receivables turnover	—	—	—
h. Sold merchandise on account.	Quick ratio	—	—	—
i. Paid current portion of long-term debt.	Return on assets	—	—	—
j. Gave sales discount.	Profit margin	—	—	—
k. Purchased marketable securities for cash.	Quick ratio	—	—	—
l. Declared 5% stock dividend.	Current ratio	—	—	—
m. Purchased a building.	Free cash flow	—	—	—

**REQUIRED**

**ACCOUNTING CONNECTION** ► Show that you understand the effect of business activities on performance measures by placing an *X* in the appropriate column to show whether the transaction increased, decreased, or had no effect on the indicated ratio.

## LO 3

RATIO

CASH FLOW

- ✓ 1a: 2014 Current ratio: 1.5 times
- ✓ 1e: 2014 Inventory turnover: 3.9 times
- ✓ 2c: 2014 Return on assets: 5.0%
- ✓ 3b: 2014 Return on equity: 8.2%
- ✓ 4a: 2014 Cash flow yield: 1.7 times
- ✓ 5b: 2014 Dividend yield: 1.3%

**Comprehensive Ratio Analysis**

**P3.** Tuxedo Corporation's condensed comparative income statements and balance sheets follow. All figures are given in thousands of dollars, except earnings per share.

**Tuxedo Corporation**  
**Comparative Income Statements**  
**For the Years Ended December 31, 2014 and 2013**

	2014	2013
Net sales	\$800,400	\$742,600
Cost of goods sold	<u>454,100</u>	<u>396,200</u>
Gross margin	<u>\$346,300</u>	<u>\$346,400</u>
Operating expenses:		
Selling expenses	\$130,100	\$104,600
Administrative expenses	<u>140,300</u>	<u>115,500</u>
Total operating expenses	<u>\$270,400</u>	<u>\$220,100</u>
Income from operations	\$ 75,900	\$126,300
Interest expense	<u>25,000</u>	<u>20,000</u>
Income before income taxes	\$ 50,900	\$106,300
Income taxes expense	<u>14,000</u>	<u>35,000</u>
Net income	<u>\$ 36,900</u>	<u>\$ 71,300</u>
Earnings per share	<u>\$ 2.46</u>	<u>\$ 4.76</u>

**Tuxedo Corporation**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$ 31,100	\$ 27,200
Accounts receivable (net)	72,500	42,700
Inventory	122,600	107,800
Property, plant, and equipment (net)	<u>577,700</u>	<u>507,500</u>
Total assets	<u>\$803,900</u>	<u>\$685,200</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$104,700	\$ 72,300
Notes payable (short-term)	50,000	50,000
Bonds payable	200,000	110,000
Common stock, \$10 par value	300,000	300,000
Retained earnings	<u>149,200</u>	<u>152,900</u>
Total liabilities and stockholders' equity	<u>\$803,900</u>	<u>\$685,200</u>

Additional data for Tuxedo in 2014 and 2013 follow.

	2014	2013
Net cash flows from operating activities	\$64,000	\$99,000
Net capital expenditures	\$119,000	\$38,000
Dividends paid	\$31,400	\$35,000
Number of common shares	30,000	30,000
Market price per share	\$80	\$120

Balances of selected accounts at the end of 2012 were accounts receivable (net), \$52,700; inventory, \$99,400; accounts payable, \$64,800; total assets, \$647,800; and stockholders' equity, \$376,600. All of the bonds payable were long-term liabilities.

*(Continued)*

**REQUIRED**

Perform the following analyses. (Round to one decimal place.)

1. Prepare an operating asset management analysis by calculating for each year the (a) current ratio, (b) quick ratio, (c) receivables turnover, (d) days' sales uncollected, (e) inventory turnover, (f) days' inventory on hand, (g) payables turnover, (h) days' payable, and (i) financing period.
2. Prepare a profitability and total asset management analysis by calculating for each year the (a) profit margin, (b) asset turnover, and (c) return on assets.
3. Prepare a financial risk analysis by calculating for each year the (a) debt to equity ratio, (b) return on equity, and (c) interest coverage ratio.
4. Prepare a liquidity analysis by calculating for each year the (a) cash flow yield, (b) cash flows to sales, (c) cash flows to assets, and (d) free cash flow.
5. Prepare an analysis of market strength by calculating for each year the (a) price/earnings (P/E) ratio and (b) dividend yield.
6. **ACCOUNTING CONNECTION** ► After making the calculations, indicate whether each ratio improved or deteriorated from 2013 to 2014 (use *F* for favorable and *U* for unfavorable and consider changes of 0.1 or less to be neutral).

**LO 3****RATIO****CASH FLOW****Comprehensive Ratio Analysis of Two Companies**

**P4.** Mel Filbert is considering an investment in the common stock of a chain of retail department stores. She has narrowed her choice to two retail companies, Single Corporation and Design Corporation, whose income statements and balance sheets follow.

**Income Statements**

	<b>Single</b>	<b>Design</b>
Net sales	\$12,560,000	\$25,210,000
Costs and expenses:		
Cost of goods sold	\$ 6,142,000	\$14,834,000
Selling expenses	4,822,600	7,108,200
Administrative expenses	986,000	2,434,000
Total costs and expenses	<u>\$11,950,600</u>	<u>\$24,376,200</u>
Income from operations	\$ 609,400	\$ 833,800
Interest expense	194,000	228,000
Income before income taxes	\$ 415,400	\$ 605,800
Income taxes expense	200,000	300,000
Net income	<u>\$ 215,400</u>	<u>\$ 305,800</u>
Earnings per share	<u>\$ 4.31</u>	<u>\$ 10.19</u>

**Balance Sheets**

	<b>Single</b>	<b>Design</b>
<b>Assets</b>		
Cash	\$ 80,000	\$ 192,400
Marketable securities (at cost)	203,400	84,600
Accounts receivable (net)	552,800	985,400
Inventory	629,800	1,253,400
Prepaid expenses	54,400	114,000
Property, plant, and equipment (net)	2,913,600	6,552,000
Intangibles and other assets	553,200	144,800
Total assets	<u>\$4,987,200</u>	<u>\$9,326,600</u>

*(Continued)*

- ✓ 1b: Single quick ratio: 1.5 times
- ✓ 1g: Single payables turnover: 17.9 times
- ✓ 2b: Single asset turnover: 2.5 times
- ✓ 3a: Single debt to equity ratio: 1.0 time
- ✓ 4b: Single cash flows to sales: 2.2%
- ✓ 5a: Single price/earnings ratio: 13.9 times

<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 344,000	\$ 572,600
Notes payable	150,000	400,000
Income taxes payable	50,200	73,400
Bonds payable	2,000,000	2,000,000
Common stock, \$20 par value	1,000,000	600,000
Additional paid-in capital	609,800	3,568,600
Retained earnings	833,200	2,112,000
Total liabilities and stockholders' equity	<u>\$4,987,200</u>	<u>\$9,326,600</u>

During the year, Single paid a total of \$50,000 in dividends. The market price per share of its stock is currently \$60. In comparison, Design paid a total of \$114,000 in dividends, and the current market price of its stock is \$76 per share. Single had net cash flows from operations of \$271,500 and net capital expenditures of \$625,000. Design had net cash flows from operations of \$492,500 and net capital expenditures of \$1,050,000. Information for prior years is not readily available. Assume that all notes payable are current liabilities and all bonds payable are long-term liabilities and that there is no change in inventory.

### REQUIRED

Conduct a comprehensive ratio analysis for each company, using the available information. Compare the results. (Round to one decimal place, and consider changes of 0.1 or less to be indeterminate.)

1. Prepare an operating asset management analysis by calculating for each company the (a) current ratio, (b) quick ratio, (c) receivables turnover, (d) days' sales uncollected, (e) inventory turnover, (f) days' inventory on hand, (g) payables turnover, (h) days' payable, and (i) financing period.
2. Prepare a profitability and total asset management analysis by calculating for each company the (a) profit margin, (b) asset turnover, and (c) return on assets.
3. Prepare a financial risk analysis by calculating for each company the (a) debt to equity ratio, (b) return on equity, and (c) interest coverage ratio.
4. Prepare a liquidity analysis by calculating for each company the (a) cash flow yield, (b) cash flows to sales, (c) cash flows to assets, and (d) free cash flow.
5. Prepare an analysis of market strength by calculating for each company the (a) price/earnings (P/E) ratio and (b) dividend yield.
6. **ACCOUNTING CONNECTION** ▶ Compare the two companies by inserting the ratio calculations from 1 through 5 in a table with the following column headings: Ratio Name, Single, Design, and Company with More Favorable Ratio. Indicate in the last column which company had the more favorable ratio in each case.
7. **BUSINESS APPLICATION** ▶ How could the analysis be improved if information about these companies' prior years were available?

#### LO 4

RATIO

SPREADSHEET

- ✓ 1: Net income using FIFO and straight line: \$190,800
- ✓ 1: Net income using LIFO and double-declining-balance: \$93,200

### Effect of Alternative Accounting Methods

**P5. BUSINESS APPLICATION** ▶ Furlong Corporation began operations in 2014. At the beginning of the year, the company purchased plant assets of \$900,000, with an estimated useful life of 10 years and no residual value. During the year, the company had net sales of \$1,300,000, salaries expense of \$200,000, and other expenses of \$80,000, excluding depreciation. In addition, Furlong purchased inventory as follows.

Jan. 15	400 units at \$400	\$160,000
Mar. 20	200 units at \$408	81,600
June 15	800 units at \$416	332,800
Sept. 18	600 units at \$412	247,200
Dec. 9	300 units at \$420	126,000
Total	<u>2,300 units</u>	<u>\$947,600</u>

At the end of the year, a physical inventory disclosed 500 units still on hand. Furlong's managers know they have a choice of accounting methods, but they are unsure how those

(Continued)

methods will affect net income. They have heard of the FIFO and LIFO inventory methods and the straight-line and double-declining-balance depreciation methods.

### REQUIRED

1. Prepare two income statements for Furlong, one using the FIFO and straight-line methods and the other using the LIFO and double-declining-balance methods. Ignore income taxes.
2. Prepare a schedule accounting for the difference in the two net income figures obtained in requirement 1.
3. What effect does the choice of accounting method have on Furlong's inventory turnover? What conclusions can you draw? Use the year-end balance to compute the ratio. (Round to one decimal place.)
4. How does the choice of accounting methods affect Furlong's return on assets? Assume the company's only assets are cash of \$80,000, inventory, and plant assets. Use year-end balances to compute the ratios. Is your evaluation of Furlong's profitability affected by the choice of accounting methods?

#### LO 4 Corporate Income Statement

✓ 1: Net income: \$145,000

**P6. BUSINESS APPLICATION** ► Information concerning Krall Corporation's operations during 2014 follows.

- a. Administrative expenses, \$90,000
- b. Cost of goods sold, \$420,000
- c. Extraordinary loss from an earthquake (net of taxes, \$36,000), \$60,000
- d. Sales (net), \$900,000
- e. Selling expenses, \$80,000
- f. Income taxes expense applicable to continuing operations, \$105,000

### REQUIRED

1. Prepare the corporation's income statement for the year ended December 31, 2014 (ignore earnings per share data).
2. Which item in Krall's income statement affects the company's quality of earnings? Why does it have an effect on quality of earnings?

## ALTERNATE PROBLEMS

#### LO 2 Horizontal and Vertical Analysis

SPREADSHEET

- ✓ 1: Net income: 34.9% increase  
 ✓ 1: Total assets: 3.6% increase  
 ✓ 2: 2014 Net income: 4.2%

**P7.** Rylander Corporation's condensed comparative income statements and balance sheets for 2014 and 2013 follow.

**Rylander Corporation**  
**Comparative Income Statements**  
**For the Years Ended December 31, 2014 and 2013**

	2014	2013
Net sales	\$6,553,600	\$6,292,800
Cost of goods sold	4,177,600	4,016,800
Gross margin	<u>\$2,376,000</u>	<u>\$2,276,000</u>
Operating expenses:		
Selling expenses	\$ 953,600	\$1,036,000
Administrative expenses	894,400	846,400
Total operating expenses	<u>\$1,848,000</u>	<u>\$1,882,400</u>
Income from operations	\$ 528,000	\$ 393,600
Interest expense	131,200	78,400
Income before income taxes	\$ 396,800	\$ 315,200
Income taxes expense	124,800	113,600
Net income	<u>\$ 272,000</u>	<u>\$ 201,600</u>
Earnings per share	<u>\$ 3.40</u>	<u>\$ 2.52</u>

**Rylander Corporation**  
**Comparative Balance Sheets**  
**December 31, 2014 and 2013**

	2014	2013
<b>Assets</b>		
Cash	\$ 162,400	\$ 81,600
Accounts receivable (net)	471,200	458,400
Inventory	1,149,600	1,189,600
Property, plant, and equipment (net)	1,500,000	1,440,000
Total assets	<u>\$3,283,200</u>	<u>\$3,169,600</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 535,200	\$ 954,400
Notes payable (short-term)	400,000	800,000
Bonds payable	800,000	—
Common stock, \$10 par value	800,000	800,000
Retained earnings	748,000	615,200
Total liabilities and stockholders' equity	<u>\$3,283,200</u>	<u>\$3,169,600</u>

**REQUIRED**

1. Prepare schedules showing the amount and percentage changes from 2013 to 2014 for the comparative income statements and the balance sheets. (Round to one decimal place.)
2. Prepare common-size income statements and balance sheets for 2013 and 2014. (Round to one decimal place.)
3. **ACCOUNTING CONNECTION** ► Comment on the results in requirements 1 and 2 by identifying favorable and unfavorable changes in the components and composition of the statements.

## LO 3

**Effects of Transactions on Ratios****RATIO**

**P8.** Koz Corporation engaged in the transactions that follow. Opposite each transaction is a ratio and space to indicate the effect of each transaction on the ratio.

Transaction	Ratio	Effect		
		Increase	Decrease	None
a. Sold merchandise on account.	Current ratio	—	—	—
b. Sold merchandise on account.	Inventory turnover	—	—	—
c. Collected on accounts receivable.	Quick ratio	—	—	—
d. Wrote off an uncollectible account.	Receivables turnover	—	—	—
e. Paid on accounts payable.	Current ratio	—	—	—
f. Declared cash dividend.	Return on equity	—	—	—
g. Incurred advertising expense.	Profit margin	—	—	—
h. Issued stock dividend.	Debt to equity ratio	—	—	—
i. Issued bonds payable.	Asset turnover	—	—	—
j. Accrued interest expense.	Current ratio	—	—	—
k. Paid previously declared cash dividend.	Dividend yield	—	—	—
l. Purchased treasury stock.	Return on assets	—	—	—
m. Recorded depreciation expense.	Cash flow yield	—	—	—

**REQUIRED**

**ACCOUNTING CONNECTION** ► Show that you understand the effect of business activities on performance measures by placing an *X* in the appropriate column to show whether the transaction increased, decreased, or had no effect on the indicated ratio.



## LO 3

RATIO

CASH FLOW

- ✓ 1a: 2014 Current ratio: 1.9 times
- ✓ 1e: 2014 Inventory turnover: 3.6 times
- ✓ 2c: 2014 Return on assets: 8.4%
- ✓ 3b: 2014 Return on equity: 18.4%
- ✓ 4d: 2014 Free cash flows: (\$280,000)
- ✓ 5b: 2014 Dividend yield: 3.1%

## Comprehensive Ratio Analysis

**P9.** Data for Obras Corporation in 2014 and 2013 follow. These data should be used in conjunction with the data in **P1**.

	2014	2013
Net cash flows from operating activities	\$(196,000)	\$144,000
Net capital expenditures	\$40,000	\$65,000
Dividends paid	\$44,000	\$34,400
Number of common shares	40,000	40,000
Market price per share	\$36	\$60

Selected balances at the end of 2012 were accounts receivable (net), \$206,800; inventory, \$547,200; total assets, \$1,465,600; accounts payable, \$386,600; and stockholders' equity, \$641,200. All of Obras's notes payable were current liabilities; all its bonds payable were long-term liabilities.

## REQUIRED

Perform a comprehensive ratio analysis following the steps outlined below. (Round to one decimal place.)

- Prepare an operating asset management analysis by calculating for each year the (a) current ratio, (b) quick ratio, (c) receivables turnover, (d) days' sales uncollected, (e) inventory turnover, (f) days' inventory on hand, (g) payables turnover, (h) days' payable, and (i) financing period.
- Prepare a profitability and total asset management analysis by calculating for each year the (a) profit margin, (b) asset turnover, and (c) return on assets.
- Prepare a financial risk analysis by calculating for each year the (a) debt to equity ratio, (b) return on equity, and (c) interest coverage ratio.
- Prepare a liquidity analysis by calculating for each year the (a) cash flow yield, (b) cash flows to sales, (c) cash flows to assets, and (d) free cash flow.
- Prepare a market strength analysis by calculating for each year the (a) price/earnings (P/E) ratio and (b) dividend yield.
- ACCOUNTING CONNECTION** ▶ After making the calculations, indicate whether each ratio improved or deteriorated from 2013 to 2014 (use *F* for favorable and *U* for unfavorable and consider changes of 0.1 or less to be neutral).

## LO 3

RATIO

CASH FLOW

- ✓ 1b: Lucent quick ratio: 1.5 times
- ✓ 1g: Lucent payables turnover: 17.9 times
- ✓ 2b: Lucent asset turnover: 2.5 times
- ✓ 3a: Lucent debt to equity ratio: 1.0 time
- ✓ 4b: Lucent cash flows to sales: 2.2%
- ✓ 5a: Lucent price/earnings ratio: 13.9 times

## Comprehensive Ratio Analysis of Two Companies

**P10.** Lucy Lee is considering an investment in the common stock of a chain of retail department stores. She has narrowed her choice to two retail companies, Lucent Corporation and Ranbaxy Corporation, whose income statements and balance sheets follow.

	Income Statements	
	Lucent	Ranbaxy
Net sales	\$50,240,000	\$100,840,000
Costs and expenses:		
Cost of goods sold	\$24,568,000	\$ 59,336,000
Selling expenses	19,290,400	28,432,800
Administrative expenses	3,944,000	9,736,000
Total costs and expenses	\$47,802,400	\$ 97,504,800
Income from operations	\$ 2,437,600	\$ 3,335,200
Interest expense	776,000	912,000
Income before income taxes	\$ 1,661,600	\$ 2,423,200
Income taxes expense	800,000	1,200,000
Net income	\$ 861,600	\$ 1,223,200
Earnings per share	\$ 8.62	\$ 20.38

Balance Sheets		
	Lucent	Ranbaxy
<b>Assets</b>		
Cash	\$ 320,000	\$ 769,600
Marketable securities (at cost)	813,600	338,400
Accounts receivable (net)	2,211,200	3,941,600
Inventory	2,519,200	5,013,600
Prepaid expenses	217,600	456,000
Property, plant, and equipment (net)	11,654,400	26,208,000
Intangibles and other assets	2,212,800	579,200
Total assets	<u>\$19,948,800</u>	<u>\$37,306,400</u>
<b>Liabilities and Stockholders' Equity</b>		
Accounts payable	\$ 1,376,000	\$ 2,290,400
Notes payable	600,000	1,600,000
Income taxes payable	200,800	293,600
Bonds payable	8,000,000	8,000,000
Common stock, \$20 par value	4,000,000	2,400,000
Additional paid-in capital	2,439,200	14,274,400
Retained earnings	3,332,800	8,448,000
Total liabilities and stockholders' equity	<u>\$19,948,800</u>	<u>\$37,306,400</u>

During the year, Lucent paid a total of \$200,000 in dividends. The market price per share of its stock is currently \$120. In comparison, Ranbaxy paid a total of \$456,000 in dividends, and the current market price of its stock is \$152 per share. Lucent had net cash flows from operations of \$1,086,000 and net capital expenditures of \$2,500,000. Ranbaxy had net cash flows from operations of \$1,970,000 and net capital expenditures of \$4,200,000. Information for prior years is not readily available. Assume that all notes payable are current liabilities and all bonds payable are long-term liabilities and that there is no change in inventory.

### REQUIRED

Conduct a comprehensive ratio analysis for each company, following the steps below. Compare the results. (Round to one decimal place, and consider changes of 0.1 or less to be indeterminate.)

1. Prepare an operating asset management analysis by calculating for each company the (a) current ratio, (b) quick ratio, (c) receivables turnover, (d) days' sales uncollected, (e) inventory turnover, (f) days' inventory on hand, (g) payables turnover, (h) days' payable, and (i) financing period.
2. Prepare a profitability and total asset management analysis by calculating for each company the (a) profit margin, (b) asset turnover, and (c) return on assets.
3. Prepare a financial risk analysis by calculating for each company the (a) debt to equity ratio, (b) return on equity, and (c) interest coverage ratio.
4. Prepare a liquidity analysis by calculating for each company the (a) cash flow yield, (b) cash flows to sales, (c) cash flows to assets, and (d) free cash flow.
5. Prepare an analysis of market strength by calculating for each company the (a) price/earnings (P/E) ratio and (b) dividend yield.
6. **ACCOUNTING CONNECTION** ► Compare the two companies by inserting the ratio calculations from 1 through 5 in a table with the following column headings: Ratio Name, Lucent, Ranbaxy, and Company with More Favorable Ratio. Indicate in the last column which company had the more favorable ratio in each case.
7. **BUSINESS APPLICATION** ► How could the analysis be improved if information about these companies' prior years were available?

## LO 4

RATIO

SPREADSHEET

- ✓ 1: Net income using FIFO and straight line: \$381,600
- ✓ 1: Net income using LIFO and double-declining-balance: \$186,400

**Effect of Alternative Accounting Methods**

**P11. BUSINESS APPLICATION** ► Minnows Corporation began operations in 2014. At the beginning of the year, the company purchased plant assets of \$1,800,000, with an estimated useful life of 10 years and no residual value. During the year, the company had net sales of \$2,600,000, salaries expense of \$400,000, and other expenses of \$160,000, excluding depreciation. In addition, Minnows purchased inventory as follows.

Jan. 15	800 units at \$400	\$ 320,000
Mar. 20	400 units at \$408	163,200
June 15	1,600 units at \$416	665,600
Sept. 18	1,200 units at \$412	494,400
Dec. 9	600 units at \$420	252,000
Total	<u>4,600 units</u>	<u>\$1,895,200</u>

At the end of the year, a physical inventory disclosed 1,000 units still on hand. Minnows's managers know they have a choice of accounting methods, but they are unsure how those methods will affect net income. They have heard of the FIFO and LIFO inventory methods and the straight-line and double-declining-balance depreciation methods.

**REQUIRED**

1. Prepare two income statements for Minnows, one using the FIFO and straight-line methods and the other using the LIFO and double-declining-balance methods. Ignore income taxes.
2. Prepare a schedule accounting for the difference in the two net income figures obtained in requirement 1.
3. What effect does the choice of accounting method have on Minnows's inventory turnover? What conclusions can you draw? Use the year-end balance to compute the ratio. (Round to one decimal place.)
4. How does the choice of accounting methods affect Minnows's return on assets? Assume the company's only assets are cash of \$160,000, inventory, and plant assets. Use year-end balances to compute the ratios. Is your evaluation of Minnows's profitability affected by the choice of accounting methods? (Round to one decimal place.)

## LO 4

**Corporate Income Statement**

- ✓ 1: Net income: \$176,000

**P12. BUSINESS APPLICATION** ► Income statement information for Linz Corporation in 2014 follows.

- a. Administrative expenses, \$220,000
- b. Cost of goods sold, \$880,000
- c. Extraordinary loss from a storm (net of taxes, \$20,000), \$40,000
- d. Income taxes expense, continuing operations, \$84,000
- e. Net sales, \$1,780,000
- f. Selling expenses, \$380,000

**REQUIRED**

1. Prepare Linz's income statement for 2014 (ignore earnings per share data).
2. Which item in Linz's income statement affects the company's quality of earnings? Why does it have this effect?

## CASES

### LO 1, 3 Conceptual Understanding: Standards for Financial Performance Evaluation

**C1.** In 2005, in a dramatic move, **Standard & Poor's Ratings Group**, the large financial company that evaluates the riskiness of companies' debt, downgraded its rating of **General Motors** and **Ford Motor Co.** debt to "junk" bond status because of concerns about the companies' profitability and cash flows. Despite aggressive cost cutting, both companies still face substantial future liabilities for health care and pension obligations. They are losing money or barely breaking even on auto operations that concentrate on slow-selling SUVs. High gas prices and competition force them to sell the cars at a discount. What standards do you think Standard & Poor's would use to evaluate General Motors' progress? What performance measures would Standard & Poor's most likely use in making its evaluation? Was Standard & Poor's right in light of future events?

### LO 1 Interpreting Financial Reports: Using Segment Information

RATIO

**C2.** Refer to Exhibit 1, which shows the segment information of **Goodyear Tire & Rubber Company**. In what business segments does Goodyear operate? What is the relative size of its business segments in terms of sales and income in the most recent year shown? Which segment is most profitable in terms of return on assets? Which segment is largest, and which segment is most profitable in terms of return on assets? (Round to one decimal place.)

### LO 2, 3 Interpreting Financial Reports: Effect of a One-Time Item on a Loan Decision

RATIO

**C3.** Apple a Day, Inc., and Unforgettable Edibles, Inc., are food catering businesses that operate in the same metropolitan area. Their customers include *Fortune* 500 companies, regional firms, and individuals. The two firms reported similar profit margins for the current year, and both base bonuses for managers on the achievement of a target profit margin and return on equity. Each firm has submitted a loan request to you, a loan officer for City National Bank. They have provided you with the following information:

	Apple a Day	Unforgettable Edibles
Net sales	\$625,348	\$717,900
Cost of goods sold	225,125	287,080
Gross margin	\$400,223	\$430,820
Operating expenses	281,300	371,565
Operating income	\$118,923	\$ 59,255
Gain on sale of real estate	—	81,923
Interest expense	(9,333)	(15,338)
Income before income taxes	\$109,590	\$125,840
Income taxes expense	25,990	29,525
Net income	\$ 83,600	\$ 96,315
Average stockholders' equity	\$312,700	\$390,560

1. Perform a vertical analysis and prepare a common-size income statement for each firm. Compute profit margin and return on equity. (Round to one decimal place.)
2. Discuss these results, the bonus plan for management, and loan considerations. Identify the company that is the better loan risk.

### LO 3 Interpreting Financial Reports: Comprehensive Ratio Analysis

RATIO

**C4.** Using data from **CVS Corporation's** annual report in the Supplement to Chapter 16, conduct a comprehensive ratio analysis that compares the company's performance in 2011 and 2010. If you have computed ratios for CVS in previous chapters, you may

(Continued)

prepare a table that summarizes the ratios and show calculations only for the ratios not previously calculated. If this is the first ratio analysis you have done for CVS, show all your computations. In either case, after each group of ratios, comment on the performance of CVS. (Round to one decimal place.) Prepare and comment on the following categories of ratios:

- Operating asset management analysis: current ratio, quick ratio, receivables turnover, days' sales uncollected, inventory turnover, days' inventory on hand, payables turnover, days' payable, and financing period (Accounts Receivable, Inventories, and Accounts Payable were [in millions] \$5,457, \$10,343, and \$3,560, respectively, in 2009.)
- Profitability and total asset management analysis: profit margin, asset turnover, and return on assets (Total assets were [in millions] \$61,641 in 2009.)
- Financial risk analysis: debt to equity ratio, return on equity, and interest coverage ratio (Total total shareholders' equity was [in millions] \$35,768 in 2009.)
- Liquidity analysis: cash flow yield, cash flows to sales, cash flows to assets, and free cash flow
- Market strength analysis: price/earnings (P/E) ratio and dividend yield

### LO 3 **Interpreting Financial Reports: Comparison of Key Financial Performance Measures**

#### RATIO

**C5.** Refer to **CVS Corporation's** annual report and **Southwest Airlines Co.'s** financial statements in the Supplement to Chapter 16. Prepare a table for the following key financial performance measures for the two most recent years for both companies. (Round to one decimal place.) Use your computations in **C4** or perform those analyses if you have not done so. Total assets for Southwest in 2009 were \$14,269 million.

- Profitability and total asset management: profit margin, asset turnover, return on assets
- Financial risk: debt to equity ratio
- Liquidity: cash flow yield, free cash flow

Evaluate and comment on the relative performance of the two companies with respect to each of the above categories.

### LO 4 **Conceptual Understanding: Classic Quality of Earnings Case**

**C6. BUSINESS APPLICATION** ► On January 19, 1988, **IBM** reported greatly increased earnings for the fourth quarter of 1987. Despite this reported gain in earnings, the price of IBM's stock on the New York Stock Exchange declined by \$6 per share to \$111.75. In sympathy with this move, most other technology stocks also declined.<sup>14</sup> IBM's fourth-quarter net earnings rose from \$1.39 billion, or \$2.28 a share, to \$2.08 billion, or \$3.47 a share, an increase of 49.6 percent and 52.2 percent over the same period a year earlier. Management declared that these results demonstrated the effectiveness of IBM's efforts to become more competitive and that, despite the economic uncertainties of 1988, the company was planning for growth. The apparent cause of the stock price decline was that the huge increase in income could be traced to nonrecurring gains. Investment analysts pointed out that IBM's high earnings stemmed primarily from such factors as a lower tax rate. Despite most analysts' expectations of a tax rate between 40 and 42 percent, IBM's was a low 36.4 percent, down from the previous year's 45.3 percent. Analysts were also disappointed in IBM's revenue growth. Revenues within the United States were down, and much of the company's growth in revenues came through favorable currency translations, increases that might not be repeated. In fact, some estimates of IBM's fourth-quarter earnings attributed \$0.50 per share to currency translations and another \$0.25 to tax-rate changes. Other factors contributing to IBM's rise in earnings were one-time transactions, such as the sale of **Intel Corporation** stock and bond redemptions, along with a corporate stock buyback program that reduced the

amount of stock outstanding in the fourth quarter by 7.4 million shares. The analysts were concerned about the quality of IBM's earnings. Identify four quality of earnings issues reported in the case and the analysts' concern about each. In percentage terms, what is the impact of the currency changes on fourth quarter earnings? (Round to one decimal place.)

(*Optional*) Comment on management's assessment of IBM's performance.

### Continuing Case: Annual Report Project

RATIO

**C7.** Using the most recent annual report of the company you have chosen to study and that you have accessed online at the company's website, examine the financial statements and accompanying notes of your company. Conduct a comprehensive financial analysis for the past two years, as follows. (Round to one decimal place.)

- Operating asset management analysis: current ratio, quick ratio, receivables turnover, days' sales uncollected, inventory turnover, days' inventory on hand, payables turnover, days' payable, and financing period
- Profitability and total asset management analysis: profit margin, asset turnover, and return on assets
- Financial risk analysis: debt to equity ratio, return on equity, and interest coverage ratio
- Liquidity analysis: cash flow yield, cash flows to sales, cash flows to assets, and free cash flow
- Market strength analysis: price/earnings (P/E) ratio and dividend yield





# SUPPLEMENT TO CHAPTER 16

## How to Read an Annual Report

More than 4 million corporations are chartered in the United States. Most of them are small, family-owned businesses. They are called *private* or *closely held corporations* because their common stock is held by only a few people and is not for sale to the public. Larger companies usually find it desirable to raise investment funds from many investors by issuing common stock to the public. These companies are called *public companies*. Although they are fewer in number than private companies, their total economic impact is much greater.

Public companies must register their common stock with the Securities and Exchange Commission (SEC), which regulates the issuance and subsequent trading of the stock of public companies. Public companies are required to report their financial performance annually to their stockholders. This report, called an *annual report*, contains the company's annual financial statements and other pertinent data. It must also be filed with the SEC on a Form 10-K.

The general public may obtain an annual report by calling or writing the company or accessing the report online at the company's website. If a company has filed its 10-K electronically with the SEC, it can be accessed at <http://www.sec.gov/edgar/searchedgar/webusers.htm>. Many libraries also maintain files of annual reports or have them available on electronic media, such as *Compact Disclosure*.

This supplement describes the major components of the typical annual report. We have included many of these components in the annual report of **CVS Caremark Corporation**, one of the country's most successful retailers. Case assignments in many chapters refer to this annual report. For purposes of comparison, the supplement also includes the financial statements and summary of significant accounting policies of **Southwest Airlines Co.**, one of the largest and most successful airlines in the United States.

## The Components of an Annual Report

In addition to listing the corporation's directors and officers, an annual report usually contains a letter to the shareholders (or *stockholders*), a multiyear summary of financial highlights, a description of the company, management's discussion and analysis of the company's operating results and financial condition, the financial statements, notes to the financial statements, a statement about management's responsibilities, and the auditors' report.

### Letter to the Shareholders

Traditionally, an annual report begins with a letter in which the top officers of the corporation tell shareholders (or stockholders) about the company's performance and prospects. In **CVS's** 2011 annual report, the chairman and chief executive officer wrote to the shareholders about the highlights of the past year, the key priorities for the new year, and other aspects of the business. He reported as follows: "By capitalizing on CVS Caremark's best-in-class businesses as well as the power of our combined entity, we are well-positioned to deliver on our goal of reinventing pharmacy for better health ... and better shareholder value." CVS Caremark reported strong revenue and earnings and record free cash flow. Total revenue rose 11.8 percent to \$107.1 billion, and generated \$4.6 billion in free cash flow, a 39 percent increase over 2010's level.

### Financial Highlights

The financial highlights section presents key statistics for at least a 5-year period but often for a 10-year period. It is often accompanied by graphs. **CVS's** annual report, for

example, gives critical figures for sales, operating profits, and other key measures. Note that the financial highlights section often includes nonfinancial data and graphs as well. For instance, CVS includes the number of its stores.

## Description of the Company

An annual report contains a detailed description of the company's products and divisions. Although this section often contains glossy photographs and other image-building or marketing material, it may provide useful information about past results and future plans.

## Management's Discussion and Analysis

In this section, management describes the company's financial condition and results of operations and explains the difference in results from one year to the next. For example, CVS's management explains the effects of an acquisition and the length of its 2011 fiscal year on its net revenues as follows.

- Net revenues increased \$11.3 billion and decreased \$2.4 billion during 2011 and 2010, respectively.
- During 2011, the Longs Acquisition increased net revenues by \$6.6 billion, compared to 2008.
- Three fewer days in the 2009 fiscal year negatively impacted net revenues by \$671 million, compared to 2008.

This kind of detail is invaluable to understanding CVS's financial performance.

## Financial Statements

All companies present the same four basic financial statements in their annual reports, but the names they use may vary. As you can see in Exhibits 1 through 4, CVS presents the following:

- Statements of income
- Balance sheets
- Statements of cash flows
- Statements of shareholders' equity (includes retained earnings)

(Note that the numbers given in the statements are in millions, but the last six digits are omitted. For example, \$107,100,000,000 is shown as \$107,100.) CVS's financial statement headings are preceded by the word *consolidated*. A corporation issues consolidated financial statements when it consists of more than one company and has combined the companies' data for reporting purposes.

CVS provides several years of data for each financial statement (two years for the balance sheet and three years for the others). Financial statements presented in this fashion are called *comparative financial statements*. Such statements are in accordance with generally accepted accounting principles and help readers assess the company's performance over several years.

CVS's fiscal year ends on the Saturday nearest the end of December (December 31, 2011 in the latest year). Retailers commonly end their fiscal years during a slow period, usually the end of January, which is in contrast to CVS's choosing the end of December.

**Income Statements** As shown in Exhibit 1, CVS uses a multistep form of the income statement in that results are shown in several steps. The steps are gross profit, operating profit, earnings before income tax provision, and net earnings. The company also shows net earnings available to common shareholders, and discloses basic earnings per share and diluted earnings per share. *Basic earnings per share* is used for most analysis. *Diluted earnings per share* assumes that all rights that could be exchanged for common shares,

**Exhibit 1**  
 CVS's Income Statements

Consolidated means that data from all companies owned by CVS are combined.

**CVS Caremark Corporation**  
**Consolidated Statements of Income**

(In millions, except per share amounts)	Year Ended December 31,		
	2011	2010	2009
Net revenues	\$ 107,100	\$ 95,778	\$ 98,215
Cost of revenues	86,539	75,559	77,857
Gross profit	20,561	20,219	20,358
Operating expenses	14,231	14,082	13,933
Operating profit	6,330	6,137	6,425
Interest expense, net	584	536	525
Income before income tax provision	5,746	5,601	5,900
Income tax provision	2,258	2,179	2,200
Income from continuing operations	3,488	3,422	3,700
Income (loss) from discontinued operations, net of tax	(31)	2	(4)
Net income	3,457	3,424	3,696
Net loss attributable to noncontrolling interest	4	3	—
Net income attributable to CVS Caremark	\$ 3,461	\$ 3,427	\$ 3,696
Basic earnings per common share:			
Income from continuing operations attributable to CVS Caremark	\$ 2.61	\$ 2.51	\$ 2.58
Loss from discontinued operations attributable to CVS Caremark	(0.02)	—	—
Net income attributable to CVS Caremark	\$ 2.59	\$ 2.51	\$ 2.58
Weighted average common shares outstanding	1,338	1,367	1,434
Diluted earnings per common share:			
Income from continuing operations attributable to CVS Caremark	\$ 2.59	\$ 2.49	\$ 2.55
Loss from discontinued operations attributable to CVS Caremark	(0.02)	—	—
Net income attributable to CVS Caremark	\$ 2.57	\$ 2.49	\$ 2.55
Weighted average common shares outstanding	1,347	1,377	1,450
Dividends declared per common share	\$ 0.500	\$ 0.350	\$ 0.305

See accompanying notes to consolidated financial statements.

such as stock options, are in fact exchanged. The weighted average number of shares of common stock, used in calculating the per share figures, are shown at the bottom of the income statement.

**Balance Sheets** CVS has a typical balance sheet for a retail company, as shown in Exhibit 2. In the assets and liabilities sections, the company separates out the current assets and the current liabilities. *Current assets* will become available as cash or will be used up in the next year. *Current liabilities* will have to be paid or satisfied in the next year. These groupings are useful in assessing a company's liquidity.

The shareholders' equity section includes a number of items. *Common stock* represents the number of shares outstanding at par value. *Capital surplus (additional paid-in capital)* represents amounts invested by stockholders in excess of the par value of the common stock. *Preferred stock* is capital stock that has certain features that distinguish it from common stock. *Treasury stock* represents shares of common stock the company repurchased.



**Statements of Cash Flows** Whereas the income statement reflects CVS's profitability, the statement of cash flows reflects its liquidity. As shown in Exhibit 3, this statement provides information about a company's cash receipts, cash payments, and investing and financing activities during an accounting period.

**Exhibit 2**  
CVS's Balance Sheets

**CVS Caremark Corporation**  
**Consolidated Balance Sheets**

**December 31,**

<b>(In millions, except per share amounts)</b>	<b>2011</b>	<b>2010</b>
<b>Assets:</b>		
Cash and cash equivalents	\$ 1,413	\$ 1,427
Short-term investments	5	4
Accounts receivable, net	6,047	4,925
Inventories	10,046	10,695
Deferred income taxes	503	511
Other current assets	580	144
<b>Total current assets</b>	<b>18,594</b>	<b>17,706</b>
Property and equipment, net	8,467	8,322
Goodwill	26,458	25,669
Intangible assets, net	9,869	9,784
Other assets	1,155	688
<b>Total assets</b>	<b>\$64,543</b>	<b>\$62,169</b>
<b>Liabilities:</b>		
Accounts payable	\$ 4,370	\$ 4,026
Claims and discounts payable	3,487	2,569
Accrued expenses	3,293	3,070
Short-term debt	750	300
Current portion of long-term debt	56	1,105
<b>Total current liabilities</b>	<b>11,956</b>	<b>11,070</b>
Long-term debt	9,208	8,652
Deferred income taxes	3,853	3,655
Other long-term liabilities	1,445	1,058
Commitments and Contingencies (Note 13)		
Redeemable noncontrolling interest	30	34
<b>Shareholders' equity:</b>		
Preferred stock, par value \$0.01: 0.1 shares authorized; none issued or outstanding	—	—
Common stock, par value \$0.01: 3,200 shares authorized; 1,640 shares issued and 1,298 shares outstanding at December 31, 2011 and 1,624 shares issued and 1,363 shares outstanding at December 31, 2010	16	16
Treasury stock, at cost: 340 shares at December 31, 2011 and 259 shares at December 31, 2010	(11,953)	(9,030)
Shares held in trust: 2 shares at December 31, 2011 and 2010	(56)	(56)
Capital surplus	28,126	27,610
Retained earnings	22,090	19,303
Accumulated other comprehensive loss	(172)	(143)
<b>Total shareholders' equity</b>	<b>38,051</b>	<b>37,700</b>
<b>Total liabilities and shareholders' equity</b>	<b>\$64,543</b>	<b>\$62,169</b>

CVS categorizes certain assets as current assets.

These are noncurrent or long-term assets.

CVS categorizes certain liabilities as current liabilities.

These are noncurrent or long-term liabilities.

Balances in the shareholders' stockholders' section are from the statements of shareholders' equity.

See accompanying notes to consolidated financial statements.

**Exhibit 3****CVS's Statements of Cash Flows**

Cash flows are shown for operating activities, investing activities, and financing activities.

**CVS Caremark Corporation**  
**Consolidated Statements of Cash Flows**

*Year Ended December 31,*

(In millions)	2011	2010	2009
→ Cash flows from operating activities:			
Cash receipts from customers	\$ 97,688	\$ 94,503	\$ 93,568
Cash paid for inventory and prescriptions dispensed by retail network pharmacies	(75,148)	(73,143)	(73,536)
Cash paid to other suppliers and employees	(13,635)	(13,778)	(13,121)
Interest received	4	4	5
Interest paid	(647)	(583)	(542)
Income taxes paid	(2,406)	(2,224)	(2,339)
→ Net cash provided by operating activities	5,856	4,779	4,035
→ Cash flows from investing activities:			
Purchases of property and equipment	(1,872)	(2,005)	(2,548)
Proceeds from sale-leaseback transactions	592	507	1,562
Proceeds from sale of property and equipment	4	34	23
Acquisitions (net of cash acquired) and other investments	(1,441)	(177)	(101)
Purchase of available-for-sale investments	(3)	—	(5)
Sale or maturity of available-for-sale investments	60	1	—
Proceeds from sale of subsidiary	250	—	—
→ Net cash used in investing activities	(2,410)	(1,640)	(1,069)
→ Cash flows from financing activities:			
Increase (decrease) in short-term debt	450	(15)	(2,729)
Proceeds from issuance of long-term debt	1,463	991	2,800
Repayments of long-term debt	(2,122)	(2,103)	(653)
Dividends paid	(674)	(479)	(439)
Derivative settlements	(19)	(5)	(3)
Proceeds from exercise of stock options	431	285	250
Excess tax benefits from stock-based compensation	21	28	19
Repurchase of common stock	(3,001)	(1,500)	(2,477)
Other	(9)	—	—
→ Net cash used in financing activities	(3,460)	(2,798)	(3,232)
Net increase (decrease) in cash and cash equivalents	(14)	341	(266)
Cash and cash equivalents at the beginning of the year	1,427	1,086	1,352
Cash and cash equivalents at the end of the year	\$ 1,413	\$ 1,427	\$ 1,086
Reconciliation of net income to net cash provided by operating activities:			
Net income	\$ 3,457	\$ 3,424	\$ 3,696
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,568	1,469	1,389
Stock-based compensation	135	150	165
Gain on sale of subsidiary	(53)	—	—
Deferred income taxes and other noncash items	144	30	48
Change in operating assets and liabilities, net of effects from acquisitions:			
Accounts receivable, net	(748)	532	(86)
Inventories	607	(352)	(1,199)
Other current assets	(420)	(4)	48
Other assets	(49)	(210)	(2)
Accounts payable	1,128	(40)	4
Accrued expenses	85	(176)	(66)
Other long-term liabilities	2	(44)	38
Net cash provided by operating activities	\$ 5,856	\$ 4,779	\$ 4,035

Cash and cash equivalents move to balance sheets.

This section explains the difference between net earnings and net cash provided by operating activities.

See accompanying notes to consolidated financial statements.

- The first major section of CVS's consolidated statements of cash flows shows cash flows from operating activities. It shows the cash received and paid for various items related to the company's operations.
- The second major section is cash flows from investing activities. The largest outflow in this category is additions for property and equipment. This figure demonstrates that CVS is a growing company.
- The third major section is cash flows from financing activities. CVS's largest cash inflows are for borrowing of long-term debt.

At the bottom of the statements of cash flows, you can see a reconciliation of net earnings to net cash provided by operating activities. This disclosure is important to the user because it relates the goal of profitability (net earnings) to liquidity (net cash provided). Most companies substitute this disclosure for the operating activities at the beginning of their statement of cash flows.

**Statements of Shareholders' Equity** Instead of a simple statement of retained earnings, **CVS** presents consolidated statements of shareholders' equity, as shown in Exhibit 4. These statements explain the changes in components of shareholders' equity (or stockholders' equity), including retained earnings.

## Notes to the Financial Statements

To meet the requirements of *full disclosure*, a company must add notes to the financial statements to help users interpret some of the more complex items. The notes are an integral part of the financial statements. In recent years, the need for explanation and further details has become so great that the notes often take more space than the statements themselves. The notes to the financial statements include a summary of significant accounting policies, explanatory notes, and supplementary information.

**Summary of Significant Accounting Policies** Generally accepted accounting principles require that the financial statements include a *Summary of Significant Accounting Policies*. In most cases, this summary is presented in the first note to the financial statements or as a separate section just before the notes. In this summary, the company tells which generally accepted accounting principles it has followed in preparing the statements. For example, in **CVS's** report, the company states the principles followed for revenue recognition for its Retail Pharmacy Segment:

**Retail Pharmacy Segment.** *The RPS recognizes revenue from the sale of merchandise (other than prescription drugs) at the time the merchandise is purchased by the retail customer. Revenue from the sale of prescription drugs is recognized at the time the prescription is filled, which is or approximates when the retail customer picks up the prescription.*

**Explanatory Notes** Other notes explain some of the items in the financial statements. For example, **CVS** describes its commitments for future lease payments as follows.

*Following is a summary of the future minimum lease payments under capital and operating leases as of December 31, 2011:*

(In millions)	Capital Leases	Operating Leases
2012	\$ 20	\$ 2,230
2013	20	2,143
2014	20	1,936
2015	20	1,880
2016	20	1,806
Thereafter	237	17,630
Total future lease payments	\$337	\$27,625

Information like this is very useful in determining the full scope of a company's liabilities and other commitments.



**Exhibit 4****CVS's Statements of Shareholders' Equity**

<b>CVS Caremark Corporation</b>						
<b>Consolidated Statements of Shareholders' Equity</b>						
(In millions)	Shares			Dollars		
	Year Ended December 31, 2011	2010	2009	Year Ended December 31, 2011	2010	2009
→ Preference stock:						
Beginning of year	—	—	4	\$ —	\$ —	\$ 191
Conversion to common stock	—	—	(4)	—	—	(191)
End of year	—	—	—	\$ —	\$ —	\$ —
→ Common stock:						
Beginning of year	1,624	1,612	1,603	\$ 16	\$ 16	\$ 16
Stock options exercised and stock awards	16	12	9	—	—	—
End of year	1,640	1,624	1,612	\$ 16	\$ 16	\$ 16
→ Treasury stock:						
Beginning of year	(259)	(219)	(165)	\$ (9,030)	\$ (7,610)	\$ (5,812)
Purchase of treasury shares	(84)	(42)	(73)	(3,001)	(1,500)	(2,477)
Conversion of preference stock	—	—	17	—	—	583
Employee stock purchase plan issuances	3	2	2	78	80	96
End of year	(340)	(259)	(219)	\$(11,953)	\$ (9,030)	\$ (7,610)
→ Shares held in trust:						
Beginning of year	(2)	(2)	(2)	\$ (56)	\$ (56)	\$ (56)
End of year	(2)	(2)	(2)	\$ (56)	\$ (56)	\$ (56)
→ Capital surplus:						
Beginning of year				\$ 27,610	\$ 27,198	\$ 27,280
Stock option activity and stock awards				495	384	291
Tax benefit on stock options and stock awards				21	28	19
Conversion of preference stock				—	—	(392)
End of year				\$ 28,126	\$ 27,610	\$ 27,198
→ Retained earnings:						
Beginning of year				\$ 19,303	\$ 16,355	\$ 13,098
Net income attributable to CVS Caremark				3,461	3,427	3,696
Common stock dividends				(674)	(479)	(439)
End of year				\$ 22,090	\$ 19,303	\$ 16,355
→ Accumulated other comprehensive loss:						
Beginning of year				\$ (143)	\$ (135)	\$ (143)
Net cash flow hedges, net of income tax				(9)	(1)	1
Pension liability adjustment, net of income tax				(20)	(7)	7
End of year				\$ (172)	\$ (143)	\$ (135)
Total shareholders' equity				\$ 38,051	\$ 37,700	\$ 35,768
Comprehensive income:						
Net income				\$ 3,457	\$ 3,424	\$ 3,696
Other comprehensive income:						
Net cash flow hedges, net of income tax				(9)	(1)	1
Pension liability adjustment, net of income tax				(20)	(7)	7
Comprehensive income				3,428	3,416	3,704
Comprehensive loss attributable to noncontrolling interest				4	3	—
Comprehensive income attributable to CVS Caremark				\$ 3,432	\$ 3,419	\$ 3,704

See accompanying notes to consolidated financial statements.



**Supplementary Information Notes** In recent years, the FASB and the SEC have ruled that certain supplemental information must be presented with financial statements. Examples are the quarterly reports that most companies present to their stockholders and to the SEC. These quarterly reports, called *interim financial statements*, are in most cases reviewed but not audited by a company's independent CPA firm. In its annual report, **CVS** presents unaudited quarterly financial data from its 2011 quarterly statements. The quarterly data also include the high and low price for the company's common stock during each quarter.

## Statements of Management's Responsibilities

Separate statements of management's responsibility for the financial statements and for internal control structure accompany the financial statements as required by the Sarbanes-Oxley Act of 2002. In its reports, **CVS's** management acknowledges its responsibility for the consistency, integrity, and presentation of the financial information and for the system of internal controls.

## Auditors' Reports

The *registered independent auditors' report* deals with the credibility of the financial statements. This report, prepared by independent certified public accountants, gives the accountants' opinion about how fairly the statements have been presented. Because management is responsible for preparing the financial statements, issuing statements that have not been independently audited would be like having a judge hear a case in which he or she was personally involved. The certified public accountants add the necessary credibility to management's figures for interested third parties. They report to the board of directors and the stockholders rather than to the company's management.

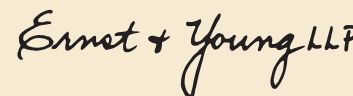
In form and language, most auditors' reports are like the one shown in Exhibit 5. Usually, such a report is short, but its language is very important. It normally has four parts, but it can have a fifth part if an explanation is needed.

1. The first paragraph identifies the financial statements that have been audited. It also identifies responsibilities. The company's management is responsible for the financial statements, and the auditor is responsible for expressing an opinion on the financial statements based on the audit.
2. The second paragraph, or *scope section*, states that the examination was made in accordance with standards of the Public Company Accounting Oversight Board (PCAOB). This paragraph also contains a brief description of the objectives and nature of the audit.
3. The third paragraph, or *opinion section*, states the results of the auditors' examination. The use of the word *opinion* is very important because the auditor does not certify or guarantee that the statements are absolutely correct. To do so would go beyond the truth, because many items, such as depreciation, are based on estimates. Instead, the auditors simply give an opinion about whether, overall, the financial statements "present fairly," in all material respects, the company's financial position, results of operations, and cash flows. This means that the statements are prepared in accordance with generally accepted accounting principles. If, in the auditors' opinion, the statements do not meet accepted standards, the auditors must explain why and to what extent.
4. The fourth paragraph states whether in the auditor's opinion, the company's internal controls are effective in accordance with the standards set by the Committee of Sponsoring Organizations (COSO).

**Exhibit 5**  
Auditors' Report for CVS**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders  
CVS Caremark Corporation

- ① We have audited the accompanying consolidated balance sheets of CVS Caremark Corporation as of December 31, 2011 and 2010, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.
- ② We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
- ③ In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CVS Caremark Corporation at December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.
- ④ We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), CVS Caremark Corporation's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 17, 2012 expressed an unqualified opinion thereon.



Boston, Massachusetts  
February 17, 2012



# **Excerpts from CVS Caremark Corporation's 2011 Annual Report**



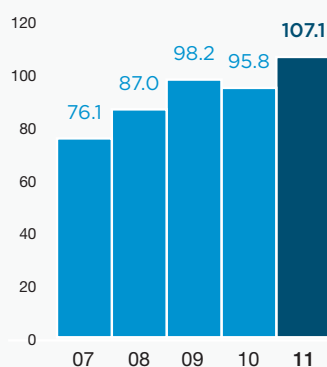


CVS Caremark is the largest pharmacy health care provider in the United States with integrated offerings across the entire spectrum of pharmacy care. Through our unique suite of assets, we are reinventing pharmacy to offer innovative solutions that help people on their path to better health. At the same time, we are highly focused on lowering overall health care costs for plan members and payors. CVS Caremark operates more than 7,300 CVS/pharmacy® stores; serves in excess of 60 million plan members as a leading pharmacy benefit manager (PBM); and cares for patients through the nation's largest retail health clinic system at our approximately 600 MinuteClinic® locations.

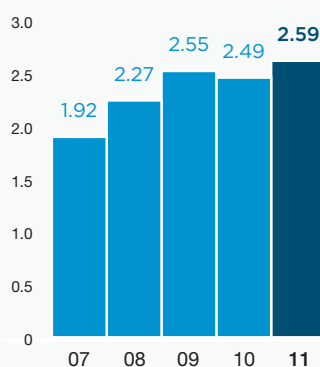
## Financial Highlights

(in millions, except per share figures)	fiscal year 2011	fiscal year 2010	% change
Net revenues	\$ 107,100	\$ 95,778	11.8%
Operating profit	\$ 6,330	\$ 6,137	3.1%
Net income attributable to CVS Caremark	\$ 3,461	\$ 3,427	1.0%
Diluted EPS from continuing operations	\$ 2.59	\$ 2.49	4.0%
Stock price at year-end	\$ 40.78	\$ 34.77	17.3%
Market capitalization at year-end	\$ 52,937	\$ 47,426	11.6%

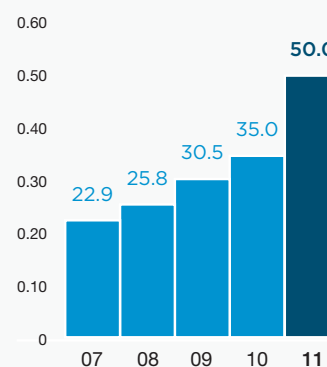
NET REVENUE  
(in billions of dollars)



DILUTED EPS FROM  
CONTINUING OPERATIONS  
(in dollars)



CASH DIVIDENDS  
(in cents per common share)







## Consolidated Statements of Income

<i>in millions, except per share amounts</i>	Year Ended December 31,		
	2011	2010	2009
Net revenues	\$ 107,100	\$ 95,778	\$ 98,215
Cost of revenues	86,539	75,559	77,857
Gross profit	20,561	20,219	20,358
Operating expenses	14,231	14,082	13,933
Operating profit	6,330	6,137	6,425
Interest expense, net	584	536	525
Income before income tax provision	5,746	5,601	5,900
Income tax provision	2,258	2,179	2,200
Income from continuing operations	3,488	3,422	3,700
Income (loss) from discontinued operations, net of tax	(31)	2	(4)
Net income	3,457	3,424	3,696
Net loss attributable to noncontrolling interest	4	3	—
Net income attributable to CVS Caremark	\$ 3,461	\$ 3,427	\$ 3,696
Basic earnings per common share:			
Income from continuing operations attributable to CVS Caremark	\$ 2.61	\$ 2.51	\$ 2.58
Loss from discontinued operations attributable to CVS Caremark	(0.02)	—	—
Net income attributable to CVS Caremark	\$ 2.59	\$ 2.51	\$ 2.58
Weighted average common shares outstanding	1,338	1,367	1,434
Diluted earnings per common share:			
Income from continuing operations attributable to CVS Caremark	\$ 2.59	\$ 2.49	\$ 2.55
Loss from discontinued operations attributable to CVS Caremark	(0.02)	—	—
Net income attributable to CVS Caremark	\$ 2.57	\$ 2.49	\$ 2.55
Weighted average common shares outstanding	1,347	1,377	1,450
Dividends declared per common share	\$ 0.500	\$ 0.350	\$ 0.305

See accompanying notes to consolidated financial statements.

## Consolidated Balance Sheets

	December 31,	
<i>in millions, except per share amounts</i>	<b>2011</b>	2010
<b>Assets:</b>		
Cash and cash equivalents	<b>\$ 1,413</b>	\$ 1,427
Short-term investments	<b>5</b>	4
Accounts receivable, net	<b>6,047</b>	4,925
Inventories	<b>10,046</b>	10,695
Deferred income taxes	<b>503</b>	511
Other current assets	<b>580</b>	144
Total current assets	<b>18,594</b>	17,706
Property and equipment, net	<b>8,467</b>	8,322
Goodwill	<b>26,458</b>	25,669
Intangible assets, net	<b>9,869</b>	9,784
Other assets	<b>1,155</b>	688
Total assets	<b>\$ 64,543</b>	\$ 62,169
<b>Liabilities:</b>		
Accounts payable	<b>\$ 4,370</b>	\$ 4,026
Claims and discounts payable	<b>3,487</b>	2,569
Accrued expenses	<b>3,293</b>	3,070
Short-term debt	<b>750</b>	300
Current portion of long-term debt	<b>56</b>	1,105
Total current liabilities	<b>11,956</b>	11,070
Long-term debt	<b>9,208</b>	8,652
Deferred income taxes	<b>3,853</b>	3,655
Other long-term liabilities	<b>1,445</b>	1,058
Commitments and Contingencies (Note 13)		
Redeemable noncontrolling interest	<b>30</b>	34
<b>Shareholders' equity:</b>		
Preferred stock, par value \$0.01: 0.1 shares authorized; none issued or outstanding	<b>—</b>	—
Common stock, par value \$0.01: 3,200 shares authorized; 1,640 shares issued and 1,298 shares outstanding at December 31, 2011 and 1,624 shares issued and 1,363 shares outstanding at December 31, 2010	<b>16</b>	16
Treasury stock, at cost: 340 shares at December 31, 2011 and 259 shares at December 31, 2010	<b>(11,953)</b>	(9,030)
Shares held in trust: 2 shares at December 31, 2011 and 2010	<b>(56)</b>	(56)
Capital surplus	<b>28,126</b>	27,610
Retained earnings	<b>22,090</b>	19,303
Accumulated other comprehensive loss	<b>(172)</b>	(143)
Total shareholders' equity	<b>38,051</b>	37,700
Total liabilities and shareholders' equity	<b>\$ 64,543</b>	\$ 62,169

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Cash Flows

<i>in millions</i>	Year Ended December 31,		
	2011	2010	2009
Cash flows from operating activities:			
Cash receipts from customers	\$ 97,688	\$ 94,503	\$ 93,568
Cash paid for inventory and prescriptions dispensed by retail network pharmacies	(75,148)	(73,143)	(73,536)
Cash paid to other suppliers and employees	(13,635)	(13,778)	(13,121)
Interest received	4	4	5
Interest paid	(647)	(583)	(542)
Income taxes paid	(2,406)	(2,224)	(2,339)
Net cash provided by operating activities	5,856	4,779	4,035
Cash flows from investing activities:			
Purchases of property and equipment	(1,872)	(2,005)	(2,548)
Proceeds from sale-leaseback transactions	592	507	1,562
Proceeds from sale of property and equipment	4	34	23
Acquisitions (net of cash acquired) and other investments	(1,441)	(177)	(101)
Purchase of available-for-sale investments	(3)	—	(5)
Sale or maturity of available-for-sale investments	60	1	—
Proceeds from sale of subsidiary	250	—	—
Net cash used in investing activities	(2,410)	(1,640)	(1,069)
Cash flows from financing activities:			
Increase (decrease) in short-term debt	450	(15)	(2,729)
Proceeds from issuance of long-term debt	1,463	991	2,800
Repayments of long-term debt	(2,122)	(2,103)	(653)
Dividends paid	(674)	(479)	(439)
Derivative settlements	(19)	(5)	(3)
Proceeds from exercise of stock options	431	285	250
Excess tax benefits from stock-based compensation	21	28	19
Repurchase of common stock	(3,001)	(1,500)	(2,477)
Other	(9)	—	—
Net cash used in financing activities	(3,460)	(2,798)	(3,232)
Net increase (decrease) in cash and cash equivalents	(14)	341	(266)
Cash and cash equivalents at the beginning of the year	1,427	1,086	1,352
Cash and cash equivalents at the end of the year	\$ 1,413	\$ 1,427	\$ 1,086
Reconciliation of net income to net cash provided by operating activities:			
Net income	\$ 3,457	\$ 3,424	\$ 3,696
Adjustments required to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,568	1,469	1,389
Stock-based compensation	135	150	165
Gain on sale of subsidiary	(53)	—	—
Deferred income taxes and other noncash items	144	30	48
Change in operating assets and liabilities, net of effects from acquisitions:			
Accounts receivable, net	(748)	532	(86)
Inventories	607	(352)	(1,199)
Other current assets	(420)	(4)	48
Other assets	(49)	(210)	(2)
Accounts payable	1,128	(40)	4
Accrued expenses	85	(176)	(66)
Other long-term liabilities	2	(44)	38
Net cash provided by operating activities	\$ 5,856	\$ 4,779	\$ 4,035

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Shareholders' Equity

<i>in millions</i>	Shares			Dollars		
	Year Ended December 31,			Year Ended December 31,		
	2011	2010	2009	2011	2010	2009
<b>Preference stock:</b>						
Beginning of year	–	–	4	\$ –	\$ –	\$ 191
Conversion to common stock	–	–	(4)	–	–	(191)
End of year	–	–	–	\$ –	\$ –	\$ –
<b>Common stock:</b>						
Beginning of year	1,624	1,612	1,603	\$ 16	\$ 16	\$ 16
Stock options exercised and stock awards	16	12	9	–	–	–
End of year	1,640	1,624	1,612	\$ 16	\$ 16	\$ 16
<b>Treasury stock:</b>						
Beginning of year	(259)	(219)	(165)	\$ (9,030)	\$ (7,610)	\$ (5,812)
Purchase of treasury shares	(84)	(42)	(73)	(3,001)	(1,500)	(2,477)
Conversion of preference stock	–	–	17	–	–	583
Employee stock purchase plan issuances	3	2	2	78	80	96
End of year	(340)	(259)	(219)	\$ (11,953)	\$ (9,030)	\$ (7,610)
<b>Shares held in trust:</b>						
Beginning of year	(2)	(2)	(2)	\$ (56)	\$ (56)	\$ (56)
End of year	(2)	(2)	(2)	\$ (56)	\$ (56)	\$ (56)
<b>Capital surplus:</b>						
Beginning of year				\$ 27,610	\$ 27,198	\$ 27,280
Stock option activity and stock awards				495	384	291
Tax benefit on stock options and stock awards				21	28	19
Conversion of preference stock				–	–	(392)
End of year				\$ 28,126	\$ 27,610	\$ 27,198

See accompanying notes to consolidated financial statements.

## Consolidated Statements of Shareholders' Equity

	Dollars		
	Year Ended December 31,		
<i>in millions</i>	2011	2010	2009
Retained earnings:			
Beginning of year	\$ 19,303	\$ 16,355	\$ 13,098
Net income attributable to CVS Caremark	3,461	3,427	3,696
Common stock dividends	(674)	(479)	(439)
End of year	\$ 22,090	\$ 19,303	\$ 16,355
Accumulated other comprehensive loss:			
Beginning of year	\$ (143)	\$ (135)	\$ (143)
Net cash flow hedges, net of income tax	(9)	(1)	1
Pension liability adjustment, net of income tax	(20)	(7)	7
End of year	\$ (172)	\$ (143)	\$ (135)
Total shareholders' equity	\$ 38,051	\$ 37,700	\$ 35,768
Comprehensive income:			
Net income	\$ 3,457	\$ 3,424	\$ 3,696
Other comprehensive income:			
Net cash flow hedges, net of income tax	(9)	(1)	1
Pension liability adjustment, net of income tax	(20)	(7)	7
Comprehensive income	3,428	3,416	3,704
Comprehensive loss attributable to noncontrolling interest	4	3	—
Comprehensive income attributable to CVS Caremark	\$ 3,432	\$ 3,419	\$ 3,704

See accompanying notes to consolidated financial statements.

## Notes to Consolidated Financial Statements

### 1 SIGNIFICANT ACCOUNTING POLICIES

**Description of business** – CVS Caremark Corporation and its subsidiaries (the “Company”) is the largest pharmacy health care provider in the United States based upon revenues and prescriptions filled. The Company currently has three reportable business segments, Pharmacy Services, Retail Pharmacy and Corporate, which are described below.

**Pharmacy Services Segment (the “PSS”)** – The PSS provides a full range of pharmacy benefit management services including mail order pharmacy services, specialty pharmacy services, plan design and administration, formulary management and claims processing. The Company’s clients are primarily employers, insurance companies, unions, government employee groups, managed care organizations and other sponsors of health benefit plans and individuals throughout the United States.

As a pharmacy benefits manager, the PSS manages the dispensing of pharmaceuticals through the Company’s mail order pharmacies and national network of approximately 65,000 retail pharmacies to eligible members in the benefits plans maintained by the Company’s clients and utilizes its information systems to perform, among other things, safety checks, drug interaction screenings and brand to generic substitutions.

The PSS’ specialty pharmacies support individuals that require complex and expensive drug therapies. The specialty pharmacy business includes mail order and retail specialty pharmacies that operate under the CVS Caremark® and CarePlus CVS/pharmacy® names.

The PSS also provides health management programs, which include integrated disease management for 28 conditions, through our strategic alliance with Alere, L.L.C. and the Company’s Accordant® health management offering.

In addition, through the Company’s SilverScript Insurance Company (“SilverScript”), Accendo Insurance Company (“Accendo”) and Pennsylvania Life Insurance Company (“Pennsylvania Life”) subsidiaries, the PSS is a national provider of drug benefits to eligible beneficiaries under the Federal Government’s Medicare Part D program.

The PSS generates net revenues primarily by contracting with clients to provide prescription drugs to plan members. Prescription drugs are dispensed by the mail order pharmacies, specialty pharmacies and national network of retail pharmacies. Net revenues are also generated by providing additional services to clients, including administrative services such as claims processing and formulary management, as well as health care related services such as disease management.

The pharmacy services business operates under the CVS Caremark® Pharmacy Services, Caremark®, CVS Caremark®, CarePlus CVS/pharmacy®, CarePlus™, RxAmerica® and Accordant® names. As of December 31, 2011, the PSS operated 31 retail specialty pharmacy stores, 12 specialty mail order pharmacies and 4 mail service pharmacies located in 22 states, Puerto Rico and the District of Columbia.

**Retail Pharmacy Segment (the “RPS”)** – The RPS sells prescription drugs and a wide assortment of general merchandise, including over-the-counter drugs, beauty products and cosmetics, photo finishing, seasonal merchandise, greeting cards and convenience foods, through the Company’s CVS/pharmacy® and Longs Drugs® retail stores and online through CVS.com®.

The RPS also provides health care services through its MinuteClinic® health care clinics. MinuteClinics are staffed by nurse practitioners and physician assistants who utilize nationally recognized protocols to diagnose and treat minor health conditions, perform health screenings, monitor chronic conditions and deliver vaccinations.

As of December 31, 2011, the retail pharmacy business included 7,327 retail drugstores (of which 7,271 operated a pharmacy) located in 41 states the District of Columbia and Puerto Rico operating primarily under the CVS/pharmacy® name, the online retail website, CVS.com and 657 retail health care clinics operating under the MinuteClinic® name (of which 648 were located in CVS/pharmacy stores).

**Corporate Segment** – The Corporate segment provides management and administrative services to support the Company. The Corporate segment consists of certain aspects of the Company’s executive management, corporate relations, legal, compliance, human resources, corporate information technology and finance departments.

**Principles of Consolidation** – The consolidated financial statements include the accounts of the Company and its majority owned subsidiaries. All intercompany balances and transactions have been eliminated.

**Use of estimates** – The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates.

**Fair Value Hierarchy** – The Company utilizes the three-level valuation hierarchy for the recognition and disclosure of fair value measurements. The categorization of assets and liabilities within this hierarchy is based upon the lowest level of input that is significant to the measurement of fair value. The three levels of the hierarchy consist of the following:

- Level 1 – Inputs to the valuation methodology are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.
- Level 2 – Inputs to the valuation methodology are quoted prices for similar assets and liabilities in active markets, quoted prices in markets that are not active or inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the instrument.
- Level 3 – Inputs to the valuation methodology are unobservable inputs based upon management's best estimate of inputs market participants could use in pricing the asset or liability at the measurement date, including assumptions about risk.

**Cash and cash equivalents** – Cash and cash equivalents consist of cash and temporary investments with maturities of three months or less when purchased. The Company invests in short-term money market funds, commercial paper, time deposits, as well as other debt securities that are classified as cash equivalents within the accompanying consolidated balance sheets, as these funds are highly liquid and readily convertible to known amounts of cash. These investments are classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices.

**Short-term investments** – The Company's short-term investments consist of certificate of deposits with initial maturities of greater than three months when purchased. These investments, which were classified as available-for-sale within Level 1 of the fair value hierarchy, were carried at historical cost, which approximated fair value at December 31, 2011 and 2010.

**Fair value of financial instruments** – As of December 31, 2011, the Company's financial instruments include cash and cash equivalents, accounts receivable, accounts payable and short-term debt. Due to the short-term nature of these instruments, the Company's carrying value approximates fair value. The carrying amount and estimated fair value of total long-term debt was \$9.3 billion and \$10.8 billion, respectively, as of December 31, 2011. The fair value of long-term debt was estimated based on rates currently offered to the Company for debt with similar terms and maturities. The Company had outstanding letters of credit, which guaranteed foreign trade purchases, with a fair value of \$6 million as of December 31, 2011 and 2010. There were no outstanding derivative financial instruments as of December 31, 2011 and 2010.

**Accounts receivable** – Accounts receivable are stated net of an allowance for doubtful accounts. The accounts receivable balance primarily includes trade amounts due from third party providers (e.g., pharmacy benefit managers, insurance companies and governmental agencies), clients and members, as well as vendors and manufacturers.

The activity in the allowance for doubtful trade accounts receivable is as follows:

<i>in millions</i>	Year Ended December 31,		
	2011	2010	2009
Beginning balance	\$ 182	\$ 224	\$ 189
Additions charged to bad debt expense	129	73	135
Write-offs charged to allowance	(122)	(115)	(100)
Ending balance	\$ 189	\$ 182	\$ 224



## Notes to Consolidated Financial Statements

**Inventories** – Inventories are stated at the lower of cost or market on a first-in, first-out basis using the retail inventory method in the retail pharmacy stores, the weighted average cost method in the mail service and specialty pharmacies, and the cost method on a first-in, first-out basis in the distribution centers. Physical inventory counts are taken on a regular basis in each store and a continuous cycle count process is the primary procedure used to validate the inventory balances on hand in each distribution center and mail facility to ensure that the amounts reflected in the accompanying consolidated financial statements are properly stated. During the interim period between physical inventory counts, the Company accrues for anticipated physical inventory losses on a location-by-location basis based on historical results and current trends.

**Property and equipment** – Property, equipment and improvements to leased premises are depreciated using the straight-line method over the estimated useful lives of the assets, or when applicable, the term of the lease, whichever is shorter. Estimated useful lives generally range from 10 to 40 years for buildings, building improvements and leasehold improvements and 3 to 10 years for fixtures, equipment and internally developed software. Repair and maintenance costs are charged directly to expense as incurred. Major renewals or replacements that substantially extend the useful life of an asset are capitalized and depreciated. Application development stage costs for significant internally developed software projects are capitalized and depreciated.

The following are the components of property and equipment at December 31:

<i>in millions</i>	2011	2010
Land	\$ 1,295	\$ 1,247
Building and improvements	2,404	2,265
Fixtures and equipment	7,582	7,148
Leasehold improvements	3,021	2,866
Software	1,098	757
	15,400	14,283
Accumulated depreciation and amortization	(6,933)	(5,961)
	\$ 8,467	\$ 8,322

The gross amount of property and equipment under capital leases was \$211 million and \$191 million as of December 31, 2011 and 2010, respectively.

**Goodwill** – Goodwill and other indefinite-lived assets are not amortized, but are subject to impairment reviews annually, or more frequently if necessary. See Note 4 for additional information on goodwill.

**Intangible assets** – Purchased customer contracts and relationships are amortized on a straight-line basis over their estimated useful lives between 10 and 20 years. Purchased customer lists are amortized on a straight-line basis over their estimated useful lives of up to 10 years. Purchased leases are amortized on a straight-line basis over the remaining life of the lease. See Note 4 for additional information about intangible assets.

**Impairment of long-lived assets** – The Company groups and evaluates fixed and finite-lived intangible assets, excluding goodwill, for impairment at the lowest level at which individual cash flows can be identified. When evaluating assets for potential impairment, the Company first compares the carrying amount of the asset group to the estimated future cash flows associated with the asset group (undiscounted and without interest charges). If the estimated future cash flows used in this analysis are less than the carrying amount of the asset group, an impairment loss calculation is prepared. The impairment loss calculation compares the carrying amount of the asset group to the asset group's estimated future cash flows (discounted and with interest charges). If required, an impairment loss is recorded for the portion of the asset group's carrying value that exceeds the asset group's estimated future cash flows (discounted and with interest charges).

**Redeemable noncontrolling interest** – The Company has an approximately 60% ownership interest in Generation Health, Inc. (“Generation Health”) and consolidates Generation Health in its consolidated financial statements. The noncontrolling shareholders of Generation Health hold put rights for the remaining interest in Generation Health that if exercised would require the Company to purchase the remaining interest in Generation Health in 2015 for a minimum of \$27 million and a maximum of \$159 million, depending on certain financial metrics of Generation Health in 2014. Since the noncontrolling shareholders of Generation Health have a redemption feature as a result of the put rights, the Company has classified the

redeemable noncontrolling interest in Generation Health in the mezzanine section of the consolidated balance sheet outside of shareholders’ equity. The Company initially recorded the redeemable noncontrolling interest at a fair value of \$37 million on the date of acquisition which was determined using inputs classified as Level 3 in the fair value hierarchy. At the end of each reporting period, if the estimated accreted redemption value exceeds the carrying value of the noncontrolling interest, the difference is recorded as a reduction of retained earnings. Any such reductions in retained earnings would also reduce income attributable to CVS Caremark in the Company’s earnings per share calculations.

The following is a reconciliation of the changes in the redeemable noncontrolling interest:

<i>in millions</i>	2011	2010	2009
Beginning balance	\$ 34	\$ 37	\$ —
Acquisition of Generation Health	—	—	37
Net loss attributable to noncontrolling interest	(4)	(3)	—
Ending balance	\$ 30	\$ 34	\$ 37

### Revenue Recognition

**Pharmacy Services Segment** – The PSS sells prescription drugs directly through its mail service pharmacies and indirectly through its retail pharmacy network. The PSS recognizes revenues from prescription drugs sold by its mail service pharmacies and under retail pharmacy network contracts where the PSS is the principal using the gross method at the contract prices negotiated with its clients. Net revenue from the PSS includes: (i) the portion of the price the client pays directly to the PSS, net of any volume-related or other discounts paid back to the client (see “Drug Discounts” later in this document), (ii) the price paid to the PSS (“Mail Co-Payments”) or a third party pharmacy in the PSS’ retail pharmacy network (“Retail Co-Payments”) by individuals included in its clients’ benefit plans, and (iii) administrative fees for retail pharmacy network contracts where the PSS is not the principal as discussed below.

The PSS recognizes revenue when: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the seller’s price to the buyer is fixed or determinable, and (iv) collectability is reasonably assured.

The Company has established the following revenue recognition policies for the PSS:

- Revenues generated from prescription drugs sold by mail service pharmacies are recognized when the prescription is shipped. At the time of shipment, the Company has performed substantially all of its obligations under its client contracts and does not experience a significant level of reshipments.
- Revenues generated from prescription drugs sold by third party pharmacies in the PSS’ retail pharmacy network and associated administrative fees are recognized at the PSS’ point-of-sale, which is when the claim is adjudicated by the PSS’ online claims processing system.

The PSS determines whether it is the principal or agent for its retail pharmacy network transactions on a contract by contract basis. In the majority of its contracts, the PSS has determined it is the principal due to it: (i) being the primary obligor in the arrangement, (ii) having latitude in establishing the price, changing the product or performing part of the service, (iii) having discretion in supplier selection, (iv) having involvement in the determination of product or service specifications, and (v) having credit risk. The PSS’ obligations under its client contracts for which revenues are reported using the gross method are separate and distinct from its obligations to the third party pharmacies included in its retail pharmacy

## Notes to Consolidated Financial Statements

network contracts. Pursuant to these contracts, the PSS is contractually required to pay the third party pharmacies in its retail pharmacy network for products sold, regardless of whether the PSS is paid by its clients. The PSS' responsibilities under its client contracts typically include validating eligibility and coverage levels, communicating the prescription price and the co-payments due to the third party retail pharmacy, identifying possible adverse drug interactions for the pharmacist to address with the physician prior to dispensing, suggesting clinically appropriate generic alternatives where appropriate and approving the prescription for dispensing. Although the PSS does not have credit risk with respect to Retail Co-Payments, management believes that all of the other indicators of gross revenue reporting are present. For contracts under which the PSS acts as an agent, the PSS records revenues using the net method.

**Drug Discounts** – The PSS deducts from its revenues any rebates, inclusive of discounts and fees, earned by its clients. The PSS pays rebates to its clients in accordance with the terms of its client contracts, which are normally based on fixed rebates per prescription for specific products dispensed or a percentage of manufacturer discounts received for specific products dispensed. The liability for rebates due to the PSS' clients is included in "Claims and discounts payable" in the accompanying consolidated balance sheets.

**Medicare Part D** – The PSS participates in the Federal Government's Medicare Part D program as a Prescription Drug Plan ("PDP"). The PSS' net revenues include insurance premiums earned by the PDP, which are determined based on the PDP's annual bid and related contractual arrangements with the Centers for Medicare and Medicaid Services ("CMS"). The insurance premiums include a beneficiary premium, which is the responsibility of the PDP member, but is subsidized by CMS in the case of low-income members, and a direct premium paid by CMS. Premiums collected in advance are initially deferred in accrued expenses and are then recognized in net revenues over the period in which members are entitled to receive benefits.

In addition to these premiums, the PSS' net revenues include co-payments, coverage gap benefits, deductibles and co-insurance (collectively, the "Member Co-Payments") related to PDP members' actual prescription claims. In certain cases, CMS subsidizes a portion of these Member Co-Payments and pays the PSS an estimated prospective Member Co-Payment subsidy amount each month. The prospective Member Co-Payment subsidy amounts received from CMS are also

included in the PSS' net revenues. The Company assumes no risk for these amounts, which represented 3.1%, 2.6% and 3.5% of consolidated net revenues in 2011, 2010 and 2009, respectively. If the prospective Member Co-Payment subsidies received differ from the amounts based on actual prescription claims, the difference is recorded in either accounts receivable or accrued expenses.

The PSS accounts for CMS obligations and Member Co-Payments (including the amounts subsidized by CMS) using the gross method consistent with its revenue recognition policies for Mail Co-Payments and Retail Co-Payments (discussed previously in this document). See Note 8 for additional information about Medicare Part D.

**Retail Pharmacy Segment** – The RPS recognizes revenue from the sale of merchandise (other than prescription drugs) at the time the merchandise is purchased by the retail customer. Revenue from the sale of prescription drugs is recognized at the time the prescription is filled, which is or approximates when the retail customer picks up the prescription. Customer returns are not material. Revenue generated from the performance of services in the RPS' health care clinics is recognized at the time the services are performed. See Note 14 for additional information about the revenues of the Company's business segments.

### Cost of Revenues

**Pharmacy Services Segment** – The PSS' cost of revenues includes: (i) the cost of prescription drugs sold during the reporting period directly through its mail service pharmacies and indirectly through its retail pharmacy network, (ii) shipping and handling costs, and (iii) the operating costs of its mail service pharmacies and client service operations and related information technology support costs including depreciation and amortization. The cost of prescription drugs sold component of cost of revenues includes: (i) the cost of the prescription drugs purchased from manufacturers or distributors and shipped to members in clients' benefit plans from the PSS' mail service pharmacies, net of any volume-related or other discounts (see "Drug Discounts" previously in this document) and (ii) the cost of prescription drugs sold (including Retail Co-Payments) through the PSS' retail pharmacy network under contracts where it is the principal, net of any volume-related or other discounts.

**Retail Pharmacy Segment** – The RPS' cost of revenues includes: the cost of merchandise sold during the reporting period and the related purchasing costs, warehousing

and delivery costs (including depreciation and amortization) and actual and estimated inventory losses. See Note 14 for additional information about the cost of revenues of the Company's business segments.

#### Vendor Allowances and Purchase Discounts

The Company accounts for vendor allowances and purchase discounts as follows:

**Pharmacy Services Segment** – The PSS receives purchase discounts on products purchased. The PSS' contractual arrangements with vendors, including manufacturers, wholesalers and retail pharmacies, normally provide for the PSS to receive purchase discounts from established list prices in one, or a combination of, the following forms: (i) a direct discount at the time of purchase, (ii) a discount for the prompt payment of invoices, or (iii) when products are purchased indirectly from a manufacturer (e.g., through a wholesaler or retail pharmacy), a discount (or rebate) paid subsequent to dispensing. These rebates are recognized when prescriptions are dispensed and are generally calculated and billed to manufacturers within 30 days of the end of each completed quarter. Historically, the effect of adjustments resulting from the reconciliation of rebates recognized to the amounts billed and collected has not been material to the PSS' results of operations. The PSS accounts for the effect of any such differences as a change in accounting estimate in the period the reconciliation is completed. The PSS also receives additional discounts under its wholesaler contract if it exceeds contractually defined annual purchase volumes. In addition, the PSS receives fees from pharmaceutical manufacturers for administrative services. Purchase discounts and administrative service fees are recorded as a reduction of "Cost of revenues".

**Retail Pharmacy Segment** – Vendor allowances received by the RPS reduce the carrying cost of inventory and are recognized in cost of revenues when the related inventory is sold, unless they are specifically identified as a reimbursement of incremental costs for promotional programs and/or other services provided. Amounts that are directly linked to advertising commitments are recognized as a reduction of advertising expense (included in operating expenses) when the related advertising commitment is satisfied. Any such allowances received in excess of the actual cost incurred also reduce the carrying cost of inventory. The total value of any upfront payments received from vendors that are linked to purchase commitments is initially deferred. The deferred amounts are then amortized to reduce cost of revenues over the life of the contract based upon purchase volume. The total value

of any upfront payments received from vendors that are not linked to purchase commitments is also initially deferred. The deferred amounts are then amortized to reduce cost of revenues on a straight-line basis over the life of the related contract. The total amortization of these upfront payments was not material to the accompanying consolidated financial statements.

**Insurance** – The Company is self-insured for certain losses related to general liability, workers' compensation and auto liability. The Company obtains third party insurance coverage to limit exposure from these claims. The Company is also self-insured for certain losses related to health and medical liabilities. The Company's self-insurance accruals, which include reported claims and claims incurred but not reported, are calculated using standard insurance industry actuarial assumptions and the Company's historical claims experience.

**Facility opening and closing costs** – New facility opening costs, other than capital expenditures, are charged directly to expense when incurred. When the Company closes a facility, the present value of estimated unrecoverable costs, including the remaining lease obligation less estimated sublease income and the book value of abandoned property and equipment, are charged to expense. The long-term portion of the lease obligations associated with facility closings was \$327 million and \$368 million in 2011 and 2010, respectively.

**Advertising costs** – Advertising costs are expensed when the related advertising takes place. Advertising costs, net of vendor funding (included in operating expenses), were \$211 million, \$234 million and \$317 million in 2011, 2010 and 2009, respectively.

**Interest expense, net** – Interest expense, net of capitalized interest, was \$588 million, \$539 million and \$530 million, and interest income was \$4 million, \$3 million and \$5 million in 2011, 2010 and 2009, respectively. Capitalized interest totaled \$37 million, \$47 million and \$39 million in 2011, 2010 and 2009, respectively.

**Shares held in trust** – The Company maintains grantor trusts, which held approximately 2 million shares of its common stock at December 31, 2011 and 2010. These shares are designated for use under various employee compensation plans. Since the Company holds these shares, they are excluded from the computation of basic and diluted shares outstanding.

## Notes to Consolidated Financial Statements

**Accumulated other comprehensive loss** – Accumulated other comprehensive loss consists of changes in the net actuarial gains and losses associated with pension and other postretirement benefit plans, and unrealized losses on derivatives. The amount included in accumulated other comprehensive loss related to the Company's pension and postretirement plans was \$250 million pre-tax (\$152 million after-tax) as of December 31, 2011 and \$217 million pre-tax (\$132 million after-tax) as of December 31, 2010. The net impact on cash flow hedges totaled \$32 million pre-tax (\$20 million after-tax) and \$18 million pre-tax (\$11 million after-tax) as of December 31, 2011 and 2010, respectively.

**Stock-based compensation** – Stock-based compensation expense is measured at the grant date based on the fair value of the award and is recognized as expense over the applicable requisite service period of the stock award (generally 3 to 5 years) using the straight-line method. Stock-based compensation costs are included in selling, general and administrative expenses.

**Income taxes** – The Company provides for federal and state income taxes currently payable, as well as for those deferred because of timing differences between reported income and expenses for financial statement purposes versus tax purposes. Federal and state tax credits are recorded as a reduction of income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the carrying amount of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Deferred tax assets and liabilities are measured using the enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recoverable or settled. The effect of a change in tax rates is recognized as income or expense in the period of the change.

**Earnings per common share** – Basic earnings per common share is computed by dividing: (i) net earnings by (ii) the weighted average number of common shares outstanding during the year (the "Basic Shares").

Diluted earnings per common share is computed by dividing: (i) net earnings by (ii) Basic Shares plus the additional shares that would be issued assuming that all dilutive stock awards are exercised. Options to purchase 30.5 million, 34.3 million and 37.7 million shares of common stock were outstanding as of December 31, 2011, 2010 and 2009, respectively, but were not included in the calculation of diluted earnings per share because the options' exercise prices were greater

than the average market price of the common shares and, therefore, the effect would be antidilutive.

**16 QUARTERLY FINANCIAL INFORMATION (UNAUDITED)**

<i>in millions, except per share amounts</i>	First Quarter <sup>(1)</sup>	Second Quarter <sup>(1)</sup>	Third Quarter	Fourth Quarter	Year
<b>2011:</b>					
Net revenues	\$ 25,695	\$ 26,414	\$ 26,674	\$ 28,317	\$ 107,100
Gross profit	4,742	5,086	5,178	5,555	20,561
Operating profit	1,305	1,484	1,584	1,957	6,330
Income from continuing operations	709	813	867	1,099	3,488
Income (loss) from discontinued operations, net of tax	3	2	—	(36)	(31)
Net income	712	815	867	1,063	3,457
Net loss attributable to noncontrolling interest	1	1	1	1	4
Net income attributable to CVS Caremark	\$ 713	\$ 816	\$ 868	\$ 1,064	\$ 3,461
<b>Basic earnings per common share:</b>					
Income from continuing operations attributable to CVS Caremark	\$ 0.52	\$ 0.60	\$ 0.65	\$ 0.84	\$ 2.61
Loss from discontinued operations attributable to CVS Caremark	\$ —	\$ —	\$ —	\$ (0.03)	\$ (0.02)
Net income attributable to CVS Caremark	\$ 0.52	\$ 0.60	\$ 0.65	\$ 0.82	\$ 2.59
<b>Diluted Earnings per common share:</b>					
Income from continuing operations attributable to CVS Caremark	\$ 0.52	\$ 0.60	\$ 0.65	\$ 0.84	\$ 2.59
Loss from discontinued operations attributable to CVS Caremark	\$ —	\$ —	\$ —	\$ (0.03)	\$ (0.02)
Net income attributable to CVS Caremark	\$ 0.52	\$ 0.60	\$ 0.65	\$ 0.81	\$ 2.57
Dividends per common share	\$ 0.125	\$ 0.125	\$ 0.125	\$ 0.125	\$ 0.500
<b>Stock price: (New York Stock Exchange)</b>					
High	\$ 35.95	\$ 39.50	\$ 38.82	\$ 41.35	\$ 41.35
Low	\$ 32.08	\$ 34.21	\$ 31.30	\$ 32.28	\$ 31.30

(1) The results of operations previously filed have been revised to reflect the results of TheraCom as discontinued operations. See Note 3.

## Notes to Consolidated Financial Statements

<i>in millions, except per share amounts</i>	First Quarter <sup>(1)</sup>	Second Quarter <sup>(1)</sup>	Third Quarter <sup>(1)</sup>	Fourth Quarter <sup>(1)</sup>	Year <sup>(1)</sup>
2010:					
Net revenues	\$ 23,593	\$ 23,885	\$ 23,711	\$ 24,589	\$ 95,778
Gross profit	4,738	5,012	5,015	5,454	20,219
Operating profit	1,404	1,494	1,478	1,761	6,137
Income from continuing operations	768	819	815	1,020	3,422
Income (loss) from discontinued operations, net of tax	2	2	(7)	5	2
Net income	770	821	808	1,025	3,424
Net loss attributable to noncontrolling interest	1	—	1	1	3
Net income attributable to CVS Caremark	\$ 771	\$ 821	\$ 809	\$ 1,026	\$ 3,427
Basic earnings per common share:					
Income from continuing operations attributable to CVS Caremark	\$ 0.56	\$ 0.60	\$ 0.60	\$ 0.75	\$ 2.51
Income (loss) from discontinued operations attributable to CVS Caremark	\$ —	\$ —	\$ (0.01)	\$ —	\$ —
Net income attributable to CVS Caremark	\$ 0.56	\$ 0.61	\$ 0.59	\$ 0.75	\$ 2.51
Diluted Earnings per common share:					
Income from continuing operations attributable to CVS Caremark	\$ 0.55	\$ 0.60	\$ 0.60	\$ 0.74	\$ 2.49
Income (loss) from discontinued operations attributable to CVS Caremark	\$ —	\$ —	\$ (0.01)	\$ —	\$ —
Net income attributable to CVS Caremark	\$ 0.55	\$ 0.60	\$ 0.59	\$ 0.75	\$ 2.49
Dividends per common share	\$ 0.0875	\$ 0.0875	\$ 0.0875	\$ 0.0875	\$ 0.3500
Stock price: (New York Stock Exchange)					
High	\$ 37.32	\$ 37.82	\$ 32.09	\$ 35.46	\$ 37.82
Low	\$ 30.36	\$ 29.22	\$ 26.84	\$ 29.45	\$ 26.84

(1) The results of operations previously filed have been revised to reflect the results of TheraCom as discontinued operations. See Note 3.



## Five-Year Financial Summary

<i>in millions, except per share amounts</i>	2011 <sup>(1)</sup>	2010 <sup>(1)</sup>	2009 <sup>(1)</sup>	2008 <sup>(1)</sup>	2007 <sup>(1) (2)</sup>
<b>Statement of operations data:</b>					
Net revenues	\$ 107,100	\$ 95,778	\$ 98,215	\$ 87,005	\$ 76,078
Gross profit	20,561	20,219	20,358	18,272	16,098
Operating expenses	14,231	14,082	13,933	12,237	11,309
Operating profit	6,330	6,137	6,425	6,035	4,789
Interest expense, net	584	536	525	509	435
Income tax provision <sup>(3)</sup>	2,258	2,179	2,200	2,189	1,720
Income from continuing operations	3,488	3,422	3,700	3,337	2,634
Income (loss) from discontinued operations, net of tax benefit <sup>(4)</sup>	(31)	2	(4)	(125)	3
Net income	3,457	3,424	3,696	3,212	2,637
Net loss attributable to noncontrolling interest <sup>(5)</sup>	4	3	—	—	—
Preference dividends, net of income tax benefit	—	—	—	(14)	(14)
Net income attributable to CVS Caremark	\$ 3,461	\$ 3,427	\$ 3,696	\$ 3,198	\$ 2,623
<b>Per common share data:</b>					
<b>Basic earnings per common share:</b>					
Income from continuing operations attributable to CVS Caremark	\$ 2.61	\$ 2.51	\$ 2.58	\$ 2.32	\$ 1.97
Loss from discontinued operations attributable to CVS Caremark	(0.02)	—	—	(0.09)	—
Net income attributable to CVS Caremark	\$ 2.59	\$ 2.51	\$ 2.58	\$ 2.23	\$ 1.97
<b>Diluted earnings per common share:</b>					
Income from continuing operations attributable to CVS Caremark	\$ 2.59	\$ 2.49	\$ 2.55	\$ 2.27	\$ 1.92
Loss from discontinued operations attributable to CVS Caremark	(0.02)	—	—	(0.09)	—
Net income attributable to CVS Caremark	\$ 2.57	\$ 2.49	\$ 2.55	\$ 2.18	\$ 1.92
Cash dividends per common share	\$ 0.50000	\$ 0.35000	\$ 0.30500	\$ 0.25800	\$ 0.22875
<b>Balance sheet and other data:</b>					
Total assets	\$ 64,543	\$ 62,169	\$ 61,641	\$ 60,960	\$ 54,722
Long-term debt	\$ 9,208	\$ 8,652	\$ 8,756	\$ 8,057	\$ 8,350
Total shareholders' equity	\$ 38,051	\$ 37,700	\$ 35,768	\$ 34,574	\$ 31,322
Number of stores (at end of year)	7,388	7,248	7,095	6,997	6,301

(1) On December 23, 2008, our Board of Directors approved a change in our fiscal year-end from the Saturday nearest December 31 of each year to December 31 of each year to better reflect our position in the health care, rather than the retail, industry. The fiscal year change was effective beginning with the fourth quarter of fiscal 2008. As you review our operating performance, please consider that 2011, 2010 and 2009 include 365 days; fiscal 2008 includes 368 days, and fiscal 2007 includes 364 days.

(2) Effective March 22, 2007, Caremark Rx, Inc. was merged into a newly formed subsidiary of CVS Corporation, with Caremark Rx, L.L.C., continuing as the surviving entity (the "Caremark Merger"). Following the Caremark Merger, the name of the Company was changed to "CVS Caremark Corporation." By virtue of the Caremark Merger, each issued and outstanding share of Caremark common stock, par value \$0.001 per share, was converted into the right to receive 1.67 shares of CVS Caremark's common stock, par value \$0.01 per share. Cash was paid in lieu of fractional shares.

(3) Income tax provision includes the effect of the following: (i) in 2010, the recognition of \$47 million of previously unrecognized tax benefits, including interest, relating to the expiration of various statutes of limitation and settlements with tax authorities and (ii) in 2009, the recognition of \$167 million of previously unrecognized tax benefits, including interest, relating to the expiration of various statutes of limitation and settlements with tax authorities.

(4) As discussed in Note 3 to the consolidated financial statements, the results of the Theracom business are presented as discontinued operations and have been excluded from continuing operations for all periods presented.

In connection with certain business dispositions completed between 1991 and 1997, the Company retained guarantees on store lease obligations for a number of former subsidiaries, including Linens 'n Things which filed for bankruptcy in 2008. The Company's income (loss) from discontinued operations includes lease-related costs which the Company believes it will likely be required to satisfy pursuant to its Linens 'n Things lease guarantees.

Below is a summary of the results of discontinued operations:

<i>in millions</i>	2011	2010	2009	2008	2007
Income from operations of TheraCom	\$ 18	\$ 28	\$ 13	\$ 11	\$ 5
Gain on disposal of TheraCom	53	—	—	—	—
Loss on disposal of Linens 'n Things	(7)	(24)	(19)	(214)	—
Income tax benefit (provision)	(95)	(2)	2	78	(2)
Income (loss) from discontinued operations, net of tax	\$ (31)	\$ 2	\$ (4)	\$ (125)	\$ 3

(5) Represents the minority shareholders' portion of the net loss from our majority owned subsidiary, Generation Health, Inc., acquired in the fourth quarter of 2009.



## Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders  
CVS Caremark Corporation

We have audited the accompanying consolidated balance sheets of CVS Caremark Corporation as of December 31, 2011 and 2010, and the related consolidated statements of income, shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of CVS Caremark Corporation at December 31, 2011 and 2010, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), CVS Caremark Corporation's internal control over financial reporting as of December 31, 2011, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 17, 2012 expressed an unqualified opinion thereon.

The logo for Ernst & Young LLP is written in a black, cursive script font. The words "Ernst & Young" are connected, and "LLP" is written in a slightly smaller font to the right.

Boston, Massachusetts  
February 17, 2012



# **Excerpts from Southwest Airlines Co.'s 2011 Annual Report**

Item 8. *Financial Statements and Supplementary Data*

**SOUTHWEST AIRLINES CO.**  
**CONSOLIDATED BALANCE SHEET**  
(in millions, except share data)

	<u>DECEMBER 31,</u>	
	<u>2011</u>	<u>2010</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents . . . . .	\$ 829	\$ 1,261
Short-term investments . . . . .	2,315	2,277
Accounts and other receivables . . . . .	299	195
Inventories of parts and supplies, at cost . . . . .	401	243
Deferred income taxes . . . . .	263	214
Prepaid expenses and other current assets . . . . .	238	89
Total current assets . . . . .	<u>4,345</u>	<u>4,279</u>
Property and equipment, at cost:		
Flight equipment . . . . .	15,542	13,991
Ground property and equipment . . . . .	2,423	2,122
Deposits on flight equipment purchase contracts . . . . .	456	230
	<u>18,421</u>	<u>16,343</u>
Less allowance for depreciation and amortization . . . . .	<u>6,294</u>	<u>5,765</u>
	12,127	10,578
Goodwill . . . . .	970	—
Other assets . . . . .	626	606
	<u>\$18,068</u>	<u>\$15,463</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable . . . . .	\$ 1,057	\$ 739
Accrued liabilities . . . . .	996	863
Air traffic liability . . . . .	1,836	1,198
Current maturities of long-term debt . . . . .	644	505
Total current liabilities . . . . .	<u>4,533</u>	<u>3,305</u>
Long-term debt less current maturities . . . . .	3,107	2,875
Deferred income taxes . . . . .	2,566	2,493
Deferred gains from sale and leaseback of aircraft . . . . .	75	88
Other noncurrent liabilities . . . . .	910	465
Stockholders' equity:		
Common stock, \$1.00 par value: 2,000,000,000 shares authorized; 807,611,634 shares issued in 2011 and 2010 . . . . .	808	808
Capital in excess of par value . . . . .	1,222	1,183
Retained earnings . . . . .	5,395	5,399
Accumulated other comprehensive loss . . . . .	(224)	(262)
Treasury stock, at cost: 35,050,991 and 60,177,362 shares in 2011 and 2010 respectively . . . . .	(324)	(891)
Total stockholders' equity . . . . .	<u>6,877</u>	<u>6,237</u>
	<u>\$18,068</u>	<u>\$15,463</u>

See accompanying notes.

**SOUTHWEST AIRLINES CO.**  
**CONSOLIDATED STATEMENT OF INCOME**  
(in millions, except per share amounts)

	<b>YEAR ENDED DECEMBER 31,</b>		
	<b>2011</b>	<b>2010</b>	<b>2009</b>
<b>OPERATING REVENUES:</b>			
Passenger .....	\$14,735	\$11,489	\$ 9,892
Freight .....	139	125	118
Other .....	784	490	340
Total operating revenues .....	<u>15,658</u>	<u>12,104</u>	<u>10,350</u>
<b>OPERATING EXPENSES:</b>			
Salaries, wages, and benefits .....	4,371	3,704	3,468
Fuel and oil .....	5,644	3,620	3,044
Maintenance materials and repairs .....	955	751	719
Aircraft rentals .....	308	180	186
Landing fees and other rentals .....	959	807	718
Depreciation and amortization .....	715	628	616
Acquisition and integration .....	134	8	—
Other operating expenses .....	1,879	1,418	1,337
Total operating expenses .....	<u>14,965</u>	<u>11,116</u>	<u>10,088</u>
<b>OPERATING INCOME</b> .....	693	988	262
<b>OTHER EXPENSES (INCOME):</b>			
Interest expense .....	194	167	186
Capitalized interest .....	(12)	(18)	(21)
Interest income .....	(10)	(12)	(13)
Other (gains) losses, net .....	198	106	(54)
Total other expenses .....	<u>370</u>	<u>243</u>	<u>98</u>
<b>INCOME BEFORE INCOME TAXES</b> .....	323	745	164
<b>PROVISION FOR INCOME TAXES</b> .....	145	286	65
<b>NET INCOME</b> .....	<u>\$ 178</u>	<u>\$ 459</u>	<u>\$ 99</u>
<b>NET INCOME PER SHARE, BASIC</b> .....	<u>\$ .23</u>	<u>\$ .62</u>	<u>\$ .13</u>
<b>NET INCOME PER SHARE, DILUTED</b> .....	<u>\$ .23</u>	<u>\$ .61</u>	<u>\$ .13</u>
<b>Cash dividends declared per common share</b> .....	<b>\$ .0180</b>	<b>\$ .0180</b>	<b>\$ .0180</b>

See accompanying notes.



**SOUTHWEST AIRLINES CO.**  
**CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

(in millions, except per share amounts)	YEAR ENDED DECEMBER 31, 2011, 2010, AND 2009					
	Common Stock	Capital in excess of par value	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
Balance at December 31, 2008	\$808	\$1,215	\$4,907	\$(984)	\$(1,005)	\$4,941
Issuance of common and treasury stock pursuant to Employee stock plans	—	—	(22)	—	42	20
Net tax benefit (expense) of options exercised	—	(13)	—	—	—	(13)
Share-based compensation	—	14	—	—	—	14
Cash dividends, \$.018 per share	—	—	(13)	—	—	(13)
Comprehensive income (loss):						
Net income	—	—	99	—	—	99
Unrealized gain on fuel derivative instruments	—	—	—	366	—	366
Other	—	—	—	40	—	40
Total comprehensive income	—	—	—	—	—	505
Balance at December 31, 2009	\$808	\$1,216	\$4,971	\$(578)	\$ (963)	\$5,454
Issuance of common and treasury stock pursuant to Employee stock plans	—	—	(18)	—	72	54
Net tax benefit (expense) of options exercised	—	(45)	—	—	—	(45)
Share-based compensation	—	12	—	—	—	12
Cash dividends, \$.018 per share	—	—	(13)	—	—	(13)
Comprehensive income (loss):						
Net income	—	—	459	—	—	459
Unrealized gain on fuel derivative instruments	—	—	—	330	—	330
Other	—	—	—	(14)	—	(14)
Total comprehensive income	—	—	—	—	—	775
Balance at December 31, 2010	\$808	\$1,183	\$5,399	\$(262)	\$ (891)	\$6,237
Repurchase of common stock	—	—	—	—	(225)	(225)
Issuance of common and treasury stock pursuant to Employee stock plans	—	(3)	(14)	—	37	20
Issuance of stock to acquire AirTran	—	—	(127)	—	650	523
Issuance of stock for conversion of debt	—	34	(27)	—	105	112
Net tax benefit (expense) of options exercised	—	(5)	—	—	—	(5)
Share-based compensation	—	13	—	—	—	13
Cash dividends, \$.018 per share	—	—	(14)	—	—	(14)
Comprehensive income (loss):						
Net income	—	—	178	—	—	178
Unrealized gain on fuel derivative instruments	—	—	—	67	—	67
Other	—	—	—	(29)	—	(29)
Total comprehensive income	—	—	—	—	—	216
Balance at December 31, 2011	\$808	\$1,222	\$5,395	\$(224)	\$ (324)	\$6,877

See accompanying notes.

**SOUTHWEST AIRLINES CO.**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**

<u>(in millions)</u>	<u>YEAR ENDED DECEMBER 31,</u>		
	<u>2011</u>	<u>2010</u>	<u>2009</u>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income	\$ 178	\$ 459	\$ 99
Adjustments to reconcile net income to cash provided by operating activities:			
Depreciation and amortization	715	628	616
Unrealized (gain) loss on fuel derivative instruments	90	139	14
Deferred income taxes	123	133	72
Amortization of deferred gains on sale and leaseback of aircraft	(13)	(14)	(12)
Changes in certain assets and liabilities (excluding the effects of acquired business):			
Accounts and other receivables	(26)	(26)	40
Other current assets	(196)	(8)	(27)
Accounts payable and accrued liabilities	253	193	59
Air traffic liability	262	153	81
Cash collateral received from (provided to) derivative counterparties	(195)	265	(90)
Other, net	194	(361)	133
Net cash provided by operating activities	<u>1,385</u>	<u>1,561</u>	<u>985</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Payment to acquire AirTran, net of AirTran cash on hand	(35)	—	—
Payments for purchase of property and equipment, net	(968)	(493)	(585)
Purchases of short-term investments	(5,362)	(5,624)	(6,106)
Proceeds from sales of short-term investments	5,314	4,852	5,120
Other, net	—	—	2
Net cash used in investing activities	<u>(1,051)</u>	<u>(1,265)</u>	<u>(1,569)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Issuance of long-term debt	—	—	455
Proceeds from credit line borrowing	—	—	83
Proceeds from sale leaseback transactions	—	—	381
Proceeds from Employee stock plans	20	55	20
Proceeds from termination of interest rate derivative instrument	76	—	—
Payments of long-term debt and capital lease obligations	(540)	(155)	(86)
Payments of convertible debt obligations	(81)	—	—
Payment of revolving credit facility obligations	—	—	(400)
Payment of credit line borrowing obligations	—	(44)	(97)
Payments of cash dividends	(14)	(13)	(13)
Repurchase of common stock	(225)	—	—
Other, net	(2)	8	(13)
Net cash provided by (used in) financing activities	<u>(766)</u>	<u>(149)</u>	<u>330</u>
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	<b>(432)</b>	<b>147</b>	<b>(254)</b>
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b><u>1,261</u></b>	<b><u>1,114</u></b>	<b><u>1,368</u></b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b><u>\$ 829</u></b>	<b><u>\$ 1,261</u></b>	<b><u>\$ 1,114</u></b>
<b>CASH PAYMENTS FOR:</b>			
Interest, net of amount capitalized	\$ 185	\$ 135	\$ 152
Income taxes	\$ 13	\$ 274	\$ 5
<b>SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS:</b>			
Fair value of equity consideration given to acquire AirTran	\$ 523	\$ —	\$ —
Fair value of common stock issued for conversion of debt	\$ 78	\$ —	\$ —

See accompanying notes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS DECEMBER 31, 2011

### 1. Summary of Significant Accounting Policies

#### *Basis of Presentation*

Southwest Airlines Co. (the “Company”) operates Southwest Airlines, a major domestic airline that provides point-to-point, low-fare service. The Consolidated Financial Statements include the accounts of the Company and its wholly owned subsidiaries, which include AirTran Holdings, LLC. On May 2, 2011 (the “acquisition date”), the Company acquired all of the outstanding equity of AirTran Holdings, Inc. (“AirTran Holdings”), the former parent company of AirTran Airways, Inc. (“AirTran Airways”), in exchange for common stock of the Company and cash. Throughout these Notes, the Company makes reference to AirTran, which is meant to be inclusive of the following: (i) for periods prior to the acquisition date, AirTran Holdings and its subsidiaries, including, among others, AirTran Airways; and (ii) for periods on and after the acquisition date, AirTran Holdings, LLC, the successor to AirTran Holdings, and its subsidiaries, including among others, AirTran Airways. The accompanying Consolidated Financial Statements include the results of operations and cash flows for AirTran from May 2, 2011 through December 31, 2011. See Note 2. All significant inter-entity balances and transactions have been eliminated. The preparation of financial statements in conformity with generally accepted accounting principles in the United States (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

#### *Cash and cash equivalents*

Cash in excess of that necessary for operating requirements is invested in short-term, highly liquid, income-producing investments. Investments with original maturities of three months or less when purchased are classified as cash and cash equivalents, which primarily consist of certificates of deposit, money market funds, and investment grade commercial paper issued by major corporations and financial institutions. Cash and cash equivalents are stated at cost, which approximates fair value.

As of December 31, 2011 and 2010, the Company had provided cash collateral deposits to its fuel hedge counterparties totaling \$226 million and \$125 million, respectively. As of December 31, 2010, the Company also held cash collateral deposits of \$60 million from a counterparty. Cash collateral amounts provided or held associated with fuel derivative instruments are not restricted in any way and earn interest income at an agreed upon rate that approximates the rates earned on short-term securities issued by the U.S. Government. Depending on the fair value of the Company’s fuel derivative instruments, the amounts of collateral deposits held or provided at any point in time can fluctuate significantly. See Note 10 for further information on these collateral deposits and fuel derivative instruments.

#### *Short-term and noncurrent investments*

Short-term investments consist of investments with original maturities of greater than three months but less than twelve months when purchased. These are primarily short-term securities issued by the U.S. Government and certificates of deposit issued by domestic banks. All of these investments are classified as available-for-sale securities and are stated at fair value, which approximates cost. For all short-term investments, at each reset period or upon reinvestment, the Company accounts for the transaction as Proceeds from sales of short-term investments for the security relinquished, and Purchases of short-term investments for the security purchased, in the accompanying Consolidated Statement of Cash Flows. Unrealized gains and losses, net of tax, if any, are recognized in Accumulated other comprehensive income (loss) (“AOCI”) in the accompanying Consolidated Balance Sheet. Realized net gains and losses on specific investments, if any, are reflected in Interest income in the accompanying Consolidated Statement of Income. Both unrealized and realized gains and/or losses associated with investments were immaterial for all years presented.

Noncurrent investments consist of investments with maturities of greater than twelve months. At December 31, 2011, these primarily consisted of the Company's auction rate security instruments that it expects will not be redeemed during 2012. See Note 11 for further information. Noncurrent investments are included as a component of Other assets in the Consolidated Balance Sheet.

#### *Accounts and other receivables*

Accounts and other receivables are carried at cost. They primarily consist of amounts due from credit card companies associated with sales of tickets for future travel, amounts due from business partners in the Company's frequent flyer program, and amounts due from counterparties associated with fuel derivative instruments that have settled. The allowance for doubtful accounts was immaterial at December 31, 2011, 2010, and 2009. In addition, the provision for doubtful accounts and write-offs for 2011, 2010, and 2009 were each immaterial.

#### *Inventories*

Inventories consist primarily of aircraft fuel, flight equipment expendable parts, materials, and supplies. All of these items are carried at average cost, less an allowance for obsolescence. These items are generally charged to expense when issued for use. The reserve for obsolescence was immaterial at December 31, 2011, 2010, and 2009. In addition, the Company's provision for obsolescence and write-offs for 2011, 2010, and 2009 were each immaterial.

#### *Property and equipment*

Property and equipment is stated at cost. Depreciation is provided by the straight-line method to estimated residual values over periods generally ranging from 23 to 30 years for flight equipment and 5 to 30 years for ground property and equipment once the asset is placed in service. Residual values estimated for aircraft generally range from 5 to 15 percent and for ground property and equipment generally range from 0 to 10 percent. Property under capital leases and related obligations are initially recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the Company's incremental borrowing rate or, when known, the interest rate implicit in the lease. Amortization of property under capital leases is on a straight-line basis over the lease term and is included in Depreciation and amortization expense. Leasehold improvements generally are amortized on a straight-line basis over the shorter of the estimated useful life of the improvement or the remaining term of the lease.

The Company evaluates its long-lived assets used in operations for impairment when events and circumstances indicate that the undiscounted cash flows to be generated by that asset are less than the carrying amounts of the asset and may not be recoverable. Factors that would indicate potential impairment include, but are not limited to, significant decreases in the market value of the long-lived asset(s), a significant change in the long-lived asset's physical condition, and operating or cash flow losses associated with the use of the long-lived asset. If an asset is deemed to be impaired, an impairment loss is recorded for the excess of the asset book value in relation to its estimated fair value.

#### *Aircraft and engine maintenance*

The cost of scheduled inspections and repairs and routine maintenance costs for all aircraft and engines are charged to Maintenance materials and repairs expense as incurred. The Company has "power-by-the-hour" agreements related to its Boeing 737-700 engines and AirTran's Boeing 717-200 engines with external service providers. Under these agreements, which the Company has determined effectively transfer the risk associated with the maintenance on such engines to the counterparty, expense is recorded commensurate with each hour flown on an engine. The Company modified its engine maintenance contract for its Classic fleet (737-300/500s) during fourth quarter 2011 and although payments made under this contract are made under a

“power-by-the-hour” basis, the risk-transfer concept under this agreement is no longer met, and the Company now records expense on a time and materials basis when an engine repair event takes place.

Modifications that significantly enhance the operating performance or extend the useful lives of aircraft or engines are capitalized and amortized over the remaining life of the asset.

### ***Goodwill and intangible assets***

Goodwill represents the excess of the consideration transferred over the fair value of AirTran’s assets and liabilities on the acquisition date. See Note 2. Goodwill is not amortized, but it is evaluated for impairment at least annually, or more frequently if events or circumstances indicate impairment may exist. A fair value-based methodology is utilized in testing the carrying value to Goodwill, utilizing assumptions including: (1) a long-term projection of revenues and expenses; (2) estimated discounted future cash flows; (3) observable earnings multiples of publicly-traded airlines; (4) weighted-average cost of capital; and (5) expected tax rate. Factors used in the valuation of goodwill include, but are not limited to, management’s plans for future operations, recent operating results and discounted projected future cash flows. These factors are considered Level 3 inputs within the fair value hierarchy. No goodwill impairment was noted during 2011.

Intangible assets primarily consist of acquired leasehold rights to certain airport owned gates at Chicago’s Midway International Airport, take-off and landing slots at certain domestic slot-controlled airports, and certain intangible assets recognized from the AirTran acquisition. See Note 2 for further information on acquired identifiable intangible assets. The following table is a summary of the Company’s intangible assets, weighted-average useful lives, and balance of accumulated amortization as of December 31, 2011:

	<b>Gross carrying amount (in millions)</b>	<b>Weighted-average useful life (in years)</b>	<b>Accumulated amortization (in millions)</b>
Customer relationships/marketing agreements . . . . .	\$ 39	4	\$14
Trademarks/trade names . . . . .	36	3	8
Domestic slots . . . . .	63	23	4
Internally developed software . . . . .	2	2	1
Noncompete agreements . . . . .	5	2	1
Gate leasehold rights . . . . .	60	19	22
<b>Total</b> . . . . .	<u>\$205</u>	<u>14</u>	<u>\$50</u>

Estimated aggregate amortization expense for the five succeeding years and thereafter is as follows: 2012 – \$25 million, 2013 – \$19 million, 2014 – \$15 million, 2015 – \$13 million, 2016 – \$10 million, 2017 and thereafter – \$73 million.

### ***Revenue recognition***

Tickets sold are initially deferred as Air traffic liability. Passenger revenue is recognized when transportation is provided. Air traffic liability primarily represents tickets sold for future travel dates and estimated refunds and exchanges of tickets sold for past travel dates. The majority of the Company’s tickets sold are nonrefundable. Tickets that are sold but not flown on the travel date (whether refundable or nonrefundable) can be reused for another flight, up to a year from the date of sale, or refunded (if the ticket is refundable). A small percentage of tickets (or partial tickets) expire unused. The Company estimates the amount of tickets that expire unused and recognizes such amounts in Passenger revenue once the scheduled flight date has passed. Amounts collected from passengers for ancillary services such as baggage and other fees are generally recognized as Other revenue when the service is provided, which is typically the flight date.

The Company is also required to collect certain taxes and fees from Customers on behalf of government agencies and remit these back to the applicable governmental entity on a periodic basis. These taxes and fees include U.S. federal transportation taxes, federal security charges, and airport passenger facility charges.

These items are collected from Customers at the time they purchase their tickets, but are not included in Passenger revenue. The Company records a liability upon collection from the Customer and relieves the liability when payments are remitted to the applicable governmental agency.

#### *Frequent flyer programs*

The Company records a liability for the estimated incremental cost of providing free travel under its (and AirTran's) frequent flyer program for all amounts earned from flight activity that are expected to be redeemed for future travel. The estimated incremental cost includes direct passenger costs such as fuel, food, and other operational costs, but does not include any contribution to overhead or profit.

Southwest and AirTran also sell frequent flyer points and/or credits and related services to companies participating in their respective frequent flyer programs. Funds received from the sale of these points and/or credits are accounted for using the residual method. Under this method, the Company has determined the portion of funds received that relate to free travel, currently estimated at 92 percent of the amount received under Southwest's Rapid Reward program and 100 percent of amounts received under AirTran's A+ Reward program as of December 31, 2011. These amounts are deferred and recognized as Passenger revenue when the ultimate free travel awards are flown or the amounts expire unused. The remainder of the amount received per points sold (the residual), which is assumed not to be associated with future travel, includes items such as access to the Company's frequent flyer program population for marketing/solicitation purposes on a monthly or quarterly basis, use of the Company's logo on co-branded credit cards, and other trademarks, designs, images, etc. of the Company for use in marketing materials. This residual portion is recognized in Other revenue in the period earned, which the Company has determined is the period in which it has fulfilled its obligation under the contract signed with the particular business partner, which is on a monthly or quarterly basis, upon sale, as the related marketing services are performed or provided.

#### *Advertising*

Advertising costs are charged to expense as incurred. Advertising and promotions expense for the years ended December 31, 2011, 2010, and 2009 was \$237 million, \$202 million, and \$204 million, respectively, and was recorded as a component of Other operating expense in the accompanying Consolidated Statement of Income.

#### *Share-based Employee compensation*

The Company has share-based compensation plans covering several of its Employee groups, including plans covering the Company's Board of Directors. The Company accounts for share-based compensation based on its grant date fair value. See Note 15.

#### *Financial derivative instruments*

The Company accounts for financial derivative instruments at fair value and applies hedge accounting rules where appropriate. The Company utilizes various derivative instruments, including crude oil, unleaded gasoline, and heating oil-based derivatives, to attempt to reduce the risk of its exposure to jet fuel price increases. These instruments consist primarily of purchased call options, collar structures, call spreads, and fixed-price swap agreements, and upon proper qualification are accounted for as cash-flow hedges. The Company also has interest rate swap agreements to convert a portion of its fixed-rate debt to floating rates and, including instruments acquired from AirTran, has swap agreements that convert certain floating-rate debt to a fixed-rate. These interest rate hedges are appropriately designated as either fair value hedges or as cash flow hedges.

Since the majority of the Company's financial derivative instruments are not traded on a market exchange, the Company estimates their fair values. Depending on the type of instrument, the values are determined by the



use of present value methods or option value models with assumptions about commodity prices based on those observed in underlying markets. Also, since there is not a reliable forward market for jet fuel, the Company must estimate the future prices of jet fuel in order to measure the effectiveness of the hedging instruments in offsetting changes to those prices. Forward jet fuel prices are estimated through utilization of a statistical-based regression equation with data from market forward prices of like commodities. This equation is then adjusted for certain items, such as transportation costs, that are stated in the Company's fuel purchasing contracts with its vendors.

For the effective portion of settled fuel hedges, the Company records the associated gains or losses as a component of Fuel and oil expense in the Consolidated Statement of Income. For amounts representing ineffectiveness, as defined, or changes in fair value of derivative instruments for which hedge accounting is not applied, the Company records any gains or losses as a component of Other (gains) losses, net, in the Consolidated Statement of Income. Amounts that are paid or received in connection with the purchase or sale of financial derivative instruments (i.e., premium costs of option contracts) are classified as a component of Other (gains) losses, net, in the Consolidated Statement of Income in the period in which the instrument settles or expires. All cash flows associated with purchasing and selling derivatives are classified as operating cash flows in the Consolidated Statement of Cash Flows, within Changes in certain assets and liabilities. See Note 10 for further information on hedge accounting and financial derivative instruments.

The Company classifies its cash collateral provided to or held from counterparties in a "net" presentation on the Consolidated Balance Sheet against the fair value of the derivative positions with those counterparties. See Note 10 for further information.

#### ***Software capitalization***

The Company capitalizes certain internal and external costs related to the acquisition and development of internal use software during the application development stages of projects. The Company amortizes these costs using the straight-line method over the estimated useful life of the software, which ranges from five to fifteen years. Costs incurred during the preliminary project or the post-implementation/operation stages of the project are expensed as incurred.

#### ***Income taxes***

The Company accounts for deferred income taxes utilizing an asset and liability method, whereby deferred tax assets and liabilities are recognized based on the tax effect of temporary differences between the financial statements and the tax basis of assets and liabilities, as measured by current enacted tax rates. The Company also evaluates the need for a valuation allowance to reduce deferred tax assets to estimated recoverable amounts.

The Company's policy for recording interest and penalties associated with uncertain tax positions is to record such items as a component of income before income taxes. Penalties are recorded in Other (gains) losses, net, and interest paid or received is recorded in Interest expense or Interest income, respectively, in the Consolidated Statement of Income. Amounts recorded for penalties and interest related to uncertain tax positions were immaterial for all years presented.

#### ***Concentration risk***

Approximately 82 percent of the Company's fulltime equivalent Employees are unionized and are covered by collective bargaining agreements, including 82 percent of Southwest's Employees and 81 percent of AirTran's Employees. Historically, the Company has managed this risk by maintaining positive relationships with its Employees and its Employee's Representatives. Southwest's Ramp, Operations, Provisioning, and Freight Agents, Aircraft Appearance Technicians, and Dispatchers are under agreements that have become amendable and are in discussions on new agreements. In addition, Southwest's Pilots, Mechanics, and Customer Service



Agents and Customer Service Representatives are subject to agreements that become amendable during 2012, which represent approximately 29 percent of the Company's (including AirTran's) fulltime equivalent Employees.

The Company attempts to minimize its concentration risk with regards to its cash, cash equivalents, and its investment portfolio. This is accomplished by diversifying and limiting amounts among different counterparties, the type of investment, and the amount invested in any individual security or money market fund.

To manage risk associated with financial derivative instruments held, the Company selects and will periodically review counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. The Company also has agreements with counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. Collateral deposits provided to or held from counterparties serve to decrease, but not totally eliminate, the credit risk associated with the Company's hedging program. See Note 10 for further information.

The Company (including AirTran) currently operates an all-Boeing fleet, the majority of which are variations of the Boeing 737. If the Company were unable to acquire additional aircraft or associated aircraft parts from Boeing, or Boeing were unable or unwilling to make timely deliveries of aircraft or to provide adequate support for its products, the Company's operations would be materially adversely impacted. In addition, the Company would be materially adversely impacted in the event of a mechanical or regulatory issue associated with the Boeing 737 or Boeing 717 aircraft type, whether as a result of downtime for part or all of the Company's fleet or because of a negative perception by the flying public. The Company is also dependent on sole suppliers for aircraft engines and certain other aircraft parts and would, therefore, also be materially adversely impacted in the event of the unavailability of, or a mechanical or regulatory issue associated with, engines and other parts. The Company considers its relationship with Boeing and other suppliers to be excellent and believes the advantages of operating with a single aircraft supplier currently outweigh the risks of such a strategy.

The Company has historically entered into agreements with some of its co-brand, payment, and loyalty partners that contain exclusivity aspects which place certain confidential restrictions on the Company from entering into certain arrangements with other payment and loyalty partners. These arrangements generally extend for the terms of the partnerships, none of which currently extend beyond May 2017. The Company believes the financial benefits generated by the exclusivity aspects of these arrangements outweigh the risks involved with such agreements.



# CHAPTER 17

## Managerial Accounting and Cost Concepts

### BUSINESS INSIGHT

#### Choice Candy Company

Choice Candy Company managers are expected to make money, use company resources wisely, operate profitably, pay debts, and abide by laws and regulations. To fulfill these expectations, managers establish goals, objectives, and strategic plans that guide and control the organization's activities in making the world's best chocolate candy bars. Its managers must know a lot about the costs of producing and selling chocolate candy and be familiar with the managerial accounting concepts discussed in this chapter.

- 1. CONCEPT** ► *How does managerial accounting recognize and define costs?*
- 2. ACCOUNTING APPLICATION** ► *How does Choice Candy determine the cost of a candy bar?*
- 3. BUSINESS APPLICATION** ► *How does managerial accounting facilitate the management process as managers plan, organize, and control costs?*

### LEARNING OBJECTIVES

- LO 1** Distinguish managerial accounting from financial accounting.
- LO 2** Explain how managers recognize costs and how they define product or service unit cost.
- LO 3** Describe the flow of costs through a manufacturer's inventory accounts.
- LO 4** Compare how service, retail, and manufacturing organizations report costs on their financial statements and how they account for inventories.
- LO 5** Compute the unit cost of a product or service.
- LO 6** Explain how managerial accounting supports the management process to produce business results.
- LO 7** Identify the standards of ethical conduct for management accountants.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Measurement
- Recognition
- Classification

RELEVANT  
LEARNING OBJECTIVES

**Lo 1** Distinguish managerial accounting from financial accounting.

**Lo 2** Explain how managers recognize costs and how they define product or service unit cost.

## Lo 1 The Role of Managerial Accounting

Both financial and managerial accounting reports adhere to the fundamental concepts of *cost measurement* and *recognition* when providing past, present, and future information about an organization's performance. Financial accounting reports follow strict guidelines defined by generally accepted accounting principles when reporting on past operations to external users. In contrast, to plan, control, and measure an organization's current and future operations and to make decisions about products or services, managers and other internal users rely on the information managerial accounting provides. The role of managerial accounting is to enable managers and people throughout an organization to:

- make informed decisions
- be more effective at their jobs
- improve the organization's performance

The Institute of Management Accountants (IMA) defines **managerial accounting** (or *management accounting*) as follows:

*Management accounting is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization's strategy.<sup>1</sup>*

This definition recognizes that regulation, globalization, and technology changes have redefined the management accountant's role to be a strategic partner within an organization. Today, managerial accounting information includes nonfinancial data as well as financial data in performance management, planning and budgeting, corporate governance, risk management, and internal controls.

## Managerial Accounting and Financial Accounting: A Comparison

Both managerial accounting and financial accounting assist decision makers by identifying, measuring, processing, and communicating relevant information. Both provide managers with key measures of a company's performance and with cost information for valuing inventories on the balance sheet. However, managerial accounting and financial accounting differ in a number of ways, as summarized in Exhibit 1. Note that managerial accounting is not a subordinate activity to financial accounting. Rather, it is a process that includes financial accounting, tax accounting, information analysis, and other accounting activities.

The primary users of managerial accounting information are people inside the organization, whereas financial accounting prepares financial statements for parties outside the organization (owners or stockholders, lenders, customers, and governmental agencies). Although these reports are prepared primarily for external use, managers also rely on them in evaluating an organization's performance.

Because managerial accounting reports are for internal use, their format is driven by the user's needs. They may report either historical or future-oriented information without any formal guidelines or restrictions. That means that managerial accounting can use innovative analyses and presentation techniques to enhance the usefulness of information to people within the company. In contrast, financial accounting reports, which focus on past performance, must follow generally accepted accounting principles as specified by the Securities and Exchange Commission (SEC).

The information in managerial accounting reports may be objective and verifiable, expressed in monetary terms or in physical measures of time or objects; or they may be more subjective and based on estimates. In contrast, the statements that financial

**Exhibit 1**  
Comparison of Managerial Accounting and Financial Accounting

Areas of Comparison	Managerial Accounting	Financial Accounting
Primary users	Managers, employees, supply-chain partners	Owners or stockholders, lenders, customers, governmental agencies
Report format	Flexible, driven by user's needs	Based on generally accepted accounting principles
Purpose of reports	Provide information for planning, control, performance measurement, and decision making	Provide information on past performance
Nature of information	Objective and verifiable for decision making; more subjective for planning (relies on estimates); confidential and private	Objective and verifiable; publicly available
Units of measure	Monetary at historical or current market or projected values; physical measures of time or number of objects	Monetary at historical or current market values
Frequency of reports	Prepared as needed; may or may not be on a periodic basis	Prepared on a periodic basis

© Cengage Learning 2014

accounting provides must be based on objective and verifiable information, which is generally historical and measured in monetary terms. Managerial accounting reports are prepared annually, quarterly, monthly, or even daily. Financial statements, on the other hand, are usually prepared and distributed on a quarterly and annual basis.

**APPLY IT!**

Indicate whether each of the characteristics that follows relates to managerial accounting (MA) or financial accounting (FA). (*Hint:* More than one answer may apply.)

- a. Focuses on various segments of the business entity
- b. Demands objectivity
- c. Relies on the criterion of usefulness rather than formal guidelines in reporting information
- d. Measures units in historical dollars
- e. Reports information on a regular basis
- f. Uses only monetary measures for reports
- g. Adheres to generally accepted accounting principles
- h. Prepares reports whenever needed

**SOLUTION**

- a. MA; b. FA; c. MA; d. FA and MA;
- e. FA; f. FA; g. FA; h. MA

**TRY IT! SE1**

**LO 2 Concepts Underlying Costs**

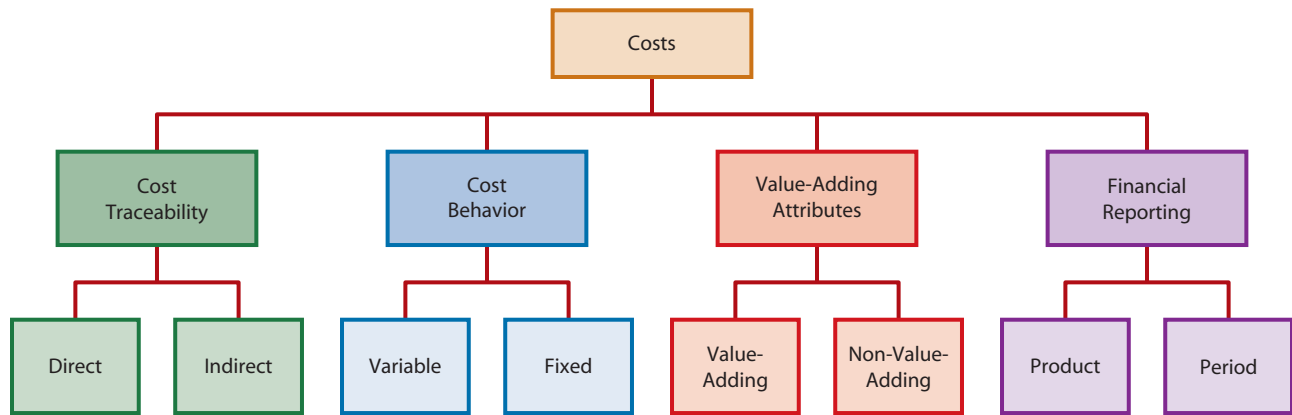
A key question for managers is “How much does it cost?” We begin by looking at how managers in different organizations *recognize* and *classify* information about costs.

**Cost Recognition**

In addition to *recognizing* costs for financial reporting, a single cost can be *classified* and used in several ways, depending on the purpose of the analysis. Exhibit 2 provides an overview of commonly used cost recognition classifications. These classifications enable managers to do the following:

- Control costs by determining which are traceable to a particular cost object, such as a service or product.
- Calculate the number of units that must be sold to achieve a certain level of profit (cost behavior).



**Exhibit 2****Overview of Cost Recognition Classifications**

© Cengage Learning 2014

- Identify the costs of activities that do and do not add value to a product or service.
- Recognize and measure costs for the preparation of financial statements.

Managers in manufacturing, retail, and service organizations use cost information to prepare budgets, make pricing and other decisions, calculate variances between estimated and actual costs, and communicate results.

## Cost Measurement

Managers *measure* costs by tracing them to cost objects, such as products or services, sales territories, departments, or operating activities.

- **Direct costs** are costs that can be measured conveniently and economically by tracing them to a cost object. For example, the wages of workers who make candy bars can be conveniently traced to a particular batch because of time cards and payroll records. Similarly, the cost of chocolate's main ingredients—chocolate liquor, cocoa butter, sugar, and milk—can be easily traced.
- **Indirect costs** are costs that cannot be measured conveniently and economically by tracing them to a cost object. Some examples include the nails used in furniture, the salt used in candy, and the rivets used in airplanes. For the sake of accuracy, however, these indirect costs must be included in the cost of a product or service. Because they are difficult to trace or an insignificant amount, management uses a formula to assign them to cost objects.

The examples that follow illustrate cost objects and their direct and indirect costs in service, retail, and manufacturing organizations.

- **Service organization:** In organizations such as an accounting firm, costs can be traced to a specific service, such as preparation of tax returns. Direct costs for such a service include the costs of computer usage and the accountant's labor. Indirect costs include the costs of supplies, office rental, utilities, secretarial labor, telephone usage, and depreciation of office furniture.
- **Retail organization:** Costs for retailers can be traced to a department. For example, the direct costs of a grocery store's produce department include the costs of fruits and vegetables and the wages of employees in that department. Indirect costs include the costs of utilities to cool the produce displays and the storage and handling of the produce.

Cost classification involves identifying costs and sorting them into direct or indirect, variable or fixed, value-adding or non-value-adding, or product or period, depending on the purpose of the analysis.



Corbis Premium RF/Alamy

- **Manufacturing organization:** Costs for organizations such as Choice Candy Company can be traced to the product. Direct costs include the costs of the materials and labor needed to make the candy. Indirect costs include the costs of utilities, depreciation of plant and equipment, insurance, property taxes, inspection, supervision, maintenance of machinery, storage, and handling.

## Financial Reporting

In order for managers to make good decisions, they need managerial accounting information about the costs involved in making a product or providing a service. Managers *recognize* and *measure* costs as period costs or product costs.

**STUDY NOTE:** *Period costs and product costs can be explained by using the matching rule (accrual accounting). Period costs are charged against the revenue of the current period, and product costs must be charged to the period in which the product generates revenue.*

- **Period costs** (or *noninventoriable costs*) are costs of resources that are not assigned to products. They are *recognized* as operating expenses on the income statement. Selling, administrative, and general expenses are examples of period costs.
- **Product costs** (or *inventoriable costs*) include direct materials, direct labor, and overhead (indirect costs). Product costs are *recognized* on the income statement as cost of goods sold and on the balance sheet as inventory. Product costs can be further *classified* as being either direct costs or indirect costs.

**Product unit cost** is the cost of manufacturing a single unit of a product. It is made up of the costs of direct materials, direct labor, and overhead. These three cost elements are accumulated as a batch of products is produced. When the batch is completed, the total costs are divided by the units produced to determine product unit cost. **Service unit cost** is the cost to perform one service. The direct materials element does not apply, so only direct labor and overhead would be totaled and divided by the number of services performed. The three elements of product or service cost are defined as follows.

- **Direct materials costs:** The costs of materials that can be conveniently and economically measured when making specific units of the product. Some examples of direct materials are the meat and bun in hamburgers, the oil and additives in a gallon of gasoline, and the sugar used in making candy. Direct materials may also include parts that a company purchases from another manufacturer, e.g., a battery and windshield for an automobile.
- **Direct labor costs:** The costs of the hands-on labor needed to make a product or service that can be measured when making specific units. For example, the wages of production-line workers are direct labor costs.
- **Overhead costs** (or *service overhead, factory overhead, factory burden, manufacturing overhead, or indirect production costs*): The costs that cannot be practically or conveniently measured directly to an end product or service. They include **indirect materials costs**, such as the costs of nails, rivets, lubricants, and small tools, and **indirect labor costs**, such as the costs of labor for maintenance, inspection, engineering design, supervision, and materials handling. Other indirect manufacturing costs include the costs of building maintenance, property taxes, property insurance, depreciation on plant and equipment, rent, and utilities.\*

To illustrate product costs and the manufacturing process, we'll refer to Choice Candy Company, which has identified the following elements of the product cost of one candy bar:

- **Direct materials costs:** costs of sugar, chocolate, and wrapper
- **Direct labor costs:** costs of labor used in making the candy bar
- **Overhead costs:** indirect materials costs, including the costs of salt and flavorings; indirect labor costs, including the costs of labor to move materials to the production area and to inspect the candy bars during production; and other indirect overhead costs, including depreciation on the building and equipment, utilities, property taxes, and insurance

\*Overhead costs are allocated to a product's cost using either traditional or activity-based costing methods, which we discuss in the next chapter.





## Business Perspective

### Has Technology Shifted the Elements of Product Costs?

New technology and manufacturing processes have created new patterns of product costs. The three elements of product costs are still direct materials, direct labor, and overhead, but the percentage that each contributes to the total cost of a product has changed. From the 1950s through the 1970s, direct material and labor costs accounted for 75 percent of total product cost. Improved production technology caused a dramatic shift in the three product cost elements. Machines replaced people, significantly reducing direct labor costs. Today, only 50 percent of the cost of a product is directly traceable to the product. The other 50 percent is overhead, an indirect cost.

© Allija / iStockphoto.com

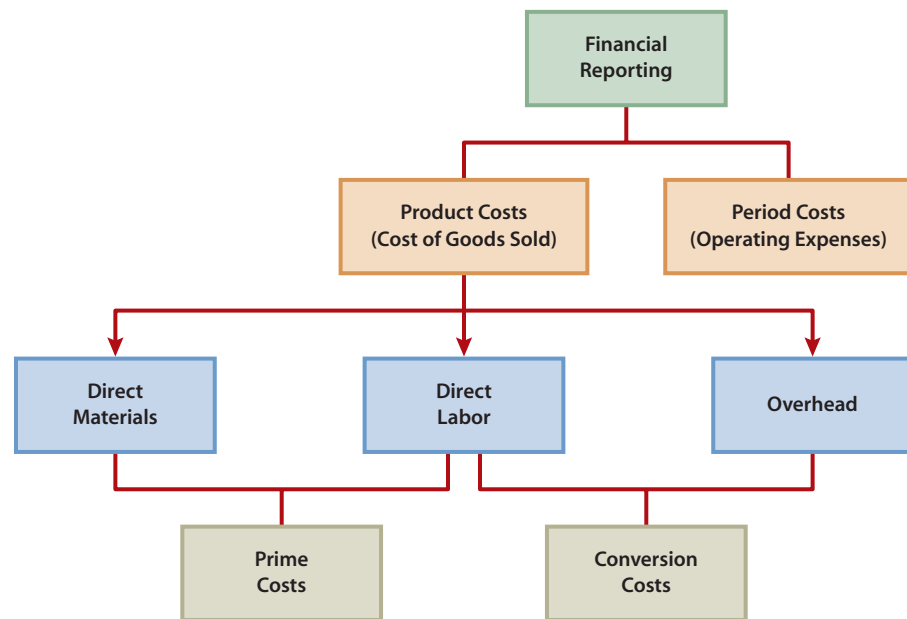
© Cengage Learning 2014

**Prime Costs and Conversion Costs** The three elements of product cost can be also grouped into prime costs and conversion costs.

- **Prime costs:** The primary costs of production. They are the sum of the direct materials costs and direct labor costs.
- **Conversion costs:** The costs of converting or processing direct materials into a finished product. They are the sum of direct labor costs and overhead costs.

These *classifications* are important for understanding the costing methods discussed in later chapters. Exhibit 3 summarizes the relationships among the product cost recognition classifications presented so far.

**Exhibit 3**  
Relationships Among Product  
Cost Recognition Classifications



© Cengage Learning 2014

## Cost Behavior

Managers are also interested in the way costs respond to changes in volume or activity. By analyzing those variable and fixed patterns of behavior, they gain information to make better management decisions.

- A **variable cost** is a cost that changes in direct proportion to a change in productive output (or some other measure of volume).
- A **fixed cost** is a cost that remains constant within a defined range of activity or time period.

All types of organizations have variable and fixed costs.

- **Service organization:** Because the number of passengers drives the consumption of food and beverages on a flight, the cost of peanuts and beverages is a variable cost for **Southwest Airlines**. Fixed costs include the depreciation on the plane and the salaries and benefits of the flight and ground crews.

**STUDY NOTE:** As more products or services are produced and sold, the variable costs increase proportionately. Fixed costs, however, remain the same for a specified period.

- **Retail organization:** The variable costs of a grocery store like **Kroger** or **Trader Joe's** include the cost of groceries sold and any sales commissions. Fixed costs include the costs of building and lot rental, depreciation on store equipment, and the manager's salary.
- **Manufacturing organization:** The variable costs of a manufacturer like **The Hershey Company** or Choice Candy include the costs of direct materials (e.g., sugar, cocoa), direct labor, indirect materials (e.g., salt), and indirect labor (e.g., inspection and maintenance labor). Fixed costs include the costs of supervisors' salaries and depreciation on buildings.

## Value-Adding versus Non-Value-Adding Costs

Costs can also be *classified* as value-adding or non-value-adding.

- A **value-adding cost** is the cost of an activity that increases the market value of a product or service.
- A **non-value-adding cost** is the cost of an activity that adds cost to a product or service but does not increase its market value.

Managers examine the value-adding attributes of their company's operating activities and, wherever possible, reduce or eliminate activities that do not directly add value to the company's products or services. For example, the costs of administrative activities, such as accounting and human resource management, are non-value-adding costs. Because they are necessary for the operation of the business, they are monitored closely but cannot be eliminated.

Exhibit 4 shows how some costs of a manufacturer like Choice Candy can be *recognized* in terms of traceability, behavior, value attribute, and financial reporting.

**Exhibit 4**  
Examples of Cost Recognition Classifications for a Candy Manufacturer

Cost Examples	Traceability to Product	Cost Behavior	Value Attribute	Financial Reporting
Sugar for candy	Direct	Variable	Value-adding	Product (direct materials)
Labor for mixing	Direct	Variable	Value-adding	Product (direct labor)
Labor for supervision	Indirect	Fixed	Non-value-adding	Product (overhead)
Depreciation on mixing machine	Indirect	Fixed	Value-adding	Product (overhead)
Sales commission	—*	Variable	Value-adding**	Period
Accountant's salary	—*	Fixed	Non-value-adding	Period

\*Sales commissions and accountants' salaries cannot be directly or indirectly traced to a cost object; they are not product costs.

\*\*Sales commissions can be value-adding because customers' perceptions of the salesperson and the selling experience can strongly affect their perceptions of the product's market value.

© Cengage Learning 2014

## APPLY IT!

Indicate whether each of the following costs for a gourmet chocolate candy maker is recognized as a product or a period cost, a variable or a fixed cost, a value-adding or a non-value-adding cost, and, if it is a product cost, a direct or an indirect candy cost:

- Chocolate
- Office rent
- Candy chef wages
- Dishwasher wages
- Pinch of salt
- Utilities to run mixer

### SOLUTION

	Cost Recognition Classification			
	Product or Period	Variable or Fixed	Value-Adding or Non-Value-Adding	Direct or Indirect
a. Chocolate	Product	Variable	Value-adding	Direct
b. Office rent	Period	Fixed	Non-value-adding	—
c. Candy chef	Product	Variable	Value-adding	Direct
d. Dishwasher	Product	Variable	Value-adding	Indirect
e. Pinch of salt	Product	Variable	Value-adding	Indirect
f. Utilities to run mixer	Product	Variable	Value-adding	Indirect

**TRY IT! SE2, SE3, E1A, E2A, E3A, E1B, E2B, E3B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Describe the materials inventory
- Describe the work in process inventory
- Describe the finished goods inventory
- Prepare the income statement
- Determine the cost of goods sold
- Prepare the statement of cost of goods manufactured
- Determine the product unit cost

## RELEVANT LEARNING OBJECTIVES

**LO 3** Describe the flow of costs through a manufacturer's inventory accounts.

**LO 4** Compare how service, retail, and manufacturing organizations report costs on their financial statements and how they account for inventories.

**LO 5** Compute the unit cost of a product or service.

## LO 3 Inventory Accounts in Manufacturing Organizations

Transforming materials into finished products requires a number of production and production-related activities. A manufacturing organization's accounting system tracks these activities as product costs flowing through the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts.

### Document Flows and Cost Flows Through the Inventory Accounts

Managers accumulate and report manufacturing costs based on documents pertaining to production and production-related activities. Exhibit 5 summarizes the typical relationships among the production activities, the documents for each of the three cost elements, and the inventory accounts affected by the activities. Looking at these relationships provides insight into how costs flow through the three inventory accounts and when an activity must be recorded in the accounting records. To illustrate document flow and changes in inventory balances for production activities in Exhibit 5, we continue with our example of Choice Candy Company, a typical manufacturing business.

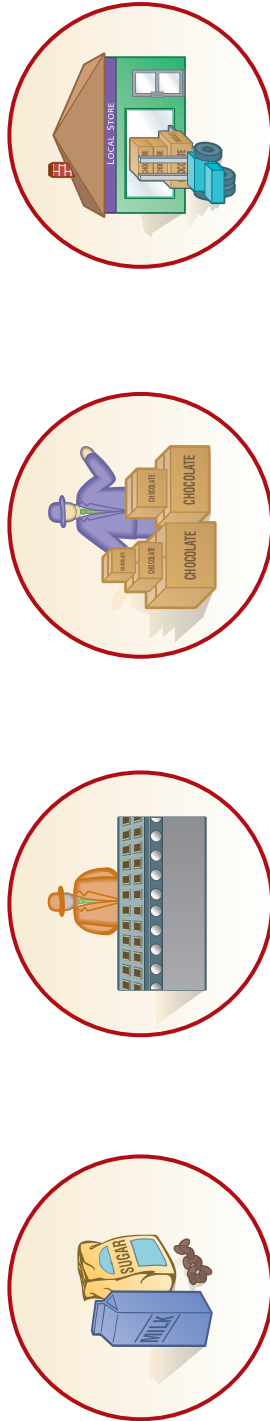
#### Purchase of Materials

- **Step 1. Acquiring the materials.** The purchasing process starts with a *purchase request* submitted for specific quantities of materials needed. A qualified manager approves the request. Based on the information in the purchase request, the Purchasing Department prepares a *purchase order* and sends it to a supplier.
- **Step 2. Receiving the materials.** When the materials arrive, an employee on the receiving dock examines the materials and enters the information into the company database as a *receiving report*. The system matches the information on the receiving report with the descriptions and quantities listed on the purchase order. A materials handler moves the newly arrived materials from the receiving area to the materials storeroom.
- **Step 3. Paying for the materials.** Choice Candy's accounting department receives a *vendor's invoice* from the supplier requesting payment for the materials. The cost of those materials increases the balance of the Materials Inventory account and an account payable is recognized. If all documents match, payment is authorized.

#### Production of Goods

- **Step 4. Preparing the materials for production.** When candy bars are scheduled for production, the storeroom clerk receives a *materials request form*. In addition to showing authorization, it describes the types and quantities of materials that the storeroom clerk is to send to the production area, and it authorizes the release of those materials from the materials inventory into production.
- **Step 5. Sending the materials into production.** If all is in order, the storeroom clerk has the materials handler move the materials to the production floor.
- **Step 6. Producing goods.** Each of the production employees who make the candy bars prepares a *time card* to record the number of hours he or she has worked on this and other orders each day. A *job order cost card* can be used to record all direct materials, direct labor, and overhead costs incurred as the products move through production.

**Exhibit 5**  
**Activities, Documents, and Cost Flows Through the Inventory Accounts of a Manufacturing Organization**



	Purchase of Materials	Production of Goods	Product Completion	Product Sale
<b>Activities</b>	<ul style="list-style-type: none"> <li>Purchase, receive, inspect, and store materials.</li> <li>Confirm receipt of materials.</li> <li>Match documents.</li> </ul>	<ul style="list-style-type: none"> <li>Move materials to production area.</li> <li>Convert materials into finished product using direct labor and overhead.</li> </ul>	<ul style="list-style-type: none"> <li>Move completed products to finished goods storage area and store until sold.</li> <li>Move sold units to shipping.</li> </ul>	<ul style="list-style-type: none"> <li>Ship products sold to customer.</li> </ul>
<b>Documents</b>	<ul style="list-style-type: none"> <li>Purchase request</li> <li>Purchase order</li> <li>Receiving report</li> <li>Vendor's invoice</li> </ul>	<ul style="list-style-type: none"> <li>Materials request form</li> <li>Time card</li> <li>Job order cost card</li> </ul>	<ul style="list-style-type: none"> <li>Job order cost card</li> </ul>	<ul style="list-style-type: none"> <li>Sales invoice</li> <li>Shipping document</li> <li>Job order cost card</li> </ul>
<b>Inventory Accounts (Related Documents)</b>	<p><b>Materials Inventory</b></p> <p>Cost of materials purchased (vendor's invoice)</p> <p>Cost of materials used in production (materials request form)</p>	<p><b>Work in Process Inventory</b></p> <p>Cost of materials used in production (materials request form)</p> <p>Cost of direct labor (time card)</p> <p>Cost of overhead</p>	<p><b>Finished Goods Inventory</b></p> <p>Cost of completed products (job order cost card)</p> <p>Cost of sold units (job order cost card)</p>	<p><b>Cost of Goods Sold</b></p> <p>Cost of sold units (job order cost card)</p>

© Cengage Learning 2014

### Product Completion and Sale

- **Step 7. Completing goods.** Employees place completed candy bars in cartons and then move the cartons to the finished goods storeroom, where they are kept until they are shipped to customers.
- **Step 8. Selling goods.** When candy bars are sold, a clerk prepares a *sales invoice*, and another employee fills the order by removing the candy bars from the storeroom, packaging them, and shipping them to the customer. A *shipping document* shows the quantity of the products that are shipped and gives a description of them.

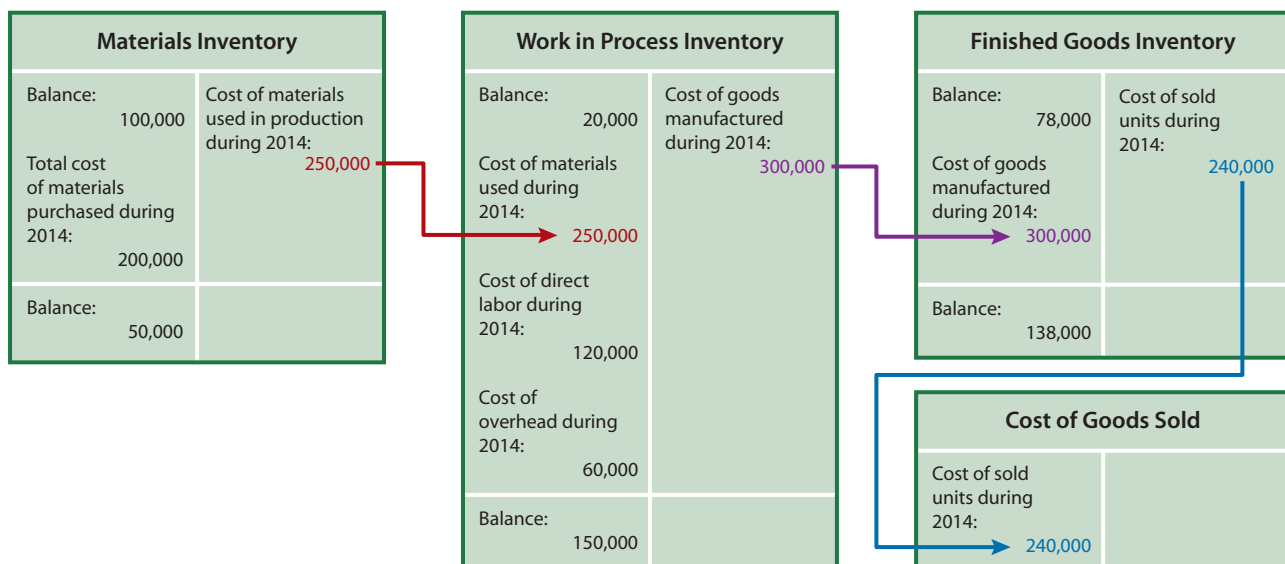
## The Manufacturing Cost Flow

**Manufacturing cost flow** is the flow of direct materials, direct labor, and overhead through the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts into the Cost of Goods Sold account. A defined manufacturing cost flow is the foundation for product costing, inventory valuation, and financial reporting. It supplies all the information necessary to prepare the statement of cost of goods manufactured and compute the cost of goods sold, as shown in Exhibit 8.

- The **Materials Inventory account** shows the balance of the cost of unused materials. In other words, this account shows the cost of materials that have been purchased but not used in the production process. For Choice Candy, this might include things like milk, sugar, cocoa beans, and other ingredients necessary to make candy.
- The **Work in Process Inventory account** shows the manufacturing costs that have been incurred and assigned to partially completed units of product. This account therefore represents the costs involved with manufacturing the unfinished product. For Choice Candy, this might include things like candy that is ready to eat but has not yet been packaged for sale.
- The **Finished Goods Inventory account** shows the costs assigned to all completed products that have not been sold. In other words, this account shows the cost of the product that is complete and ready for sale. For Choice Candy, this would include things like the wrapped packages of candy.

Exhibit 6 summarizes the manufacturing cost flow as it relates to Choice Candy's inventory accounts and production activity for the year ended December 31. To show

**Exhibit 6**  
Manufacturing Cost Flow:  
Choice Candy Company



the basic flows in this example, we assume that all materials are direct materials to the candy bars produced.

**Materials Inventory** The Materials Inventory account holds the balance of the cost of materials that have been purchased, but have not yet been used in the production process.

### The Materials Inventory Account

**Transactions** Choice Candy began the period with \$100,000 in Beginning Materials Inventory. During the period, Choice Candy purchased \$200,000 of direct materials and used \$250,000 of direct materials.

**Analysis** Because there are no indirect materials in this case, the Materials Inventory account shows the balance of unused direct materials.

- ▲ The cost of direct materials purchased *increases* the balance of the *Materials Inventory* account.
- ▼ The cost of direct materials used by the Production Department *decreases* the *Materials Inventory* account as it flows into the Work in Process Inventory account.

### Application of Double Entry

Materials Inventory			
Balance	100,000	Cost of materials used in production during 2014	250,000
Total cost of materials purchased during 2014	200,000		
Balance	50,000		

**Comment** If indirect materials had been used, the cost of the indirect materials transferred would

- ▲ *increase* the balance of the *Overhead* account
- ▼ *decrease* the balance of the *Materials Inventory* account

We discuss overhead in more detail in the next chapter.

**STUDY NOTE:** When costs are transferred from one inventory account to another in a manufacturing company, they remain assets. They are on the balance sheet and are not expensed on the income statement until the finished goods are sold.

**Work in Process Inventory** The Work in Process Inventory account records the balance of partially completed units of the product. As direct materials and direct labor enter the production process, their costs are added to the Work in Process Inventory account. The cost of overhead for the current period is also added. The total costs of direct materials, direct labor, and overhead incurred and transferred to the Work in Process Inventory account during a period are called **total manufacturing costs** (or *current manufacturing costs*).

Exhibit 6 recaps the inflows of direct materials, direct labor, and overhead into the Work in Process Inventory T account and the resulting outflow of completed product costs.

### The Work in Process Inventory Account

**Transactions** Choice Candy began the period with \$20,000 in beginning Work in Process Inventory. Choice Candy used \$250,000 of direct materials, \$120,000 of direct labor, and \$60,000 of overhead during the period to manufacture \$300,000 of goods.

### Analysis

- ▲ The costs of the direct materials used to manufacture the candy bars *increase* the balance of the *Work in Process Inventory* account as the costs flow out of the Material Inventory account and into Work in Process Inventory (see previous transaction).



- ▲ The costs of the direct labor used to manufacture the candy bars *increase* the balance of the *Work in Process Inventory* account.
- ▲ The costs of overhead used to support the manufacture of the candy bars *increase* the balance of the *Work in Process Inventory* account.

### Application of Double Entry

Work in Process Inventory			
Balance	20,000	Cost of goods manufactured during 2014	300,000
Cost of materials used during 2014	250,000		
Cost of direct labor during 2014	120,000		
Cost of overhead during 2014	60,000		
Balance	150,000		

**Comment** The cost of all units completed and moved to Finished Goods Inventory during a period is the **cost of goods manufactured**.

- ▼ The cost of goods manufactured *decreases* the balance of the *Work in Process Inventory* account as these costs flow into the Finished Goods Inventory account.

**STUDY NOTE:** *Materials Inventory and Work in Process Inventory support the production process, while Finished Goods Inventory supports the sales and distribution functions.*

**Finished Goods Inventory** The Finished Goods Inventory account holds the balance of costs assigned to all completed products that a manufacturing company has not yet sold.

### The Finished Goods Inventory Account

**Transactions** Choice Candy began the period with \$78,000 in beginning Finished Goods Inventory. During the period, Choice Candy manufactured \$300,000 of goods and sold \$240,000 units.

### Analysis

- ▲ The cost of goods manufactured *increases* the balance in the *Finished Goods Inventory* account when the goods are completed and flow out of the Work in Process Inventory account and into the Finished Goods account.
- ▼ The cost of goods sold *decreases* the balance in the *Finished Goods* account.

### Application of Double Entry

Finished Goods Inventory			
Balance	78,000	Cost of sold units during 2014	240,000
Cost of goods manufactured during 2014	300,000		
Balance	138,000		
Cost of Goods Sold			
Cost of sold units during 2014	240,000		

**Comment** The cost of all units sold during a period that move out of Finished Goods Inventory is called the **cost of goods sold**.



**APPLY IT!**

Given the following information, use T accounts to compute the ending balances of the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts:

Materials Inventory, beginning balance	\$ 230
Work in Process Inventory, beginning balance	250
Finished Goods Inventory, beginning balance	380
Direct materials purchased	850
Direct materials (DM) used	740
Direct labor (DL) costs	970
Overhead (OH) costs	350
Cost of goods manufactured (COGM)	1,230
Cost of goods sold (COGS)	935

**SOLUTION**

Materials Inventory			
Beg. bal.	230	Used	740
Purchased	850		
End. bal.	340		

Work in Process Inventory			
Beg. bal.	250	COGM	1,230
DM	740		
DL	970		
OH	350		
End. bal.	1,080		

Finished Goods Inventory			
Beg. bal.	380	COGS	935
COGM	1,230		
End. bal.	675		

**TRY IT! SE4, SE5**

## LO 4 Financial Statements and the Reporting of Costs

Managers prepare financial statements at least once a year to communicate the results of their activities. The key to preparing an income statement or a balance sheet in any kind of organization is *recognizing* and *measuring* its cost of goods or services sold and the value of its inventories, if any.

### Income Statement and Accounting for Inventories

All organizations—service, retail, and manufacturing—use the following income statement format:

$$\text{Sales} - \frac{\text{Cost of Sales or}}{\text{Cost of Goods Sold}} = \text{Gross Margin} - \frac{\text{Operating}}{\text{Expenses}} = \text{Operating Income}$$

How the cost of sales or cost of goods sold is computed, however, varies depending on the organization.

Service organizations like **Southwest Airlines** and **United Parcel Service (UPS)** sell services and not products. They maintain no inventories and they have no inventory accounts. Instead, service organizations use cost of sales. For example, suppose that UPS delivers packages of chocolate to Choice Candy. The cost of sales for UPS would include the wages and salaries of personnel plus the expense of the trucks, planes, supplies, and anything else used to deliver packages for Choice Candy.

In contrast, retail organizations, such as **Wal-Mart** and **The Gap**, which purchase products ready for resale, maintain just one inventory account on the balance sheet. This

Merchandise Inventory account reflects the costs of goods held for resale. Suppose a retailer had a balance of \$3,000 in its Merchandise Inventory account at the beginning of the year. During the year, its purchases of products totaled \$23,000 (adjusted for purchase discounts, returns and allowances, and freight-in). At year-end, its Merchandise Inventory balance was \$4,500. As illustrated in Exhibit 7, the cost of goods sold was thus \$21,500 ( $\$3,000 + \$23,000 = \$26,000 - \$4,500 = \$21,500$ ).

On the other hand, manufacturing organizations like **The Hershey Company**, **Godiva Chocolatier, Inc.**, or Choice Candy, which make products for sale, maintain three inventory accounts on the balance sheet: Materials Inventory, Work in Process Inventory, and Finished Goods Inventory. Suppose that Choice Candy had a balance of \$52,000 in its Finished Goods Inventory account at the beginning of the year. During the year, the cost of the products that the company manufactured totaled \$144,000. At year end, its Finished Goods Inventory balance was \$78,000. As illustrated in Exhibit 7, the cost of goods sold would be \$118,000 ( $\$52,000 + \$144,000 = \$196,000 - \$78,000 = \$118,000$ ).

Exhibit 7 compares the financial statements of service, retail, and manufacturing organizations. Note the differences in inventory accounts and cost of goods sold.

**Exhibit 7**  
Financial Statements of Service, Retail,  
and Manufacturing Organizations

	Service Company	Retail Company	Manufacturing Company
<b>Income Statement</b>	Sales – <u>Cost of sales</u> = Gross margin – Operating expenses = <u>Operating income</u>	Sales – <u>Cost of goods sold*</u> = Gross margin – Operating expenses = <u>Operating income</u> * Cost of goods sold: Beginning merchandise inventory + <u>Net cost of purchases</u> = <u>Cost of goods available for sale</u> – Ending merchandise inventory = <u>Cost of goods sold</u>	Sales – <u>Cost of goods sold†</u> = Gross margin – Operating expenses = <u>Operating income</u> † Cost of goods sold: Beginning finished goods inventory + <u>Cost of goods manufactured</u> = <u>Cost of goods available for sale</u> – Ending finished goods inventory = <u>Cost of goods sold</u>
<b>Balance Sheet (Current Assets Section)</b>	No inventory accounts	One inventory account: Merchandise Inventory (finished product ready for sale)	Three inventory accounts: Materials Inventory (unused materials) Work in Process Inventory (unfinished product) Finished Goods Inventory (finished product ready for sale)
<b>Example With Numbers</b>		Income Statement: Beg. merchandise inventory      \$ 3,000 + <u>Net cost of purchases</u> 23,000 = <u>Cost of goods available for sale</u> \$26,000 – End. merchandise inventory        4,500 = <u>Cost of goods sold</u> \$21,500  Balance Sheet: Merchandise inventory, ending      \$ 4,500	Income Statement: Beg. finished goods inventory      \$ 52,000 + <u>Cost of goods manufactured</u> 144,000 = <u>Cost of goods available for sale</u> \$196,000 – <u>End. finished goods inventory</u> 78,000 = <u>Cost of goods sold</u> \$118,000  Balance Sheet:* Finished goods inventory, ending    \$ 78,000  *The balance sheet would also disclose the following: Materials inventory, ending Work in process inventory, ending

**STUDY NOTE:** It is important not to confuse the cost of goods manufactured with the cost of goods sold. These amounts may differ because not all units produced may be sold in the same period.

## Statement of Cost of Goods Manufactured

As illustrated in Exhibit 7, for manufacturing companies, the cost of goods manufactured needs to be determined before cost of goods sold can be computed. The cost of goods manufactured is calculated in the **statement of cost of goods manufactured**, which summarizes the flow of all manufacturing costs incurred during the period. Exhibit 8 shows Choice Candy’s statement of cost of goods manufactured for the year.

**Exhibit 8**  
Statement of Cost of Goods Manufactured and Partial Income Statement for a Manufacturing Organization

Choice Candy Company Statement of Cost of Goods Manufactured For the Year		
Direct materials used:		
Beginning materials inventory	\$100,000	
Direct materials purchased	200,000	
Cost of direct materials available for use	<u>\$300,000</u>	
Less ending materials inventory	<u>50,000</u>	
<b>Step 1: Cost of direct materials used</b>		<b>\$250,000</b>
Direct labor		120,000
Overhead		<u>60,000</u>
<b>Step 2: Total manufacturing costs</b>		<b>\$430,000</b>
Add beginning work in process inventory		<u>20,000</u>
Total cost of work in process during the year		<u>\$450,000</u>
Less ending work in process inventory		<u>150,000</u>
<b>Step 3: Cost of goods manufactured</b>		<b><u>\$300,000</u></b>

Choice Candy Company Income Statement For the Year		
Sales		\$500,000
Cost of goods sold:		
Beginning finished goods inventory	\$ 78,000	
<b>Cost of goods manufactured</b>	<u>300,000</u>	
Cost of goods available for sale	\$378,000	
Less ending finished goods inventory	<u>138,000</u>	
<b>Cost of goods sold</b>		<b><u>240,000</u></b>
Gross margin		\$260,000
Selling and administrative expenses		<u>160,000</u>
Operating income		<u>\$100,000</u>

© Cengage Learning 2014

The statement of cost of goods manufactured is developed in three steps.

- **Step 1. Compute the cost of direct materials used during the accounting period.** As shown in Exhibit 8, for Choice Candy, this would be computed as follows.

Beginning Materials Inventory	+	Direct Materials Purchased	=	Direct Materials Available for Use
\$100,000		\$200,000		\$300,000
Direct Materials Available for Use	-	Ending Materials Inventory	=	Direct Materials Used
\$300,000		\$50,000		<u>\$250,000</u>

- **Step 2. Calculate total manufacturing costs for the period.** As shown in Exhibit 8, for Choice Candy this would be computed as follows.

$$\begin{array}{r} \text{Direct Materials} + \text{Direct Labor} + \text{Overhead} = \text{Total Manufacturing Costs} \\ \$250,000 + \$120,000 + \$60,000 = \underline{\underline{\$430,000}} \end{array}$$

- **Step 3. Determine total cost of goods manufactured for the period.** As shown in Exhibit 8, for Choice Candy this would be computed as follows.

$$\begin{array}{r} \text{Beginning Work in} + \text{Total Manufacturing} - \text{Ending Work in} = \text{Cost of Goods} \\ \text{Process Inventory} \quad \text{Costs} \quad \text{Process Inventory} \quad \text{Manufactured} \\ \$20,000 + \$430,000 - \$150,000 = \underline{\underline{\$300,000}} \end{array}$$

## Cost of Goods Sold and a Manufacturer's Income Statement

Exhibit 8 shows the relationship between Choice Candy's income statement and its statement of cost of goods manufactured. The total amount of the cost of goods manufactured is carried over to the income statement, where it is used to compute the cost of goods sold. The cost of goods sold is considered an expense in the period in which the goods are sold.

$$\begin{array}{r} \text{Beginning Finished} + \text{Cost of Goods} = \text{Cost of Goods} \\ \text{Goods Inventory} \quad \text{Manufactured} \quad \text{Available for Sale} \\ \$78,000 + \$300,000 = \$378,000 \\ \text{Cost of Goods Available for Sale} - \text{Ending Finished Goods} = \text{Cost of Goods} \\ \text{(what was available for sale)} \quad \text{Inventory (what was not sold)} \quad \text{Sold} \\ \$378,000 - \$138,000 = \underline{\underline{\$240,000}} \end{array}$$

### APPLY IT!

Given the following information, compute the ending balances of the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts:

Materials inventory, beginning balance	\$ 230
Work in process inventory, beginning balance	250
Finished goods inventory, beginning balance	380
Direct materials purchased	850
Direct materials used	740
Direct labor costs	970
Overhead costs	350
Cost of goods completed	1,230
Cost of goods sold	935

### SOLUTION

Materials Inventory, ending balance:

Materials Inventory, beginning balance	\$ 230
Direct materials purchased	850
Direct materials used	(740)
Materials Inventory, ending balance	<u>\$ 340</u>

Work in Process Inventory, ending balance:

Work in Process Inventory, beginning balance	\$ 250
Direct materials used	740
Direct labor costs	970
Overhead costs	350
Cost of goods completed	(1,230)
Work in Process Inventory, ending balance	<u>\$ 1,080</u>

Finished Goods Inventory, ending balance:

Finished Goods Inventory, beginning balance	\$ 380
Cost of goods completed	1,230
Cost of goods sold	(935)
Finished Goods Inventory, ending balance	<u>\$ 675</u>

**TRY IT! SE6, E4A, E5A, E6A, E7A, E4B, E5B, E6B, E7B**

## LO 5 Measurement of Product Costs

Making or delivering products, selling insurance policies, or preparing a client’s income taxes are all examples of a product or service that can be produced and sold, but how much does a single unit cost?

### Computing Product Unit Cost

*Product unit cost* is the cost of manufacturing a single unit of a product. It is made up of the cost of goods manufactured costs of direct materials, direct labor, and overhead. These three cost elements are accumulated as a batch of products is being produced. When the batch has been completed, the product unit cost is computed.

$$\text{Product Unit Cost} = \frac{\text{Direct Materials Cost} + \text{Direct Labor Cost} + \text{Overhead Cost}}{\text{Number of Units Produced}}$$

or

$$\text{Product Unit Cost} = \text{Direct Materials Cost per Unit} + \text{Direct Labor Cost per Unit} + \text{Overhead Cost per Unit}$$

### Product Cost Measurement Methods

How products flow physically and how costs are incurred does not always match. For example, Choice Candy physically produces candy bars 24 hours a day, 7 days a week, but the accounting department only does accounting 8 hours a day, 5 days a week. Because product cost data must be available 24/7, managers may use estimates or pre-determined standards to compute product costs during the period. At the end of the period, these estimates are reconciled with the actual product costs so actual product costs appear in the financial statements. The three methods managers and accountants can use to calculate product unit cost include:

- Actual costing
- Normal costing
- Standard costing

Exhibit 9 summarizes how these three methods use actual and estimated costs.

**Exhibit 9**  
Three Product Cost-Measurement Methods: Actual and Estimated Costs

© Cengage Learning 2014

Product Cost Elements	Actual Costing	Normal Costing	Standard Costing
Direct materials	Actual costs	Actual costs	Estimated costs
Direct labor	Actual costs	Actual costs	Estimated costs
Overhead	Actual costs	Estimated costs	Estimated costs

**Actual Costing Method** The **actual costing method** uses the actual costs of direct materials, direct labor, and overhead to calculate the product unit cost. These costs, however, may not be known until the end of the period. In the following example, assume the product unit cost is computed after the job is completed and all cost information is known.

Choice Candy produced 3,000 candy bars for a customer. The company accountant calculated the actual costs for the order as follows: direct materials, \$540; direct labor, \$420; and overhead, \$240. The actual product unit cost for the order was \$0.40, calculated as follows.

Actual direct materials (\$540 ÷ 3,000 candy bars)	\$0.18
Actual direct labor (\$420 ÷ 3,000 candy bars)	0.14
Actual overhead (\$240 ÷ 3,000 candy bars)	0.08
Actual product cost per candy bar (\$1,200 ÷ 3,000 candy bars)	<u>\$0.40</u>

**STUDY NOTE:** The use of normal costing is widespread, since many overhead bills, such as utility bills, are not received until after products or services are produced and sold.

**Normal Costing Method** The **normal costing method** combines the easy-to-track actual direct costs of materials and labor with estimated overhead costs to determine a product unit cost. The normal costing method is simple and allows a smooth assignment of overhead costs to production during a period. At the end of the period, any difference between the estimated and actual costs must be identified and removed so that the financial statements show only the actual product costs.

For Choice Candy, assume the company accountant used normal costing to price the order for 3,000 candy bars and that overhead was applied to the product's cost using an estimated rate of 50 percent of direct labor costs. In this case, the costs for the order would include the actual direct materials cost of \$540, the actual direct labor cost of \$420, and an estimated overhead cost of \$210 ( $\$420 \times 50\%$ ). The product unit cost would be \$0.39:

Actual direct materials ( $\$540 \div 3,000$ candy bars)	\$0.18
Actual direct labor ( $\$420 \div 3,000$ candy bars)	0.14
Estimated overhead ( $\$210 \div 3,000$ candy bars)	<u>0.07</u>
Normal product cost per candy bar ( $\$1,170 \div 3,000$ candy bars)	<u>\$0.39</u>

**Standard Costing Method** Managers sometimes need product cost information before the accounting period begins so that they can control the cost of operating activities or price a proposed product for a customer. In such situations, product unit costs must be estimated, and the standard costing method can be helpful. The **standard costing method** uses estimated or standard costs of direct materials, direct labor, and overhead to calculate the product unit cost. Standard costing is very useful in performance management and evaluation because a manager can compare actual and standard costs to compute the variances.\*

Assume that Choice Candy is placing a bid to manufacture 2,000 candy bars for a new customer. From standard cost information developed at the beginning of the period, the company accountant estimates the following costs: \$0.20 per unit for direct materials, \$0.15 per unit for direct labor, and \$0.09 per unit for overhead (assuming a standard overhead rate of 60 percent of direct labor cost). The standard cost per unit would be \$0.44:

Standard direct materials	\$0.20
Standard direct labor	0.15
Standard overhead ( $\$0.15 \times 60\%$ )	<u>0.09</u>
Standard product cost per candy bar	<u>\$0.44</u>

## Computing Service Unit Cost

Delivering products, representing people in courts of law, selling insurance policies, and computing people's income taxes are typical of the services performed in service organizations. Like other services, these are labor-intensive processes supported by indirect materials or supplies, indirect labor, and other overhead costs. The most important cost in a service organization is the direct cost of labor that can be traceable to the service rendered. The indirect costs incurred in performing a service are similar to those incurred in manufacturing a product. They are *classified* as overhead. These service costs appear on service organizations' income statements as cost of sales.

**STUDY NOTE:** Any material costs in a service organization would be for supplies used in providing services. Because these are indirect materials costs, they are included in overhead.

## APPLY IT!

Fickle Picking Services provides inexpensive, high-quality labor for farmers growing vegetable and fruit crops. In September, Fickle Picking paid laborers \$4,000 to harvest 500 acres of apples. The company incurred overhead costs of \$2,400 for apple-picking services in September. This amount included the costs of transporting the laborers to the orchards; of providing facilities, food, and beverages for the laborers; and of scheduling, billing, and collecting from the farmers. Of this amount, 50 percent was related to picking apples. Compute the cost per acre to pick apples.

### SOLUTION

Total cost to pick apples:  $\$4,000 + (0.50 \times \$2,400) = \$5,200$

Cost per acre to pick apples:  $\$5,200 \div 500 \text{ acres} = \underline{\underline{\$10.40 \text{ per acre}}}$

**TRY IT! SE7, E8A, E9A, E8B, E9B**

\*This is covered in more detail in the chapter on standard costing and variance analysis.

## SECTION 3

## BUSINESS APPLICATIONS

### BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating
- Ethics

### RELEVANT LEARNING OBJECTIVES

**LO 6** Explain how managerial accounting supports the management process to produce business results.

**LO 7** Identify the standards of ethical conduct for management accountants.

## LO 6 Managerial Accounting and the Management Process

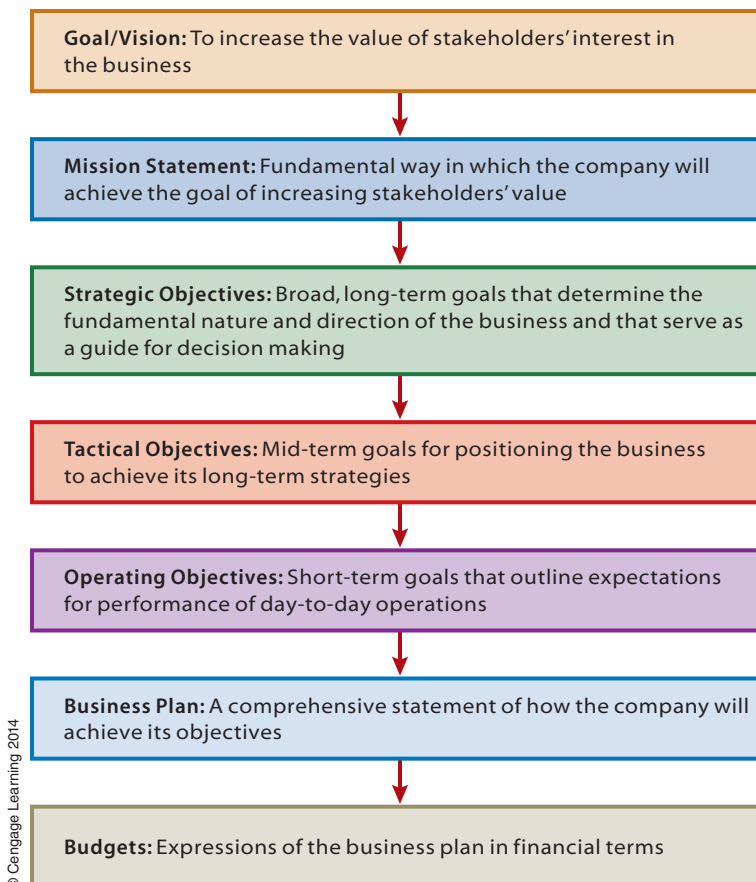
The fundamentals of managing an organization include planning and forecasting operations, organizing and coordinating resources and data, and commanding and controlling resources. Managers use managerial accounting principles to guide their actions and decisions in the management process. Although management actions differ from organization to organization, they generally follow a four-stage management process:

- planning
- performing
- evaluating
- communicating

Managerial accounting is essential in each stage of the process.

**Planning** Exhibit 10 shows the overall framework in which planning takes place. The overriding **goal/vision** of a business is to increase the value of the stakeholders' interest in the business. The fundamental way in which the company will achieve this goal/

**Exhibit 10**  
Overview of the Planning Framework



© Cengage Learning 2014





## Business Perspective

### What's Going on in the Grocery Business?

© Aljia / iStockphoto.com

Sales at large supermarket chains, such as **Kroger**, **Safeway**, and **Albertson's**, have been flat and profits weak because both ends of their customer market are being squeezed. Large-scale retailers like **Wal-Mart** and **Costco** are attracting cost-conscious grocery shoppers, and upscale grocery customers are being lured by quality to specialty grocers like **Trader Joe's** and **Whole Foods Market**. Other grocery chains are reconsidering their company's mission and strategic options by adding new products and services, such as walk-in medical clinics, closing stores and downsizing, or entering new geographic markets.<sup>2</sup>

vision is described in its **mission statement**. This statement also expresses the company's identity and unique character. For example, **Wal-Mart's** mission statement says that the company wants “to give ordinary folk the chance to buy the same things as rich people.” **The Hershey Company's** mission is “bringing sweet moments of Hershey happiness to the world every day.”

The mission statement is essential to the planning process, which must consider how to add value through strategic, tactical, and operating objectives.

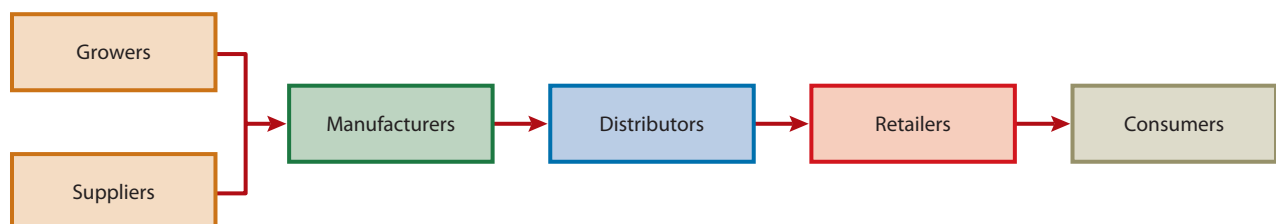
- **Strategic objectives:** Broad, long-term goals that determine the fundamental nature and direction of a business and that serve as a guide for decision making. Strategic objectives involve such basic issues as what a company's main products or services will be, who its primary customers will be, and where it will operate. They stake out a company's strategic position—whether it will be a cost leader, quality leader, or niche satisfier.
- **Tactical objectives:** Mid-term goals that position an organization to achieve its long-term strategies. These objectives, which usually cover a three- to five-year period, lay the groundwork for attaining the company's strategic objectives.
- **Operating objectives:** Short-term goals that outline expectations for the performance of day-to-day operations. Operating objectives link to performance targets and specify how success will be measured.

A **business plan** is a comprehensive statement of how a company will achieve its strategic, tactical, and operating objectives. It is usually expressed in financial terms in the form of budgets, and it often includes performance goals for individuals, teams, products, or services. A business plan provides a full description of the business, including a complete operating budget for the first two years of operations. The **budget** must include a forecasted income statement, a forecasted statement of cash flows, and a forecasted balance sheet.

**Performing** Planning alone does not guarantee satisfactory operating results. Management must implement the business plan in ways that make optimal use of available resources in an ethical manner.

Critical to managing any retail business is a thorough understanding of the supply chain. As Exhibit 11 shows, the **supply chain** (or *supply network*) is the path that leads from the suppliers to the final consumer. In the supply chain for a company that produces and sells candy, materials and resources flow from growers and suppliers to the company (manufacturer) and then on to candy distributors to retailers to consumers. Managers' knowledge of their supply chain allows them to coordinate deliveries from local growers and international suppliers so that they can meet the demands of customers without having too much or too little inventory on hand.

**Exhibit 11**  
The Supply Chain



© Cengage Learning 2014



## Business Perspective

### What Do You Do to Cure a Bottleneck Headache?

A single seat belt can have as many as 50 parts, and getting the parts from suppliers was once a big problem for **Autoliv, Inc.**, a Swedish maker of auto safety devices. Autoliv's plant in Indianapolis was encountering constant bottlenecks in dealing with 125 different suppliers. To keep the production lines going required high-priced, rush shipments on a daily basis. To solve the problem, the company began using supply-chain management, keeping in touch with suppliers through the Internet rather than through faxes and phone calls. This system allowed suppliers to monitor the inventory at Autoliv and thus to anticipate problems. It also provided information on quantity and time of recent shipments, as well as continuously updated forecasts of parts that would be needed in the next 12 weeks. With supply-chain management, Autoliv reduced inventory by 75 percent and rush freight costs by 95 percent.<sup>3</sup>

© Allija / iStockphoto.com

## Evaluating

Managers evaluate operating results by comparing the organization's actual performance with the performance levels established in the planning stage. They earmark any significant variations for further analysis so that they can correct the problems. If the problems are the result of a change in the organization's operating environment, the managers may revise their original estimates and/or objectives.

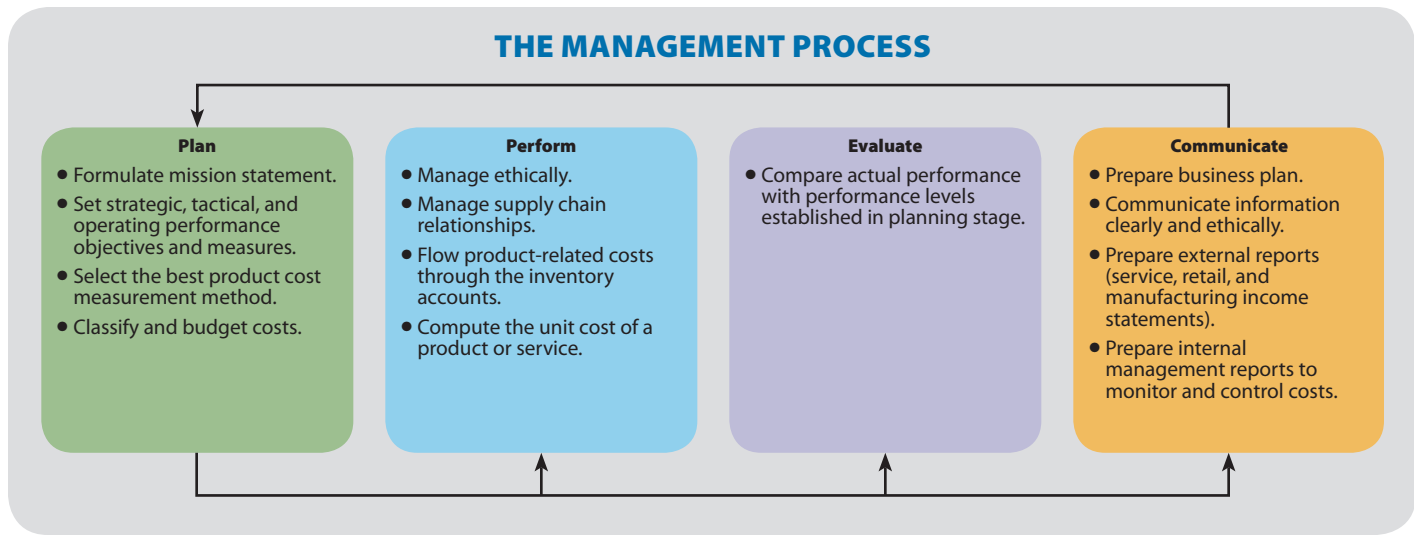
## Communicating

Whether accounting reports are prepared for internal or external use, they must provide accurate information and clearly communicate this information. Inaccurate or confusing internal reports can have a negative effect on a company's operations. Full disclosure and transparency in financial statements issued to external parties is a basic concept of generally accepted accounting principles, and violation of this principle can result in stiff penalties. After several scandals, Congress passed legislation that requires the top management of companies to certify that financial statements filed with the SEC are accurate. The penalty for issuing false public reports can be loss of compensation, fines, and jail time.

The key to producing accurate and useful internal and external reports is to apply the four *w*'s:

- **Why?** Know the purpose of the report. Focus on it as you write.
- **Who?** Identify the audience for your report. Communicate at a level that matches your readers' understanding of the issue and their familiarity with accounting information. A detailed, informal report may be appropriate for your manager, but a more concise summary may be necessary for other audiences, such as the president or board of directors of your organization.
- **What?** What information is needed, and what method of presentation is best? Select relevant information from reliable sources. You may draw information from pertinent documents or from interviews with knowledgeable managers and employees. The information should be not only relevant but also easy to read and understand. You may need to include visual aids, such as bar charts or graphs, to present the information clearly.
- **When?** Know the due date for the report. Strive to prepare an accurate report on a timely basis. If the report is urgently needed, you may have to sacrifice some accuracy in the interest of timeliness.

In summary, managerial accounting can provide a constant stream of relevant information to the management process. Managers start with a business plan, implement the plan, and evaluate and report the results. Accounting information helps managers develop their business plan, communicate that plan to their employees or their bank, evaluate their operating performance, and report the results of operations. As you can see in Exhibit 12, accounting plays a critical role in managing the operations of any organization.

**Exhibit 12****Producing Results with the Management Process****APPLY IT!**

Indicate whether each of the following activities takes place during the planning (PL), performing (PE), evaluating (E), or communicating (C) stage of the management process.

- Changing regular price to clearance price
- Reporting results to appropriate personnel
- Preparing budgets of operating costs
- Comparing estimated and actual costs to determine variances

**SOLUTION**

a. PE, b. C, c. PL, d. E

**TRY IT! SE8, SE9, E10A, E11A, E10B, E11B**

**LO 7 Standards of Ethical Conduct**

Managers consider the interests of external parties (e.g., customers, owners, suppliers, governmental agencies, and the local community) when they make decisions about the proper use of organizational resources and the financial reporting of their actions. When ethical conflicts arise, management accountants have a responsibility to help managers balance those interests.

To be viewed credibly by the various parties who rely on the information they provide, management accountants must adhere to the highest standards of performance. To provide guidance, the Institute of Management Accountants has issued standards of ethical conduct for practitioners of managerial accounting and financial management. Those standards, presented in Exhibit 13, emphasize that management accountants have responsibilities in the following areas:

- competence
- confidentiality
- integrity
- credibility

**Exhibit 13****Statement of Ethical Professional Practice**

Members of IMA shall behave ethically. A commitment to ethical professional practice includes: overarching principles that express our values, and standards that guide our conduct.

**PRINCIPLES**

IMA's overarching ethical principles include: Honesty, Fairness, Objectivity, and Responsibility. Members shall act in accordance with these principles and shall encourage others within their organizations to adhere to them.

**STANDARDS**

A member's failure to comply with the following standards may result in disciplinary action.

**I. COMPETENCE**

Each member has a responsibility to:

1. Maintain an appropriate level of professional expertise by continually developing knowledge and skills.
2. Perform professional duties in accordance with relevant laws, regulations, and technical standards.
3. Provide decision support information and recommendations that are accurate, clear, concise, and timely.
4. Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

**II. CONFIDENTIALITY**

Each member has a responsibility to:

1. Keep information confidential except when disclosure is authorized or legally required.
2. Inform all relevant parties regarding appropriate use of confidential information. Monitor subordinates' activities to ensure compliance.
3. Refrain from using confidential information for unethical or illegal advantage.

**III. INTEGRITY**

Each member has a responsibility to:

1. Mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts.
2. Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
3. Abstain from engaging in or supporting any activity that might discredit the profession.

**IV. CREDIBILITY**

Each member has a responsibility to:

1. Communicate information fairly and objectively.
2. Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
3. Disclose delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.

**RESOLUTION OF ETHICAL CONFLICT**

In applying the Standards of Ethical Professional Practice, you may encounter problems identifying unethical behavior or resolving an ethical conflict. When faced with ethical issues, you should follow your organization's established policies on the resolution of such conflict. If these policies do not resolve the ethical conflict, you should consider the following courses of action:

Discuss the issue with your immediate supervisor except when it appears that the supervisor is involved. In that case, present the issue to the next level. If you cannot achieve a satisfactory resolution, submit the issue to the next management level. If your immediate superior is the chief executive officer or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with your superior's knowledge, assuming he or she is not involved. Communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate, unless you believe there is a clear violation of the law.

Clarify relevant ethical issues by initiating a confidential discussion with an IMA Ethics Counselor or other impartial advisor to obtain a better understanding of possible courses of action.

Consult your own attorney as to legal obligations and rights concerning the ethical conflict.

Source: *IMA Statement of Ethical Professional Practice*, Institute of Management Accountants, [www.imanet.org](http://www.imanet.org). Reprinted by permission.



## Business Perspective

### How to Blow the Whistle on Fraud

According to **PricewaterhouseCoopers**'s fourth biennial survey of more than 5,400 companies in 40 countries, eradicating fraud is extremely difficult. Despite increased attention to fraud detection systems and stronger internal controls, half of the companies interviewed had fallen victim to some type of fraud in the previous two years. The average cost of the fraud was about \$3.2 million per company. Fraud appeared most likely to happen in Africa, North America, and Central-Eastern Europe.

The Sarbanes-Oxley Act of 2002 requires that all publicly traded companies have an anonymous incident reporting system. Such a system can help prevent fraud, as can hotlines that provide guidance on ethical dilemmas involved in reporting fraud. An example of such an ethics hotline is the one that the Institute of Management Accountants instituted in 2002. However, PricewaterhouseCoopers's study found that the best fraud deterrents were a company-wide risk management system with a continuous proactive fraud-monitoring component and a strong ethical culture to which all employees subscribe.<sup>4</sup>

© Alija / iStockphoto.com

## APPLY IT!

Rank in order of importance the management accountant's four areas of responsibility: competence, confidentiality, integrity, and credibility. Explain the reasons for your ranking.

### SOLUTION

Rankings will vary depending on the reasoning used concerning the four areas of responsibility. Ranking differences among individuals also reinforces the fact that we approach ethical behavior in a variety of ways and why a code of ethics is necessary.

**TRY IT! SE10, E12A, E13A, E12B, E13B**

## TriLevel Problem



Choice Candy Company

Yurchyke/Shutterstock

The beginning of this chapter focused on Choice Candy Company, a company that manufactures and sells quality chocolate bars. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*How does managerial accounting recognize and define costs?*

- In this chapter we learned that how managers recognize and measure costs depends on how the cost information is used for decision making. Based on what you learned, match this chapter's cost classifications and uses.

#### Cost Classifications

- Direct costs; indirect costs
- Product costs; period costs
- Variable costs; fixed costs
- Value-adding costs; non-value-adding costs

#### Use of Cost Analysis

- Recognize costs for the preparation of financial statements.
  - Measure the number of units that must be sold to achieve a certain level of profit (cost behavior).
  - Recognize the costs of activities that do and do not add value to a product or service.
  - Measure costs by tracking them to a particular cost object, such as a service or product.
- Discuss the three elements of product or service cost.
  - Define product or service unit cost.

**Section 2: Accounting Applications**

*How does Choice Candy determine the cost of a candy bar?*

Assume that one of Choice Candy's factories produces 50-pound blocks of dark chocolate and that it needs to prepare a year-end balance sheet and income statement, as well as a statement of cost of goods manufactured, and compute its product's actual unit cost. During the year, the factory purchased \$361,920 of direct materials. The factory's direct labor costs for the year were \$99,085 (10,430 hours at \$9.50 per hour); its indirect labor costs totaled \$126,750 (20,280 hours at \$6.25 per hour). Account balances for the year follow.

<b>Account</b>	<b>Balance</b>
Plant Supervision	\$ 42,500
Factory Insurance	8,100
Utilities, Factory	29,220
Depreciation, Factory Building	46,200
Depreciation, Factory Equipment	62,800
Factory Security	9,460
Factory Repair and Maintenance	14,980
Selling and Administrative Expenses	76,480
Materials Inventory, beginning	26,490
Work in Process Inventory, beginning	101,640
Finished Goods Inventory, beginning	148,290
Materials Inventory, ending	24,910
Work in Process Inventory, ending	100,400
Finished Goods Inventory, ending	141,100

1. Compute the cost of materials used during the year.
2. From the cost of materials used, compute the total manufacturing costs for the year.
3. From the total manufacturing costs for the year, compute the cost of goods manufactured during the year.
4. If 13,397 units (1 unit = 50-pound block of dark chocolate) were manufactured during the year, what was the actual product unit cost? (Round to two decimal places.)

**Section 3: Business Applications**

*How does managerial accounting facilitate the management process as managers plan, organize, and control costs?*

To answer this question, match this chapter's management responsibilities with when they occur within the management process.

- |                |  |
|----------------|--|
| a. plan        | 1. Track the flow of product costs   |
| b. perform     | 2. Compare actual and planned results  |
| c. evaluate    | 3. Prepare financial statements  |
| d. communicate | 4. Manage ethically  |
|                | 5. Classify costs  |
|                | 6. Prepare internal management reports   |
|                | 7. Communicate clearly and ethically   |
|                | 8. Select the best product cost measurement method                             |
|                | 9. Formulate mission statement   |
|                | 10. Set strategic, tactical, and operating performance objectives and measures |
|                | 11. Prepare business plan.   |
|                | 12. Compute the unit cost of a product or service.                             |



**SOLUTION****Section 1: Concepts**

1. b; 2. c; 3. d; 4. a
2. Managers must measure the elements of a product or service unit cost, which may include the traceable costs of direct materials and direct labor and the indirect costs known as overhead.
3. Product unit cost is defined as the cost of manufacturing a single unit of product. Service unit cost is defined as the cost of performing a single service.

**Section 2: Accounting Applications**

1. Cost of materials used:	
Materials inventory, beginning	\$ 26,490
Direct materials purchased	<u>361,920</u>
Cost of materials available for use	\$388,410
Less materials inventory, ending	<u>24,910</u>
Cost of materials used	<u>\$363,500</u>
2. Total manufacturing costs:	
Cost of materials used	\$363,500
Direct labor costs	99,085
Overhead costs	
Indirect labor	\$126,750
Plant supervision	42,500
Factory insurance	8,100
Utilities, factory	29,220
Depreciation, factory building	46,200
Depreciation, factory equipment	62,800
Factory security	9,460
Factory repair and maintenance	<u>14,980</u>
Total overhead costs	<u>340,010</u>
Total manufacturing costs	<u>\$802,595</u>
3. Cost of goods manufactured:	
Total manufacturing costs	\$802,595
Add work in process inventory, beginning	<u>101,640</u>
Total cost of work in process during the year	\$904,235
Less work in process inventory, ending	<u>100,400</u>
Cost of goods manufactured	<u>\$803,835</u>

## 4. Actual product unit cost:

$$\frac{\text{Cost of Goods Manufactured}}{\text{Number of Units Manufactured}} = \frac{\$803,835}{13,397 \text{ units}} = \underline{\underline{\$60.00^*}}$$

\*Rounded

**Section 3: Business Applications**

- |      |       |
|------|-------|
| 1. b | 7. d  |
| 2. c | 8. a  |
| 3. d | 9. a  |
| 4. b | 10. a |
| 5. a | 11. d |
| 6. d | 12. b |



## Chapter Review

**Distinguish managerial accounting from financial accounting.** **LO 1**

Managerial accounting involves partnering with management in decision making, devising planning and performance management systems to assist management in the formulation and implementation of an organization's strategy. Managerial accounting reports provide information for planning, control, performance measurement, and decision making to managers and employees. These reports have a flexible format; they can present either historical or future-oriented information expressed in dollar amounts or physical measures. In contrast, financial accounting reports provide information about an organization's past performance to owners, lenders, customers, and governmental agencies on a periodic basis. Financial accounting reports follow strict guidelines defined by generally accepted accounting principles.

**Explain how managers recognize costs and how they define product or service unit cost.** **LO 2**

A single cost can be recognized as a direct or an indirect cost, a variable or a fixed cost, a value-adding or a non-value-adding cost, and a product or a period cost. The three measured elements of product costs are direct materials, direct labor, and overhead. Direct materials costs are the costs of materials measured when making a product that can be traced to specific product units. Direct labor costs include all labor costs that can be traced to specific product units. All other production-related costs are measured and recognized as overhead costs. Such costs cannot be easily traced to end products or services, so a cost allocation method is used to assign them to products or services. When a batch of products has been completed, the product unit cost is computed by dividing the total cost of direct materials, direct labor, and overhead by the total number of units produced.

These cost classifications enable managers to control costs by tracing them to cost objects, to calculate the number of units that must be sold to obtain a certain level of profit, to identify the costs of activities that do and do not add value to a product or service, and to prepare financial statements for parties outside the organization. Managers in manufacturing, retail, and service organizations use information about operating costs and product or service unit costs to prepare budgets, make pricing and other decisions, calculate variances between estimated and actual costs, and communicate results.

**Describe the flow of costs through a manufacturer's inventory accounts.** **LO 3**

The flow of costs through the inventory accounts begins when costs for direct materials, direct labor, and overhead are incurred. Materials costs flow first into the Materials Inventory account, which is used to record the costs of materials when they are received and again when they are issued for use in a production process. All manufacturing-related costs—direct materials, direct labor, and overhead—are recorded in the Work in Process Inventory account. When products are completed, their costs are transferred from the Work in Process Inventory account to the Finished Goods Inventory account. When the products are sold, these costs are transferred to the Cost of Goods Sold account.

**Compare how service, retail, and manufacturing organizations report costs on their financial statements and how they account for inventories.** **LO 4**

Because the operations of service, retail, and manufacturing organizations differ, their financial statements differ as well. A service organization maintains no inventory accounts on its balance sheet. The cost of sales on its income statement reflects the net cost of the services sold. A retail organization, which purchases products ready for resale, maintains only a Merchandise Inventory account. The cost of goods sold is simply the difference between the cost of goods available for sale and the ending merchandise inventory. A manufacturing organization maintains three inventory accounts: Materials Inventory, Work in Process Inventory, and Finished Goods Inventory. Manufacturing costs flow through all three inventory accounts. During the accounting period, the cost of completed products is transferred to the Finished Goods Inventory account, and the cost of units that have been manufactured and sold is transferred to the Cost of Goods Sold account.

Compute the unit cost of a product or service. **LO 5**

The product unit cost is computed by dividing the cost of goods manufactured by the total number of units produced. The product unit cost can be calculated using the actual, normal, or standard costing method. Under actual costing, the actual costs are used to compute the product unit cost. Under normal costing, the actual costs of direct materials and direct labor are combined with the estimated cost of overhead to determine the product unit cost. Under standard costing, the estimated costs are used to calculate the product unit cost. The components of product cost may be classified as prime costs or conversion costs. Prime costs are the primary costs of production—the sum of direct materials costs and direct labor costs. Conversion costs are the costs of converting direct materials into finished product—the sum of direct labor costs and overhead costs.

Service organizations have no materials costs; but they do have both direct labor costs and overhead costs. To determine the cost of performing a service, professional labor and service-related overhead costs are included in the analysis.

Explain how managerial accounting supports the management process to produce business results. **LO 6**

Managerial accounting supports each stage of the management process. When managers plan, they work with managerial accounting to establish strategic, tactical, and operating objectives that reflect their company's mission and to formulate a business plan for achieving those objectives. The plan is usually expressed in the form of budgets. When managers implement the plan, they use the information provided in the budgets to manage the business in the context of its supply chain. In evaluating performance, managers compare actual performance with planned performance and take steps to correct any problems. Reports reflect the results of planning, executing, and evaluating operations and may be prepared for external or internal use.

Identify the standards of ethical conduct for management accountants. **LO 7**

The Statement of Ethical Professional Practice emphasizes the Institute of Management Accounting members' responsibilities in the areas of competence, confidentiality, integrity, and credibility. These standards of conduct help management accountants recognize and avoid situations that could compromise their ability to supply management with accurate and relevant information.

## Key Terms

**actual costing method** 775 (LO5)  
**budget** 778 (LO6)  
**business plan** 778 (LO6)  
**conversion costs** 764 (LO2)  
**cost of goods manufactured** 770 (LO3)  
**cost of goods sold** 770 (LO3)  
**direct costs** 762 (LO2)  
**direct labor costs** 763 (LO2)  
**direct materials costs** 763 (LO2)  
**Finished Goods Inventory account** 768 (LO3)  
**fixed cost** 764 (LO2)  
**goal/vision** 777 (LO6)

**indirect costs** 762 (LO2)  
**indirect labor costs** 763 (LO2)  
**indirect materials costs** 763 (LO2)  
**managerial accounting** 760 (LO1)  
**manufacturing cost flow** 768 (LO3)  
**Materials Inventory account** 768 (LO3)  
**mission statement** 778 (LO6)  
**non-value-adding cost** 765 (LO2)  
**normal costing method** 776 (LO5)  
**operating objectives** 778 (LO6)  
**overhead costs** 763 (LO2)  
**period costs** 763 (LO2)  
**prime costs** 764 (LO2)

**product costs** 763 (LO2)  
**product unit cost** 763 (LO2)  
**service unit cost** 763 (LO2)  
**standard costing method** 776 (LO5)  
**statement of cost of goods manufactured** 773 (LO4)  
**strategic objectives** 778 (LO6)  
**supply chain** 778 (LO6)  
**tactical objectives** 778 (LO6)  
**total manufacturing costs** 769 (LO3)  
**value-adding cost** 765 (LO2)  
**variable cost** 764 (LO2)  
**Work in Process Inventory account** 768 (LO3)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT ► BUSINESS APPLICATION ►** How do the concepts of cost measurement and cost recognition underlie management accountants partnering with managers?
- LO 1 **DQ2. CONCEPT ►** Explain how this statement: “Managerial accounting and financial accounting work is interrelated and the accountants must work together closely” relates to accounting concepts.
- LO 1 **DQ3.** In 1982, the IMA defined management accounting as follows.
- The process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of financial information used by management to plan, evaluate, and control within the organization and to assure appropriate use of and accountability for its resources.<sup>5</sup>*
- Compare this definition with the updated one that appears in LO1. Has the role of a management accountant changed?
- LO 5 **DQ4. CONCEPT ►** Describe the three cost measurement methods that can be used to compute the unit cost of a product or service.
- LO 6 **DQ5. CONCEPT ► BUSINESS APPLICATION ►** How do managers in various organizations use cost information in the management process to measure and recognize costs during a period?

### SHORT EXERCISES

- LO 1 **Managerial Accounting versus Financial Accounting**
- SE1.** Indicate whether each of the following characteristics relates to managerial accounting (MA) or financial accounting (FA):
- Forward looking
  - Publicly reported
  - Complies with accounting standards
  - Usually confidential
  - Reports past performance
  - Uses physical measures as well as monetary ones for reports
  - Driven by user needs
  - Focuses on business decision making
- LO 2 **Elements of Manufacturing Costs**
- SE2. CONCEPT ►** Stoney Saure, Votives, Inc.’s accountant, must group the costs of manufacturing tealights. Indicate whether each of the following items should be classified as direct materials (DM), direct labor (DL), overhead (O), or none of these (N). Also indicate whether each is a prime cost (PC), a conversion cost (CC), or neither (N). (*Hint:* More than one answer per category may apply.)
- Cost of wax
  - Depreciation of the cost of vats to hold melted wax
  - Cost of Gigi’s time to dip the wicks into the wax
  - Rent on the factory where candles are made
  - Cost of coloring for candles
  - Steve’s commission to sell candles to Brightlights, Inc.
  - Cost of Ramos’s time to design candles for Halloween

**LO 2 Cost Recognition**

**SE3. CONCEPT** ▶ Indicate whether each of the following is a direct cost (D), an indirect cost (ID), or neither (N) and whether it is a variable (V) or a fixed (F) cost. Also indicate whether each adds value (VA) or does not add value (NVA) to the product and whether each is a product cost (PD) or a period cost (PER).

- Production foreman's salary
- Straight-line depreciation on office equipment
- Wages of a production-line worker

**LO 3 Cost Flow in a Manufacturing Organization**

**SE4.** Given the following information, compute the ending balances of the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts:

Materials Inventory, beginning balance	\$ 25,000
Work in Process Inventory, beginning balance	5,750
Finished Goods Inventory, beginning balance	38,000
Direct materials purchased	85,000
Direct materials used	74,000
Direct labor costs	70,000
Overhead costs	35,000
Cost of goods manufactured	133,000
Cost of goods sold	103,375

**LO 3 Document Flows in a Manufacturing Organization**

**SE5.** Identify the document needed to support each of the following activities in a manufacturing organization:

- Recording direct labor time at the beginning and end of each work shift
- Placing an order for direct materials with a supplier
- Receiving direct materials at the shipping dock
- Recording the costs of a specific job's direct materials, direct labor, and overhead
- Issuing direct materials into production
- Fulfilling a Production Department request for the purchase of direct materials
- Billing the customer for a completed order

**LO 4 Income Statement for a Manufacturing Organization**

**SE6.** Using the following information from Nathan Company, prepare an income statement through operating income for the year:

Sales	\$900,000
Finished goods inventory, beginning	45,000
Cost of goods manufactured	575,000
Finished goods inventory, ending	80,000
Operating expenses	300,000

**LO 5 Computation of Product Unit Cost**

**SE7.** What is the product unit cost for Job SZ, which consists of 600 units and has total manufacturing costs of direct materials, \$4,800; direct labor, \$7,200; and overhead, \$3,600? What are the prime costs and conversion costs per unit?

LO 6 **The Management Process**

**SE8. BUSINESS APPLICATION** ► Indicate whether each of the following management activities in a department store is part of planning (PL), performing (PE), evaluating (E), or communicating (C):

- Completing a balance sheet and income statement at the end of the year
- Meeting with sales managers to develop performance measures for sales personnel
- Training a clerk to complete a cash sale
- Renting a local warehouse to store excess inventory of clothing
- Preparing an annual sales budget for each department and the entire store
- Evaluating the performance of the shoe department by examining the significant differences between its actual and planned expenses for the month

LO 6 **Strategic Positioning**

**SE9. BUSINESS APPLICATION** ► Organizations stake out different strategic positions to add value and achieve success. Some strive to be low-cost leaders like **Wal-Mart**, while others become the high-end quality leaders like **Whole Foods Market**. Identify which of the following organizations are low-cost leaders (C) and which are quality leaders (Q):

- Tiffany & Co.
- Yale University
- Local community college
- Lexus
- All-you-can-eat restaurant
- Rent-a-Wreck
- Apple Computers
- Coca-Cola
- Store-brand soda

LO 7 **Ethical Conduct**

**SE10. BUSINESS APPLICATION** ► ABC Cosmetics Company's managerial accountant has lunch every day with his friend who is a managerial accountant for XYZ Cosmetics, Inc., a competitor of ABC. Last week, ABC's accountant couldn't decide how to treat some information in a report he was preparing, so he discussed it with his friend. Is ABC's accountant adhering to the ethical standards of management accountants? Defend your answer.

**EXERCISES: SET A**LO 2 **Cost Recognition**

**E1A. CONCEPT** ► Indicate whether each of the following costs for a moped manufacturer is a product or a period cost, a variable or a fixed cost, a value-adding or a non-value-adding cost, and, if it is a product cost, a direct or an indirect cost of the moped:

Item	Cost Recognition Classifications			
	Product or Period	Variable or Fixed	Value-Adding or Non-Value-Adding	Direct or Indirect
Example: Motor	Product	Variable	Value-adding	Direct

- Office rent
- Labor to assemble moped
- Labor to inspect moped
- Accountant's salary
- Lubricant for brakes

**LO 4 Comparison of Income Statement Formats**

**E2A.** Indicate whether each of these equations applies to a service organization (SER), a retail organization (RET), or a manufacturing organization (MANF):

- Cost of Sales = Net Cost of Services Sold
- Cost of Goods Sold = Beginning Merchandise Inventory + Net Cost of Purchases – Ending Merchandise Inventory
- Cost of Goods Sold = Beginning Finished Goods Inventory + Cost of Goods Manufactured – Ending Finished Goods Inventory

**LO 4 Characteristics of Organizations**

**E3A.** Indicate whether each of the following is typical of a service organization (SER), a retail organization (RET), or a manufacturing organization (MANF):

- Purchases products ready for resale
- Maintains no balance sheet inventory accounts
- Maintains only one balance sheet inventory account
- Maintains three balance sheet inventory accounts
- Designs and makes products for sale
- Sells services
- Includes the net cost of purchases in calculating cost of goods sold
- Determines the net cost of services sold
- Includes the cost of goods manufactured in calculating cost of goods sold

**LO 4 Statement of Cost of Goods Manufactured**

**E4A.** During June, Agron Inc. purchases of direct materials totaled \$119,000; direct labor for the month was 3,400 hours at \$10.00 per hour. Agron also incurred the following overhead costs: utilities, \$5,870; supervision, \$17,300; indirect materials, \$6,750; depreciation, \$6,200; insurance, \$1,830; and miscellaneous, \$1,100.

Beginning inventory accounts were as follows: Materials Inventory, \$48,600; Work in Process Inventory, \$55,250; and Finished Goods Inventory, \$38,500. Ending inventory accounts were as follows: Materials Inventory, \$55,100; Work in Process Inventory, \$48,400; and Finished Goods Inventory, \$37,450.

Prepare a statement of cost of goods manufactured.

**LO 4 Statement of Cost of Goods Manufactured and Cost of Goods Sold**

**E5A.** FruTee Corp. makes irrigation sprinkler systems for fruit tree nurseries. FruTee's new controller can find only the following partial information for the past year:

	<b>Lime Division</b>	<b>Lemon Division</b>	<b>Orange Division</b>	<b>Fig Division</b>
Direct materials used	\$ 4	\$ 7	\$(g)	\$ 8
Total manufacturing costs	11	(d)	(h)	17
Overhead	5	3	3	(j)
Direct labor	(a)	9	4	4
Ending work in process inventory	(b)	3	2	5
Cost of goods manufactured	12	23	15	(l)
Beginning work in process inventory	2	(e)	5	(k)
Ending finished goods inventory	2	6	(i)	9
Beginning finished goods inventory	3	(f)	5	7
Cost of goods sold	(c)	21	16	12

Compute the unknown values. List the accounts in the proper order, and show sub-totals and totals as appropriate.



LO 4 **Missing Amounts—Manufacturing**

**E6A.** Incomplete inventory and income statement data for Gator Corporation follow. Determine the missing amounts.

	<b>Cost of Goods Sold</b>	<b>Cost of Goods Manufactured</b>	<b>Beginning Finished Goods Inventory</b>	<b>Ending Finished Goods Inventory</b>
a.	\$ 15,000	\$20,000	\$ 1,000	?
b.	\$140,000	?	\$55,000	\$60,000
c.	?	\$99,000	\$23,000	\$29,000

LO 4 **Inventories, Cost of Goods Sold, and Net Income**

**E7A.** The data that follow are for a retail organization and a manufacturing organization.

1. Fill in the missing data for the retail organization:

	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth Quarter</b>
Sales	\$10	\$(e)	\$15	\$(k)
Gross margin	(a)	4	5	(l)
Ending merchandise inventory	5	(f)	5	(m)
Beginning merchandise inventory	4	(g)	(h)	5
Net cost of purchases	(b)	7	11	(n)
Operating income	3	2	(i)	2
Operating expenses	(c)	2	1	4
Cost of goods sold	5	8	(j)	12
Cost of goods available for sale	(d)	12	15	15

2. Fill in the missing data for the manufacturing organization:

	<b>First Quarter</b>	<b>Second Quarter</b>	<b>Third Quarter</b>	<b>Fourth Quarter</b>
Ending finished goods inventory	\$(a)	\$3	\$(h)	\$ 6
Cost of goods sold	6	3	5	(l)
Operating income	2	3	2	(m)
Cost of goods available for sale	8	(d)	10	13
Cost of goods manufactured	5	(e)	(i)	8
Gross margin	4	(f)	(j)	7
Operating expenses	2	(g)	4	5
Beginning finished goods inventory	(b)	2	3	(n)
Sales	(c)	10	(k)	14

LO 5 **Unit Cost Determination**

**E8A.** Anderson Winery produces a red wine called Old Vines. Recently, management has become concerned about the increasing cost of making Old Vines and needs to determine if the current selling price of \$10 per bottle is adequate. The winery wants to achieve a 25 percent gross profit on the sale of each bottle. The following information is given to you for analysis:

Batch size	6,264 bottles
Costs:	
Total direct materials costs	\$25,056
Total direct labor costs	12,528
Total overhead costs	21,924
Total production costs	<u>\$59,508</u>

(Continued)



1. Compute the unit cost per bottle for materials, labor, and overhead.
2. **ACCOUNTING CONNECTION** ► How would you advise management regarding the price per bottle of wine? (Round to the nearest cent.)
3. Compute the prime costs per unit and the conversion costs per unit.

**LO 5 Unit Costs in a Service Business**

**E9A.** Roll in the Hay, Inc., provides harvesting services. In June, the business earned \$3,600 by cutting, turning, and baling 6,000 bales. During the month, the following costs were incurred: gas, \$900; tractor maintenance, \$360; and labor, \$1,200. Annual tractor depreciation is \$3,000. What was the company's cost per bale? (Round to the nearest cent.) What was its revenue per bale? Should the price per bale be increased?

**LO 6 The Management Process**

**E10A. BUSINESS APPLICATION** ► Indicate whether each of the following management activities of a chain of retail stores is part of planning (PL), performing (PE), evaluating (E), or communicating (C):

- a. Leasing five delivery trucks for the current year
- b. Comparing the actual number with the planned number of customers for the year
- c. Developing a strategic plan for a new store
- d. Preparing a report showing the past performance of a retail store
- e. Developing standards, or expectations, for performance of sales staff for next year
- f. Preparing the chain's balance sheet and income statement and distributing them to the board of directors
- g. Maintaining an inventory of a variety of merchandise
- h. Formulating a corporate policy for the treatment and disposition of recyclables
- i. Preparing a report on the types and amounts of recyclables removed from each store in the last three months
- j. Recording the time taken to deliver online orders to customers

**LO 6 The Planning Framework**

**E11A. BUSINESS APPLICATION** ► Yuan Xi has just opened a company that imports fine ceramic gifts from China and sells them over the Internet. In planning his business, Xi did the following:

1. Listed his expected expenses and revenues for the first year of operations
2. Determined that he would keep his expenses low and generate enough revenues during the first four months of operations so that he would have a positive cash flow by the fifth month
3. Decided that he wanted the company to provide him with income for a good life-style and funds for retirement
4. Developed a complete list of goals, objectives, procedures, and policies relating to how he would find, buy, store, sell, and ship goods and collect payment
5. Decided to focus his business on providing customers with the finest Chinese ceramics at a favorable price
6. Decided to expand his website to include ceramics from other Far Eastern countries over the next five years
7. Decided to solely rely on the Internet to market the products

Match each of Xi's actions to the components of the planning framework: goal, mission, strategic objectives, tactical objectives, operating objectives, business plan, and budget.

**LO 7 Ethical Conduct**

**E12A. BUSINESS APPLICATION** ► Dula Gibbon was recently promoted to accounting manager and now has a new boss, Tim Paine, the corporate controller. Last week, they went to a two-day workshop on accounting security. During the first hour of the first day's program, Paine disappeared. The same thing happened on the second day. During the trip home, Gibbon asked Paine about the conference. Paine replied, "I haven't sat in on one of those workshops in years. This is my R&R time. Those sessions are for the

new people. My experience is enough to keep me current. Plus, I have excellent people, like you, to help me.”

Does Dula Gibbon have an ethical dilemma? If so, what is it? What are her options? How would you solve her problem? Be prepared to defend your answer.

#### LO 7 Corporate Ethics

**E13A. BUSINESS APPLICATION** ► To answer the following questions, conduct a search of several companies’ websites: (1) Does the company have an ethics statement? (2) Does it express a commitment to environmental or social issues? (3) In your opinion, is the company ethically responsible? Select one of the companies you researched and write a brief description of your findings.

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

#### LO 4 A Manufacturing Organization’s Balance Sheet

✓ 2d: Cost of goods manufactured: \$312,100

**P1.** The information that follows is from Manufacturing Company’s trial balance.

	Debits	Credits
Cash	34,000	
Accounts Receivable	27,000	
Materials Inventory, ending	31,000	
Work in Process Inventory, ending	47,900	
Finished Goods Inventory, ending	54,800	
Factory Supplies	5,700	
Small Tools	9,330	
Land	160,000	
Factory Building	575,000	
Accumulated Depreciation—Factory Building		199,000
Factory Equipment	310,000	
Accumulated Depreciation—Factory Equipment		137,000
Patents	33,500	
Accounts Payable		26,900
Insurance Premiums Payable		6,700
Income Taxes Payable		41,500
Mortgage Payable		343,000
Common Stock		200,000
Retained Earnings		334,130
	1,288,230	1,288,230

#### REQUIRED

- Manufacturing organizations use asset accounts that are not needed by retail organizations.
  - List the titles of the asset accounts that are specifically related to manufacturing organizations.
  - List the titles of the asset, liability, and equity accounts that you would see on the balance sheets of both manufacturing and retail organizations.
- Assuming that the following information reflects the results of operations for the year, calculate the (a) gross margin, (b) cost of goods sold, (c) cost of goods available for sale, and (d) cost of goods manufactured:

Operating income	\$138,130
Operating expenses	53,670
Sales	500,000
Finished goods inventory, beginning	50,900
Finished goods inventory, ending	54,800

### LO 4 Statement of Cost of Goods Manufactured

#### SPREADSHEET

✓ Cost of goods manufactured: \$3,645,800

**P2.** Jackplum Vineyards, whose fiscal year begins on November 1, has just completed a record-breaking year producing and selling wine. Its inventory account balances on October 31 of this year were Materials Inventory, \$83,800; Work in Process Inventory, \$2,700,500; and Finished Goods Inventory, \$1,800,200. At the beginning of the year, the inventory account balances were Materials Inventory, \$56,200; Work in Process Inventory, \$3,300,000; and Finished Goods Inventory, \$1,596,400.

During the fiscal year, the company's purchases of direct materials totaled \$750,000. Direct labor hours totaled 140,000, and the average labor rate was \$11.00 per hour. The following overhead costs were incurred during the year: depreciation—plant and equipment, \$85,600; indirect labor, \$207,300; property tax—plant and equipment, \$96,000; plant maintenance, \$80,000; small tools, \$42,400; utilities, \$96,500; and employee benefits, \$176,100.

#### REQUIRED

Prepare a statement of cost of goods manufactured for the year ended October 31.

### LO 5 Computation of Unit Cost

#### SPREADSHEET

✓ 2: Total unit cost: \$5.20  
 ✓ 4: Dept. 70 prime costs: \$3.80  
 ✓ 4: Dept. 70 conversion costs: \$1.30

**P3.** Keep Cool Industries, Inc., manufactures fans for personal use. Department 70 is responsible for assembling the fan. Department 71 packages them for shipment. Keep Cool recently produced 10,000 fans for a national retailer. In fulfilling this order, the departments incurred the following costs:

	Department	
	70	71
Direct materials used	\$30,000	\$4,000
Direct labor	8,000	2,000
Overhead	5,000	3,000

1. Compute the unit cost for each department.
2. Compute the total unit cost for the national retailer order.
3. **ACCOUNTING CONNECTION** ▶ The selling price for this order was \$10 per unit. Was the selling price adequate? List the assumptions and/or computations upon which you based your answer. What suggestions would you make to Keep Cool's management about the pricing of future orders?
4. Compute the prime costs and conversion costs per unit for each department.

### LO 5 Unit Costs in a Service Business

✓ 1: Total cost per patient day: \$2,000  
 ✓ 3: Total cost per patient day using industry average: \$2,899

**P4.** Sunny Day Nursing Home relies heavily on cost data to keep its pricing structures in line with those of its competitors. The facility provides a wide range of services, including assisted living and skilled nursing. The facilities' controller is concerned about the profits generated by the 30-bed memory unit, so she is reviewing current billing procedures for that unit. The focus of her analysis is the unit's billing per patient day. This billing equals the per diem cost of the memory unit plus a 40 percent markup to cover other operating costs and generate a profit. Memory unit patient costs include the following:

Memory aids	\$30 per patient day (average)
Doctors' care	1 hour per day @ \$200 per hour (actual)
Memory therapy care	3 hours per day @ \$90 per hour (actual)
Regular nursing care	24 hours per day @ \$30 per hour (average)
Medications	\$250 per day (average)
Daily living supplies	\$80 per day (average)
Room rental	\$400 per day (average)
Food services	\$50 per day (average)

The nursing home director has asked the controller to compare the current billing procedure with one that uses industry averages to determine the billing per patient day.

**REQUIRED**

1. Compute the cost per patient per day.
2. Compute the billing per patient day using the memory unit's existing markup rate.
3. Compute the billing per patient day using the following industry averages for markup rates:

Memory aids	30%	Medications	50%
Doctors' care	50	Daily living supplies	50
Memory therapy care	50	Room rental	30
Regular nursing care	50	Food services	20

4. **ACCOUNTING CONNECTION** ► Based on your findings in requirements 2 and 3, which billing procedure would you recommend? Why?

**LO 7 Professional Ethics**

**P5. BUSINESS APPLICATION** ► Ted Thalia is Tops Corporation's controller. He has been with the company for 20 years and is being considered for the job of chief financial officer. His boss, who is the current chief financial officer and former company controller, will be Tops's new president. Thalia has just discussed the year-end closing with his boss, who made the following statement during their conversation: "Ted, why are you being so inflexible? I'm only asking you to postpone the \$5,000,000 write-off of obsolete inventory for 10 days so that it won't appear on this year's financial statements. Ten days! Do it. Your promotion is coming up, you know. Make sure you keep all the possible outcomes in mind as you complete your year-end work. Oh, and keep this conversation confidential—just between you and me. Okay?"

**REQUIRED**

1. Identify the ethical issue or issues involved.
2. What do you believe is the appropriate solution to the problem? Be prepared to defend your answer.

**ALTERNATE PROBLEMS****LO 4 A Manufacturing Organization's Balance Sheet**

✓ 2d: Cost of goods manufactured:  
\$352,000

**P6.** The information that follows is from Miles Production Company's trial balance.

	Debits	Credits
Cash	40,000	
Accounts Receivable	30,000	
Materials Inventory, ending	41,000	
Work in Process Inventory, ending	37,000	
Finished Goods Inventory, ending	70,000	
Production Supplies	5,000	
Small Tools	3,000	
Land	200,000	
Factory Building	600,000	
Accumulated Depreciation—Factory Building		300,000
Production Equipment	210,000	
Accumulated Depreciation—Production Equipment		100,000
Patents	20,000	
Accounts Payable		40,000
Insurance Premiums Payable		6,000
Income Taxes Payable		40,000
Mortgage Payable		400,000
Common Stock		300,000
Retained Earnings		70,000
	1,256,000	1,256,000

(Continued)

**REQUIRED**

- Manufacturing organizations use asset accounts that are not needed by retail organizations.
  - List the titles of the asset accounts that are specifically related to manufacturing organizations.
  - List the titles of the asset, liability, and equity accounts that you would see on the balance sheets of both manufacturing and retail organizations.
- Assuming that the following information reflects the results of operations for the year, calculate the (a) gross margin, (b) cost of goods sold, (c) cost of goods available for sale, and (d) cost of goods manufactured:

Operating income	\$ 68,000
Operating expenses	40,000
Sales	450,000
Finished goods inventory, beginning	60,000

**LO 4 Statement of Cost of Goods Manufactured**
**SPREADSHEET**

- ✓ Cost of goods manufactured: \$10,163,200

**P7.** Reggi Vineyards produces a full line of varietal wines. The company, whose fiscal year begins on November 1, has just completed a record-breaking year. Its inventory account balances on October 31 of this year were Materials Inventory, \$1,803,800; Work in Process Inventory, \$2,764,500; and Finished Goods Inventory, \$1,883,200. At the beginning of the year, the inventory account balances were Materials Inventory, \$2,156,200; Work in Process Inventory, \$3,371,000; and Finished Goods Inventory, \$1,596,400.

During the fiscal year, the company's purchases of direct materials totaled \$6,750,000. Direct labor hours totaled 142,500, and the average labor rate was \$8.20 per hour. The following overhead costs were incurred during the year: depreciation—plant and equipment, \$685,600; indirect labor, \$207,300; property tax—plant and equipment, \$94,200; plant maintenance, \$83,700; small tools, \$42,400; utilities, \$96,500; and employee benefits, \$76,100.

**REQUIRED**

Prepare a statement of cost of goods manufactured for the fiscal year ended October 31.

**LO 5 Computation of Unit Cost**
**SPREADSHEET**

- ✓ 2: Total unit cost: \$13.72
- ✓ 4: Dept. 60 prime costs: \$9.06
- ✓ 4: Dept. 60 conversion costs: \$3.54

**P8.** Disco Industries, Inc., manufactures discs for several of the leading recording studios in the United States and Europe. Department 60 is responsible for pressing each disc. Department 61 then packages them for shipment. Disco recently produced 4,000 discs for Vintage Records Company. In fulfilling this order, the departments incurred the following costs:

	<b>Department</b>	
	<b>60</b>	<b>61</b>
Direct materials used	\$29,440	\$3,920
Direct labor	6,800	2,560
Overhead	7,360	4,800

- Compute the unit cost for each department.
- Compute the total unit cost for the Vintage Records Company order.
- ACCOUNTING CONNECTION** ▶ The selling price for this order was \$14 per unit. Was the selling price adequate? List the assumptions and/or computations upon which you based your answer. What suggestions would you make to Disco's management about the pricing of future orders?
- Compute the prime costs and conversion costs per unit for each department.

**LO 5 Unit Costs in a Service Business**

- ✓ 1: Total cost per patient day: \$2,792
- ✓ 3: Total cost per patient day using industry average: \$4,013

**P9.** Everymans Hospital relies heavily on cost data to keep its pricing structures in line with those of its competitors. The hospital provides a wide range of services, including intensive care, intermediate care, and a neonatal nursery. The hospital's controller is concerned about the profits generated by the 30-bed intensive care unit (ICU), so

she is reviewing current billing procedures for that unit. The focus of her analysis is the hospital's billing per ICU patient day. This billing equals the per diem cost of intensive care plus a 40 percent markup to cover other operating costs and generate a profit. ICU patient costs include the following:

Equipment usage	\$180 per day (average)
Doctors' care	2 hours per day @ \$360 per hour (actual)
Special nursing care	4 hours per day @ \$85 per hour (actual)
Regular nursing care	24 hours per day @ \$28 per hour (average)
Medications	\$240 per day (average)
Medical supplies	\$150 per day (average)
Room rental	\$350 per day (average)
Food and services	\$140 per day (average)

The hospital director has asked the controller to compare the current billing procedure with one that uses industry averages to determine the billing per patient day.

#### REQUIRED

1. Compute the cost per patient per day.
2. Compute the billing per patient day using the hospital's existing markup rate. (Round to the nearest dollar.)
3. Compute the billing per patient day using the following industry averages for markup rates:

Equipment	30%	Medications	50%
Doctors' care	50	Medical supplies	50
Special nursing care	40	Room rental	30
Regular nursing care	50	Food and services	25

4. **ACCOUNTING CONNECTION** ► Based on your findings in requirements 2 and 3, which billing procedure would you recommend? Why?

#### LO 7 Professional Ethics

**P10. BUSINESS APPLICATION** ► For almost a year, OK Company has been changing its manufacturing processes. Management has asked for employees' assistance in the transition and has offered bonuses for suggestions that cut time from the production operation. Jim Han and Jerome Smith each identified a time-saving opportunity and turned in their suggestions to their boss.

The boss sent the suggestions to the committee charged with reviewing employees' suggestions, which inadvertently identified them as being the boss's own. The committee decided that the two suggestions were worthy of reward and voted a large bonus for the boss. When notified of this, the boss could not bring himself to identify the true authors of the suggestions.

When Han and Smith heard about their boss's bonus, they confronted him and expressed their grievances. He told them that he needed the recognition to be eligible for an upcoming promotion and promised that if they kept quiet about the matter, he would make sure that they both received significant raises.

#### REQUIRED

1. Should Han and Smith keep quiet? What other options are open to them?
2. How should their boss have dealt with Han's and Smith's complaints?

## CASES

#### LO 2 Conceptual Understanding: Cost Recognition

**C1. CONCEPT** ► Visit a local fast-food restaurant. Observe all aspects of the operation and take notes on the entire process. Describe the procedures used to take, process, and fill an order and deliver the food to the customer. Based on your observations, make a list of the costs incurred by the restaurant. Then create a table similar to Exhibit 4 in the

*(Continued)*



text, in which you recognize the costs you have identified by their traceability (direct or indirect), cost behavior (variable or fixed), value attribute (value-adding or non-value-adding), and implications for financial reporting (product or period costs). Bring your notes and your table to class and be prepared to discuss your findings.

**LO 2, 6 Business Communication: Management Decision about a Supporting Service Function**

**C2.** As the manager of grounds maintenance for a large insurance company in Missouri, you are responsible for maintaining the grounds surrounding the company's three buildings, the six entrances to the property, and the recreational facilities, which include a golf course, a soccer field, jogging and bike paths, and tennis, basketball, and volleyball courts. Maintenance includes gardening (watering, planting, mowing, trimming, removing debris, and so on) and land improvements (e.g., repairing or replacing damaged or worn concrete and gravel areas).

Early in January, you receive a memo from the company president requesting information about the cost of operating your department for the last 12 months. She has received a bid from Outsource Landscapes, Inc., to perform the gardening activities you now perform. You are to prepare a cost report that will help her decide whether to keep gardening activities within the company or to outsource the work.

1. **BUSINESS APPLICATION** ► Before preparing your report, answer the following questions:
  - a. What kinds of information do you need about your department?
  - b. Why is this information relevant?
  - c. Where would you go to obtain this information (sources)?
  - d. When would you want to obtain this information?
2. Draft a report showing only headings and line items that best communicate the costs of your department. How would you change your report if the president asked you to reduce the costs of operating your department?
3. **CONCEPT** ► One of your department's cost accounts is the Maintenance Expense—Garden Equipment account.
  - a. Is this a direct or an indirect cost?
  - b. Is it a product or a period cost?
  - c. Is it a variable or a fixed cost?
  - d. Does the activity add value to the company business of insurance services?
  - e. Is it a budgeted or an actual cost in your report?

**LO 4, 6 Conceptual Understanding: Management Information Needs**

**C3.** H&Y Drug Corporation manufactures most of its three pharmaceutical products in India. Inventory balances for March and April follow.

	March 31	April 30
Materials Inventory	\$258,400	\$228,100
Work in Process Inventory	138,800	127,200
Finished Goods Inventory	111,700	114,100

During April, purchases of direct materials, which include natural materials, basic organic compounds, catalysts, and suspension agents, totaled \$612,600. Direct labor costs were \$160,000, and actual overhead costs were \$303,500. Sales of the company's three products for April totaled \$2,188,400. General and administrative expenses were \$362,000.

1. Prepare a statement of cost of goods manufactured and an income statement through operating income for the month ended April 30.
2. Why is it that the total manufacturing costs do not equal the cost of goods manufactured?
3. What additional information would you need to determine the profitability of each of the three product lines?
4. **CONCEPT** ► Indicate whether each of the following is a product cost or a period cost:
  - a. Import duties for indirect materials
  - b. Shipping expenses to deliver manufactured products to the United States



- c. Rent for manufacturing facilities in India
- d. Salary of the American manager working at the Indian manufacturing facilities
- e. Training costs for an Indian accountant

**LO 6 Interpreting Managerial Reports: Financial Performance Measures**

**C4.** Shape It Manufacturing Company makes sheet metal products. For the past several years, the company's income has been declining. Its statements of cost of goods manufactured and income statements for the last two years are shown here. Review and comment on why the ratios for Shape It's profitability have deteriorated.

**Shape It Manufacturing Company  
Statements of Cost of Goods Manufactured  
For the Years Ended December 31**

	This Year	Last Year
Direct materials used:		
Materials inventory, beginning	\$ 91,240	\$ 93,560
Direct materials purchased (net)	<u>987,640</u>	<u>959,940</u>
Cost of direct materials available for use	\$1,078,880	\$1,053,500
Less materials inventory, ending	<u>95,020</u>	<u>91,240</u>
Cost of direct materials used	\$ 983,860	\$ 962,260
Direct labor	571,410	579,720
Total overhead	<u>482,880</u>	<u>452,110</u>
Total manufacturing costs	\$2,038,150	\$1,994,090
Add work in process inventory, beginning	<u>148,875</u>	<u>152,275</u>
Total cost of work in process during the period	\$2,187,025	\$2,146,365
Less work in process inventory, ending	146,750	148,875
Cost of goods manufactured	<u>\$2,040,275</u>	<u>\$1,997,490</u>

**Shape It Manufacturing Company  
Income Statements  
For the Years Ended December 31**

	This Year	Last Year
Sales	\$2,942,960	\$3,096,220
Cost of goods sold	\$ 142,640	\$ 184,820
Cost of goods manufactured	<u>2,040,275</u>	<u>1,997,490</u>
Cost of goods available for sale	\$2,182,915	\$2,182,310
Less finished goods inventory, ending	<u>186,630</u>	<u>142,640</u>
Total	<u>1,996,285</u>	<u>2,039,670</u>
Gross margin	\$ 946,675	\$1,056,550
Selling and administrative expenses:		
Sales salaries and commissions	\$ 394,840	\$ 329,480
Advertising expense	116,110	194,290
Other selling expenses	82,680	72,930
Administrative expenses	<u>242,600</u>	<u>195,530</u>
Total selling and administrative expenses	<u>836,230</u>	<u>792,230</u>
Income from operations	\$ 110,445	\$ 264,320
Other revenues and expenses:		
Interest expense	54,160	56,815
Income before income taxes	\$ 56,285	\$ 207,505
Income tax expense	<u>19,137</u>	<u>87,586</u>
Net income	<u>\$ 37,148</u>	<u>\$ 119,919</u>

*(Continued)*

1. In preparing your comments, compute the following ratios for each year:
  - a. Ratios of cost of direct materials used to total manufacturing costs, direct labor to total manufacturing costs, and total overhead to total manufacturing costs. (Round to one decimal place.)
  - b. Ratios of sales salaries and commission expense, advertising expense, other selling expenses, administrative expenses, and total selling and administrative expenses to sales. (Round to one decimal place.)
  - c. Ratios of gross margin to sales and net income to sales. (Round to one decimal place.)
2. From your evaluation of the ratios computed in **1**, state the probable causes of the decline in net income.
3. What other factors or ratios do you believe should be considered in determining the cause of the company's decreased income?

LO 6,7 **Ethical Dilemma: Preventing Pollution and the Costs of Waste Disposal**

**C5. BUSINESS APPLICATION** ► Lake Waburg Power Plant provides power to a metropolitan area of 4 million people. The plant's controller, Sunny Hope, has just returned from a conference on the Environmental Protection Agency's regulations concerning pollution prevention. She is meeting with the company's president, Guy Poe, to discuss the impact of the EPA's regulations on the plant.

"Guy, I'm really concerned. We haven't been monitoring the disposal of the radioactive material we send to the Willis Disposal Plant. If Willis is disposing of our waste material improperly, we could be sued," said Sunny. "We also haven't been recording the costs of the waste as part of our product cost. Ignoring those costs will have a negative impact on our decision about the next rate hike."

"Sunny, don't worry. I don't think we need to concern ourselves with the waste we send to Willis. We pay the company to dispose of it. The company takes it off our hands, and it's their responsibility to manage its disposal. As for the cost of waste disposal, I think we would have a hard time justifying a rate increase based on a requirement to record the full cost of waste as a cost of producing power. Let's just forget about waste and its disposal as a component of our power cost. We can get our rate increase without mentioning waste disposal," replied Guy.

What responsibility for monitoring the waste disposal practices at the Willis Disposal Plant does Lake Waburg Power Plant have? Should Sunny take Guy's advice to ignore waste disposal costs in calculating the cost of power? Be prepared to discuss your response.

**Continuing Case: Cookie Company**

**C6. BUSINESS APPLICATION** ► Each of the rest of the chapters in this text includes a "cookie company" case that allows you to explore operating your own cookie business. For this chapter, you will form a company team and assign roles to team members. As a team, you will prepare a mission statement; set strategic, tactical, and operating objectives; decide on a company name; set cookie specifications, decide on a cookie recipe, and answer some questions about product costs.

**REQUIRED**

1. Join with 4 or 5 other students in the class to form a company team. (Your instructor may assign groups or allow students to organize their own teams.)
2. In researching how to start and run a cookie business, your team found the following three examples of cookie company mission statements:
  - To provide cheap cookies that taste great with fast and courteous service!
  - To make the best chocolate chip cookies that anyone has ever tasted!
  - To handmade the best in custom cookie creations!
  - a. Consider which of the mission statements most closely expresses what you want your company's identity and unique character to be. Why?
  - b. Will your business focus on cost, quality, or satisfying a specific need?
  - c. Write your company's mission statement.

3. Based on your mission statement, describe your company's broad long-term strategic objectives:
  - a. What will be your main products?
  - b. Who will be your primary customers?
  - c. Where will you operate your business?
4. Your team made the following decisions about your business:
  - To list expected expenses and revenues for the first six months of operations
  - To keep expenses low and generate enough revenues during the first two months of operations to have a positive cash flow by the third month
  - To develop a complete list of goals, objectives, procedures, and policies relating to how to find, buy, store, sell, and ship goods and collect payment
  - To rely solely on the Internet to market products
  - To expand the e-commerce website to include 20 varieties of cookies over the next five years

Match each of the above to the following components of the planning framework: strategic objectives, tactical objectives, operating objectives, business plan, and budget.
5. As a team:
  - Determine the name of your cookie company.
  - Determine team members' tasks, and make team assignments (e.g., mixer, baker, quality controller, materials purchaser, accountant, marketing manager).
  - Assign each task an hourly pay rate or monthly salary based on your team's perception of the job market for the task involved.
  - Give the plan compiled thus far to your instructor and all team members in writing.
6. As a team, determine cookie specifications: quality, size, appearance, and special features (such as types of chips or nuts), as well as quantity and packaging.
7. As a team, select a cookie recipe that best fits the company's mission.
8. As a team, answer the following questions and submit the answers to your instructor:
  - Will your company use actual or normal costing when computing the cost per cookie? Explain your answer.
  - List the types of costs that your company will recognize as overhead.



# CHAPTER 18

## Costing Systems: Job Order Costing

### BUSINESS INSIGHT

#### Custom Golf Carts, Inc.

Custom Golf Carts, Inc., builds both general-purpose and made-to-order golf carts. Custom's customers can choose the type of wheels and windshield the golf cart should have, the cart's interior and exterior trim, the upholstery fabric, and a dashboard with or without oversized cup holders. They can also specify whether they want the cart to have a music system, a global positioning system, and a propane heater. They can even specify the sound of the golf cart's horn. In this chapter, we focus on the job order costing system—the type of system that makers of special-order products, such as a customized golf cart, use to account for costs and to make informed product decisions.

- 1. CONCEPT** ▶ *Why is a job order costing system appropriate for Custom Golf Carts to measure and recognize costs?*
- 2. ACCOUNTING APPLICATION** ▶ *How does a product costing system account for costs when made-to-order products or services are produced?*
- 3. BUSINESS APPLICATION** ▶ *How does a job order costing system help managers organize and control costs and facilitate management decisions?*

### LEARNING OBJECTIVES

- LO 1** Distinguish between the two basic types of product costing systems, and identify the information that each provides.
- LO 2** Explain the cost flow in a manufacturer's job order costing system.
- LO 3** Prepare a job order cost card, and compute a job order's product or service unit cost.
- LO 4** Explain cost allocation, and describe how allocating overhead costs figures into calculating product or service unit cost.
- LO 5** Explain why unit cost measurement is important to the management process in producing business results.





## SECTION 1

## CONCEPTS

## CONCEPTS

- Cost measurement
- Cost recognition
- Matching rule (accrual accounting)

## RELEVANT LEARNING OBJECTIVE

**LO 1** Distinguish between the two basic types of product costing systems, and identify the information that each provides.

## LO 1 Concepts Underlying Product Costing Systems

A **product costing system** is used to account for an organization's product costs and to provide timely and accurate unit cost information for pricing, cost planning and control, inventory valuation, and financial statement preparation.

- The product costing system enables managers to measure and recognize costs throughout the management process.
- It provides a measurement and recognition structure for *matching* the recording of the revenues earned from product or service sales to their related cost flows.

### Job Order and Process Costing Systems

Two basic types of product costing systems have been developed: job order costing systems and process costing systems.

A **job order costing system** is used by companies that make unique or special-order products, such as custom-tailored suits. A job order costing system *measures* and *recognizes* the costs of direct materials, direct labor, and overhead to a specific batch of products or a specific **job order** (i.e., a customer order for a specific number of specially designed, made-to-order products) by using job order cost cards. A **job order cost card** is usually an electronic or paper document on which all costs incurred in the production of a particular job order—a completed unit—are recorded and *matched* with the job's revenues. In other words, in a job order costing system, the specific job or batch of a product (not a department or work cell) is the focus of *cost measurement* and *recognition*.

A **process costing system** is used by companies that produce large amounts of similar products or liquid products or that have long, continuous production runs of identical products. Makers of soft drinks, candy, bricks, and paper would use such a system. It first traces the costs of direct materials, direct labor, and overhead to processes, departments, or work cells and then assigns the costs to the products manufactured by those processes, departments, or work cells during a specific period using a process cost report. A **process cost report** is

usually an electronic or paper document prepared every period for each process, department, or work cell and is explained fully in the next chapter.

The typical product costing system combines parts of job order costing and process costing to create a hybrid system known as an **operations costing system**.

Exhibit 1 summarizes the characteristics of both costing systems.

## Exhibit 1

## Characteristics of Job Order Costing and Process Costing Systems

Job Order Costing System	Process Costing System
Traces production costs to a specific job order	Traces production costs to processes, departments, or work cells and then assigns the costs to products manufactured
Measures the cost of each completed unit	Measures costs in terms of units completed during a specific period
Uses a single Work in Process Inventory account	Uses several Work in Process Inventory accounts
Measures the cost of all job orders using one inventory account	Measures costs of each process, department, or work cell, using an inventory account for each
Typically used by companies that make unique or special-order products, such as customized publications, built-in cabinets, or made-to-order draperies	Typically used by companies that make large amounts of similar products or liquid products or that have long, continuous production runs of identical products, such as paint, soft drinks, candy, bricks, and paper

## APPLY IT!

State whether a job order costing system or a process costing system would typically be used to account for the costs of the following:

- |   |                                   |
|---|-----------------------------------|
| a. Manufacturing golf tees  | c. Providing pet grooming         |
| b. Manufacturing custom-designed fencing for a specific golf course | d. Manufacturing golf balls       |
|   | e. Manufacturing dog food         |
|   | f. Providing private golf lessons |

### SOLUTION

- a. process; b. job order;  
c. job order; d. process;  
e. process; f. job order

**TRY IT! SE1, E1A, E2A, E3A, E1B, E2B, E3B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Prepare a job order cost card
- Compute a job order's product or service unit cost

## RELEVANT LEARNING OBJECTIVES

**LO 2** Explain the cost flow in a manufacturer's job order costing system.

**LO 3** Prepare a job order cost card, and compute a job order's product or service unit cost.

**LO 4** Explain cost allocation, and describe how allocating overhead costs figures into calculating product or service unit cost.

## LO 2 Job Order Costing in a Manufacturing Company

The basic parts of a job order costing system are the cost measurement and recognition procedures, electronic documents, and accounts that a company uses when it incurs costs for direct materials, direct labor, and overhead. Job order cost cards and cost flows through the inventory accounts form the core of a job order costing system.

As noted at the beginning of the chapter, Custom Golf Carts builds both customized and general-purpose golf carts. To study these cost flows, let's look at how Custom operates.

- Direct materials costs include the costs of a cart frame, wheels, upholstered seats, a windshield, a motor, and a rechargeable battery.
- Direct labor costs include the wages of the two production workers who assemble the golf carts.
- Overhead costs include indirect materials costs for upholstery zippers; cloth straps to hold equipment in place; wheel lubricants, screws and fasteners; silicon to attach the windshield; indirect labor costs for moving materials to the production area and inspecting a golf cart during its construction; depreciation on the manufacturing plant and equipment used to make the golf carts; and utilities, insurance, and property taxes related to the manufacturing plant.

Exhibit 2 shows the flow of each of these costs. The beginning balance in the Materials Inventory account means that there are already direct and indirect materials in the materials storeroom. The beginning balance in Work in Process Inventory means that Job CC is in production (with specifics given in the job order cost card). The zero beginning balance in Finished Goods Inventory means that all previously completed golf carts have been shipped.

### Materials

The purchasing process begins with a request for specific quantities of direct and indirect materials that are needed for a sales order but are not currently available in the materials storeroom. When the new materials arrive, the Accounting Department records the materials purchased. It is helpful to understand the process of tracking production costs as they flow through the three inventory accounts and the entries that are triggered by the organization's source documents. The entries that track product cost flows are provided as background.

#### Purchase of Materials

**Transactions 1 and 2** During the month, Custom made two purchases on credit. In transaction 1, the company purchased cart frames costing \$572 and wheels costing \$340 for a total of \$912. In transaction 2, the company purchased indirect materials costing \$82.

**Analysis** The journal entry to record these purchases

- ▲ increases the *Materials Inventory* account with a debit
- ▲ increases the *Accounts Payable* account with a credit

#### Journal Entries

	Dr.	Cr.
Materials Inventory	912	
Accounts Payable		912
Materials Inventory	82	
Accounts Payable		82

**Comment** Cost of direct and indirect materials are *recognized* when purchased.



**Exhibit 2**

The Job Order Costing System—Custom Golf Carts, Inc.

Materials Inventory			Work in Process Inventory		
Beg. bal.	1,230	(3) 1,880	Beg. bal.	400	(9) 3,880
(1)	912	(3) 96	(3)	1,880	
(2)	82		(4)	1,640	
<b>End. bal.</b>	<b>248</b>		(8)	1,394	
			<b>End. bal.</b>	<b>1,434</b>	
Payroll Payable			Finished Goods Inventory		
		(4) 1,640	Beg. bal.	—	(10) 1,940
		(5) 760	(9)	3,880	
		<b>End. bal.</b> 2,400	<b>End. bal.</b>	<b>1,940</b>	
Overhead			Cost of Goods Sold		
(3)	96	(8) 1,394	(10)	1,940	(11) 3
(5)	760		<b>End. bal.</b>	<b>1,937</b>	
(6)	295				
(7)	240				
	1,391	1,394			
(11)	3				
<b>End. bal.</b>	<b>—</b>				
Cash			Accounts Payable		
		(6) 295		(1) 912	
		<b>End. bal.</b> 295		(2) 82	
				<b>End. bal.</b> 994	
Accounts Receivable			Sales		
(10)	3,000			(10) 3,000	
<b>End. bal.</b>	<b>3,000</b>			<b>End. bal.</b> 3,000	
Accumulated Depreciation					
		(7) 240			
		<b>End. bal.</b> 240			

© Cengage Learning 2014

**Transfer of Direct Materials to Production**

**Transaction 3—Direct Materials** When golf carts are scheduled for production, requested materials are sent to the production area. Custom requested \$1,880 of direct materials for the production of two jobs. These costs are also recorded on the corresponding job order cost cards. Job CC, a batch run of two general-purpose golf carts already in production, required \$1,038 of the additional direct materials. Job JB, a customized golf cart made to the specifications of an individual customer, Alex Special, required \$842 of the direct materials.

**Analysis** The journal entry to record the transfer of direct materials to production

- ▲ increases the *Work in Process Inventory* account with a debit (and also increases the charges to the corresponding job order cost cards)
- ▼ decreases the *Materials Inventory* account with a credit

**Journal Entry**

	<i>Dr.</i>	<i>Cr.</i>
Work in Process Inventory—Job CC	1,038	
Work in Process Inventory—Job JB	842	
Materials Inventory		1,880

**Comment** Custom processes requests for direct materials through journal entries to track cost flows and *measure* the cost of each job order.

**Transfer of Indirect Materials to Production**

**Transaction 3—Indirect Materials** Custom also requests indirect materials. When indirect materials are requested and sent to production, the indirect materials cost flows from the Materials Inventory account into the Overhead account.

**Analysis** The journal entry to record the transfer of indirect materials to production

- ▲ *increases* the *Overhead* account with a debit
- ▼ *decreases* the *Materials Inventory* account with a credit

**Journal Entry**

	<i>Dr.</i>	<i>Cr.</i>
Overhead	96	
Materials Inventory		96

**Comment** Custom processes requests for indirect materials through journal entries to track cost flows and *measure* the actual cost of overhead.

**Labor**

In general, the payroll costs include salaries and wages for direct and indirect production labor as well as for nonproduction-related employees. Custom's two production employees assemble the golf carts. Several other employees support production by moving materials and inspecting the products.

**Payroll Costs Incurred for Production Labor**

**Transactions 4 and 5** Transactions 4 and 5 show the total production-related wages earned by employees during the period. Custom incurred \$1,640 of direct labor costs—\$1,320 for Job CC and \$320 for Job JB—(transaction 4) and \$760 indirect labor costs (transaction 5).

**Analysis** The journal entry to record the direct labor costs

- ▲ *increases* the *Work in Process Inventory* account with a debit
- ▲ *increases* the *Payroll Payable* account with a credit

The journal entry to record the indirect labor costs

- ▲ *increases* the *Overhead* account with a debit
- ▲ *increases* the *Payroll Payable* account with a credit

**Journal Entry**

	<i>Dr.</i>	<i>Cr.</i>
Work in Process Inventory—Job CC	1,320	
Work in Process Inventory—Job JB	320	
Payroll Payable		1,640
Overhead (indirect labor costs)	760	
Payroll Payable		760

**Comment** Custom *recognizes* labor costs through journal entries to *measure* the direct labor cost of each job order and to measure the actual cost of indirect labor and other nonproduction-related labor cost flows into overhead.

## Overhead

Thus far, indirect materials and indirect labor have been the only costs debited to the Overhead account. Other actual indirect production costs, such as utilities, property taxes, insurance, and depreciation, are also charged to the Overhead account as they are incurred during the period.

### Other Overhead Costs Incurred for Production

**Transactions 6 and 7** Transaction 6 shows that other indirect costs amounting to \$295 were paid. Transaction 7 records the \$240 of production-related depreciation.

**Analysis** The journal entry to record incurring actual overhead costs

- ▲ *increases* the *Overhead* account with a debit
- ▼ *decreases* the *Cash* and *Accumulated Depreciation* accounts with a credit

### Journal Entry

	<i>Dr.</i>	<i>Cr.</i>
Overhead	295	
Cash		295
Overhead	240	
Accumulated Depreciation		240

**Comment** Custom *recognizes* actual overhead costs on the debit side of the Overhead account so it can *measure* them against the overhead costs estimated for job orders.

During the period, to *recognize* all product-related costs for a job, an overhead cost estimate is applied to a job using a predetermined rate since the business uses a normal costing method to *measure* product costs. Based on its budget and past experience, Custom currently uses a predetermined overhead rate of 85 percent of direct labor costs.

### Estimate of Overhead Costs

**Transaction 8** In transaction 8, Custom estimates the overhead incurred by each job to date by charging each job order in process with a percentage of its labor cost incurred. Total overhead of \$1,394 is applied to the job orders, with \$1,122 going to Job CC (85 percent of \$1,320) and \$272 going to Job JB (85 percent of \$320).

**Analysis** The journal entry to record applying overhead using a predetermined rate

- ▲ *increases* the *Work in Process Inventory* account with a debit for \$1,394 (85 percent of \$1,640; see transaction 4)
- ▼ *decreases* the *Overhead* account with a credit for the applied overhead of \$1,394

### Journal Entry

	<i>Dr.</i>	<i>Cr.</i>
Work in Process Inventory—Job CC	1,122	
Work in Process Inventory—Job JB	272	
Overhead		1,394

**Comment** Custom compares the actual (debit side of the Overhead account) and applied (credit side of the Overhead account) overhead amounts at the end of the period to determine the accuracy of job order overhead *cost recognition*.

## Completed Units

When a custom job or a batch of general-purpose golf carts is completed and ready for sale, the products are moved from the manufacturing area to the finished goods storeroom.

### Transfer of Completed Production to Finished Goods

**Transaction 9** In transaction 9, a job order is completed and transferred to the Finished Goods Inventory account since it is ready for sale. Custom's Job CC is completed and its cost of \$3,880 is transferred from the Work in Process Inventory account to the Finished Goods Inventory account. The \$3,880 includes the beginning balance of \$400, materials of \$1,038, labor of \$1,320, and overhead of \$1,122. Thus, the cost to produce one golf cart is \$1,940 ( $\$3,880 \div 2$ ).

**Analysis** The journal entry to record completing a job order

- ▲ increases the *Finished Goods Inventory* account with a debit
- ▼ decreases the *Work in Process Inventory* account with a credit

### Journal Entry

	Dr.	Cr.
Finished Goods Inventory	3,880	
Work in Process Inventory—Job CC		3,880

**Comment** When a job order is complete, its job order cost card has *measured* and *recognized* all the costs associated with its production. The job's cost of goods manufactured and product unit cost can be computed. The card is also transferred to the finished goods file.

## Sold Units

When a company uses a perpetual inventory system, as Custom does, two accounting entries are made when products are sold. One is prompted by the sales invoice and records the quantity and selling price of the products sold. The other entry, prompted by the delivery of products to a customer, records the quantity and cost of the products shipped.

### Sales and the Transfer of Production Costs to Cost of Goods Sold

**Transaction 10** In transaction 10, a golf cart is sold to a customer and its cost of the goods sold is recognized. The \$3,000 sales price of the one general-purpose golf cart sold on account by Custom is recorded. As was explained in Transaction 9, the sold golf cart's related cost is \$1,940. This cost is now transferred from the Finished Goods Inventory account to the Cost of Goods Sold account.

**Analysis** The journal entry to record a product's sales price and associated costs

- ▲ increases the *Accounts Receivable* account
- ▲ increases the *Sales* account
- ▲ increases the *Cost of Goods Sold* account
- ▼ decreases the *Finished Goods Inventory* account

### Journal Entries

	Dr.	Cr.
Accounts Receivable (sales price of 1 unit sold)	3,000	
Sales (sales price of 1 unit sold)		3,000
Cost of Goods Sold (unit cost)	1,940	
Finished Goods Inventory (unit cost)		1,940

**STUDY NOTE:** In this example, the company uses a perpetual inventory system. In a periodic inventory system, the cost of goods sold is calculated at the end of the period.

**Comment** When a job or product is sold, its revenues are *matched* with its costs. Since the job or product's revenue and costs have been *measured* and *recognized*, profitability can be analyzed. Notice the Finished Goods Inventory account has an ending balance of \$1,940 for the one remaining unsold car from Job CC.

## APPLY IT!

Partial operating data for Sample Company follows. Sample's management has set the predetermined overhead rate for the current year at 60 percent of direct labor costs.

Account/Transaction	October
Beginning Materials Inventory	\$ 4,000
Beginning Work in Process Inventory	6,000
Beginning Finished Goods Inventory	2,000
Direct materials used	16,000
Direct materials purchased	(a)
Direct labor costs	24,000
Overhead applied	(b)
Cost of units completed	(c)
Cost of Goods Sold	50,000
Ending Materials Inventory	3,000
Ending Work in Process Inventory	10,000
Ending Finished Goods Inventory	(d)

Using T accounts, compute the unknown values. Show all your computations.

### SOLUTION

Materials Inventory			
Beg. bal.	4,000	Used	16,000
(a) Purchases	15,000		
<b>End. bal.</b>	<b>3,000</b>		

Work in Process Inventory			
Beg. bal.	6,000	(c) Completed during period	50,400
Direct materials used	16,000		
Direct labor	24,000		
(b) Overhead applied	14,400*		
<b>End. bal.</b>	<b>10,000</b>		

Finished Goods Inventory			
Beg. bal.	2,000	Cost of goods sold	50,000
(c) Completed during period	50,400		
(d) <b>End. bal.</b>	<b>2,400</b>		

\*\$24,000 × 60% = \$14,400

**TRY IT! SE2, SE3, SE4, E4A, E5A, E6A, E7A, E8A, E4B, E5B, E6B, E7B, E8B**

## Lo 3 A Job Order Cost Card and the Computation of Unit Cost

**STUDY NOTE:** Traditionally, job order cost cards were paper, but today, most cards reside electronically in a computer system.

In a job order costing system, each job in production has a job order cost card. As costs are incurred, they are classified by job and recorded on the appropriate card.

### A Manufacturer's Job Order Cost Card

A manufacturer's job order cost card typically has space for direct materials, direct labor, and overhead costs, as shown in Exhibit 3. It also includes the job order number, product specifications, customer name, date of the order, projected completion date, and a cost summary. As a job incurs direct materials and direct labor costs, its job order cost card is updated. Overhead is also posted to the job order cost card at the predetermined rate.

Job order cost cards for incomplete jobs make up the subsidiary ledger for the Work in Process Inventory account. To ensure correctness, the ending balance in the Work in Process Inventory account is compared with the total of the costs shown on the job order cost cards.

### Computation of Unit Cost

A job order costing system simplifies the calculation of product unit costs. When a job is finished, the costs of direct materials, direct labor, and overhead that have been recorded on its job order cost card are totaled. The product unit cost is then computed and entered on the job order cost card. It will be used to value items in inventory. The job

**Exhibit 3**  
Job Order Cost Card for a  
Manufacturing Company

Job Order: <u>CC</u>			
<b>JOB ORDER COST CARD *</b> Custom Golf Carts, Inc. Spring Hill, Florida			
Customer:	<u>Stock</u>	Batch:	<u>x</u> Custom: _____
Specifications:	<u>Two general-purpose golf carts</u>		
Date of Order:	<u>2/26/14</u>		
Date of Completion:	<u>3/6/14</u>		
Costs Charged to Job	Previous Months	Current Month	Total Cost
Direct materials	\$165	\$1,038	\$1,203
Direct labor	127	1,320	1,447
Overhead (85% of direct labor cost)	108*	1,122	1,230*
Totals	<u>\$400</u>	<u>\$3,480</u>	<u>\$3,880</u>
<b>Units completed</b>			÷ <u>2</u>
<b>Product unit cost</b>			<u>\$1,940</u>
*Rounded to nearest dollar			

© Cengage Learning 2014

order cost card in Exhibit 3 shows the costs for completed Job CC. The product unit cost is computed as follows.

$$\begin{aligned}
 \text{Product Unit Cost} &= \text{Total Costs for Job} \div \text{Number of Good (Salable) Units Produced} \\
 &= \$3,880 \div 2 \\
 &= \underline{\underline{\$1,940}}
 \end{aligned}$$

## Job Order Costing in a Service Organization

Many service organizations use a job order costing system to compute the cost of rendering services. The most important cost for a service organization is labor, which is accounted for through the use of time cards. The cost flow of services is similar to the cost flow of manufactured products. Job order cost cards are used to keep track of the labor, materials and supplies, and service overhead incurred for each job.

To cover these costs and earn a profit, many service organizations base jobs on **cost-plus contracts**. Such contracts require the customer to pay all costs incurred in performing the job plus a predetermined amount of profit, which is based on the amount of costs incurred. When the job is complete, the costs on the completed job order cost card become the cost of services.

To illustrate how a service organization uses a job order costing system, assume that Dream Golf Retreats earns its revenue by designing and selling golf retreat packages to corporate clients. Exhibit 4 shows Dream Golf Retreats' job order cost card for Work Corporation. Costs have been categorized into three separate activities: planning, golf activities, and nongolf activities.

**STUDY NOTE:** Job order cost cards for service businesses record costs by activities done for the job. The activity costs may include supplies, labor, and overhead.

**Exhibit 4**  
Job Order Cost Card for a Service Organization

Job Order: <u>2011-A7</u>			
<b>JOB ORDER COST CARD</b>			
Dream Golf Retreats			
<b>Customer:</b>	<u>Work Corporation</u>	<b>Batch:</b> _____	<b>Custom:</b> <u>X</u>
<b>Specifications:</b>	<u>Golf retreat for 45 executives</u>		
<b>Date of Order:</b>	<u>3/24/14</u>	<b>Date of Completion:</b> <u>4/8/14</u>	
	<b>Previous Months</b>	<b>Current Month</b>	<b>Total Cost</b>
<b>Costs Charged to Job</b>			
Planning:			
Supplies	\$ 100	\$ —	\$ 100
Labor	850		850
Overhead (40% of planning labor costs)	340	—	340
Totals	<u>\$1,290</u>	<u>\$ 0</u>	<u>\$1,290</u>
Golf activities:			
Supplies	\$ 970	\$1,200	\$2,170
Labor	400	620	1,020
Overhead (50% of on-site labor costs)	200	310	510
Totals	<u>\$1,570</u>	<u>\$2,130</u>	<u>\$3,700</u>
Nongolf activities:			
Cost of outsourcing	\$ 90	\$ 320	\$ 410
Totals	<u>\$ 90</u>	<u>\$ 320</u>	<u>\$ 410</u>
<b>Cost Summary to Date</b>		<b>Total Cost</b>	
Planning		\$1,290	
Golf activities		3,700	
Nongolf activities		410	
Total		<u>\$5,400</u>	
Profit margin (15% of total cost)		810	
Job revenue		<u>\$6,210</u>	

© Cengage Learning 2014

As Exhibit 4 illustrates, the service overhead cost for planning is 40 percent of planning labor cost ( $\$850 \times 0.40 = \$340$ ) and the service overhead cost for golf activities is 50 percent of on-site labor cost ( $\$1,020 \times 0.50 = \$510$ ). Total costs incurred for this job were \$5,400. Dream Golf Retreats' cost-plus contract with Work Corporation has a 15 percent profit guarantee. Therefore, \$810 of profit margin ( $\$5,400 \times 0.15 = \$810$ ) is added to the total cost to arrive at the total contract revenue ( $\$5,400 + \$810 = \$6,210$ ), which is billed to Work Corporation.



**APPLY IT!**

Complete the following job order cost card for six handcrafted sets of golf clubs:

**Job Order 16**

**JOB ORDER COST CARD  
Craftsman Golf Clubs  
World of Golf, FL**

Customer: Kalpesh Patel Batch:      Custom: X  
 Specifications: 6 sets of clubs  
 Date of Order: 5/4/14 Date of Completion: 6/8/14

Costs Charged to Job	Previous Months	Current Month	Total Cost
Direct materials	\$3,500	\$2,800	\$ ?
Direct labor	2,300	1,600	?
Overhead applied	1,150	800	?
Totals	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>
Units completed			÷ ?
Product unit cost			<u>\$ ?</u>

**SOLUTION**

**Job Order 16**

**JOB ORDER COST CARD  
Craftsman Golf Clubs  
World of Golf, FL**

Customer: Kalpesh Patel Batch:      Custom: X  
 Specifications: 6 sets of clubs  
 Date of Order: 5/4/14 Date of Completion: 6/8/14

Costs Charged to Job	Previous Months	Current Month	Total Cost
Direct materials	\$3,500	\$2,800	\$ 6,300
Direct labor	2,300	1,600	3,900
Overhead applied	1,150	800	1,950
Totals	<u>\$6,950</u>	<u>\$5,200</u>	<u>\$12,150</u>
Units completed			÷ 6
Product unit cost			<u>\$ 2,025</u>

**TRY IT! SE5, SE6, SE7, E6A, E7A, E8A, E9A, E10A, E11A, E12A, E13A, E6B, E7B, E8B, E9B, E10B, E11B, E12B, E13B**

**LO 4 Cost Allocation**

The costs of direct materials and direct labor can be easily traced to a product or service, but overhead costs are indirect costs that must be collected and allocated in some manner since their physical flow and how these costs are incurred do not always match. For example, utilities are used daily, but the utility bill comes once a month.

- **Cost allocation** is the process of assigning a collection of indirect costs, such as overhead, to a specific **cost object**, such as a product or service, a department, or an operating activity, using an allocation base known as a cost driver.
- A **cost driver** might be direct labor hours, direct labor costs, units produced, or another activity base that has a cause-and-effect relationship with the cost.
- As the cost driver increases in volume, it causes the **cost pool**—the collection of indirect costs assigned to a cost object—to increase in amount.



AfrIPics.com/Alamy

Cost allocation is the process of assigning costs to a specific cost object using a cost driver. This ties the cost to an identifiable and measurable activity base.

## Allocating the Costs of Overhead

Allocating overhead costs to products or services is a four-step process.

**Step 1. Planning the Overhead Rate** Before a period begins, managers determine cost pools and cost drivers and calculate a **predetermined overhead rate** as follows.

$$\text{Predetermined Overhead Rate} = \frac{\text{Estimated Overhead Costs}}{\text{Estimated Cost Driver Activity}}$$

For example, earlier in this chapter, Custom Golf Carts used a predetermined overhead rate of 85 percent of direct labor costs.

**Step 2. Applying the Overhead Rate** As units of the product or service are produced during the period, the estimated overhead costs are assigned to the product or service using the predetermined overhead rate as follows.

$$\text{Overhead Applied} = \text{Predetermined Overhead Rate} \times \text{Actual Cost Driver Activity}$$

The purpose of this calculation is to assign a consistent overhead cost to each unit produced during the period.

Custom used a predetermined overhead rate of 85 percent of direct labor costs to apply overhead of \$1,394, with \$1,122 going to Job CC (85% of \$1,320 direct labor costs) and \$272 going to Job JB (85% of \$320 direct labor costs) as shown in Transaction 8 in Exhibit 2.

**Step 3. Recording Actual Overhead Costs** The actual overhead costs are recorded as they are incurred during the period. These costs include the actual costs of indirect materials, indirect labor, depreciation, property taxes, and other production costs. The entry for the actual overhead costs debits the Overhead account and credits the asset, contra-asset, or liability account(s) affected.

For example, Custom incurred actual overhead costs for indirect materials, indirect labor, other indirect costs, and production-related depreciation by debiting Overhead and crediting the appropriate accounts, as shown in Transactions 3, 5, 6, and 7 in Exhibit 2.

**Step 4. Reconciling the Applied and Actual Overhead Amounts** At the end of the period, the difference between the applied and actual overhead costs is calculated and reconciled.

For example, Custom incurred actual overhead costs of \$1,391 and applied overhead of \$1,394, as shown in the Overhead account in Exhibit 2.

Overhead	
(3)	96
(5)	760
(6)	295
(7)	240
	1,394
	Bal. (overapplied)
	3

**Overapplied Overhead** If the overhead costs applied to production during the period are greater than the actual overhead costs, the difference in the amounts represents **overapplied overhead costs**. If this difference is immaterial, the Overhead account

**STUDY NOTE:** Why do financial statements require the reconciliation of overhead costs? Financial statements report actual cost information; therefore, estimated overhead costs applied during the accounting period must be adjusted to reflect actual overhead costs.

is debited or increased and the Cost of Goods Sold or Cost of Sales account is credited or decreased by the difference. If the difference is material for the products produced, adjustments are made to the accounts affected—that is, the Work in Process Inventory, Finished Goods Inventory, and Cost of Goods Sold accounts.

For example, Custom determined that actual overhead cost for the period (\$1,391) is less than the overhead applied during the period (\$1,394), resulting in the \$3 credit balance. This \$3 overapplied balance must be closed to the Cost of Goods Sold account, as shown in Transaction 11 in Exhibit 2.

**Closing the Overhead Account**

**Transaction 11** In transaction 11, Custom closes the Overhead account balance to Cost of Goods Sold at the end of a period so the Cost of Goods Sold account will contain the actual costs of direct materials, direct labor, and overhead. Overhead has a \$3 credit balance so Custom has overapplied overhead costs to the jobs produced.

**Analysis** The journal entry to close immaterial overapplied overhead

- ▲ increases the *Overhead* account with a debit
- ▼ decreases the *Cost of Goods Sold* account with a credit

**Journal Entry**

	<i>Dr.</i>	<i>Cr.</i>
Overhead	3	
Cost of Goods Sold		3

**Comment** Custom compares the actual (debit side of the Overhead account) and applied (Credit side of the Overhead account) overhead amounts at the end of the period and closes the difference to improve the accuracy of *cost measurement* of products produced and sold.

**Underapplied Overhead** If the overhead costs applied to production during the period are less than the actual overhead costs, the difference represents **underapplied overhead costs**. If the difference is immaterial, the Cost of Goods Sold or Cost of Sales account is debited or increased and the Overhead account is credited or decreased by this difference. If the difference is material for the products produced, adjustments are made to the accounts affected—that is, the Work in Process Inventory, Finished Goods Inventory, and Cost of Goods Sold accounts.

If the actual overhead debit balance exceeds the applied overhead credit balance, then the Overhead account is said to be underapplied and the debit balance must be closed to the Cost of Goods Sold account. The journal entry would be as follows.

	<i>Dr.</i>	<i>Cr.</i>
Cost of Goods Sold	XX	
Overhead		XX

**Actual Cost of Goods Sold or Cost of Sales**

The adjustment for overapplied or underapplied overhead costs is necessary to reflect the actual overhead costs on the income statement. For example, Custom Golf Carts determined Cost of Goods Sold ending balance was actually \$1,937 after the overapplied amount of \$3 reduced Cost of Goods Sold, as shown in Exhibit 2.

Exhibit 5 summarizes the four steps involved in allocating overhead costs to products or services in terms of their timing, the procedures involved, and the entries required. It also shows how the cost flows in the various steps affect the accounting records.

**Exhibit 5**  
Allocating Overhead Cost: A Four-Step Process



	Step 1: Planning the Overhead Rate	Step 2: Applying the Overhead Rate	Step 3: Recording Actual Overhead Costs	Step 4: Reconciling Applied and Actual Overhead Costs																																												
<b>Timing and Procedure</b>	Before the accounting period begins, determine cost pools and cost drivers. Calculate the overhead rate by dividing the cost pool of total estimated overhead costs by the total estimated cost driver level.	During the accounting period, as units are produced, apply overhead costs to products by multiplying the predetermined overhead rate for each cost pool by the actual cost driver level for that pool. Record costs.	Record actual overhead costs as they are incurred during the accounting period.	At the end of the accounting period, calculate and reconcile the difference between applied and actual overhead costs.																																												
<b>Entry</b>	None	Increase Work in Process Inventory account and decrease Overhead account: Dr. Work in Process Inventory    XX Cr. Overhead                    XX	Increase Overhead account and decrease asset accounts or increase contra-asset or liability accounts: Dr. Overhead                    XX Cr. Various Accounts       XX	Entry will vary depending on how costs have been applied. If overapplied, increase Overhead and decrease Cost of Goods Sold. If underapplied, increase Cost of Goods Sold and decrease Overhead.																																												
<b>Cost Flow Through the Accounts</b>		<table border="1" style="margin-left: auto; margin-right: auto;"> <tr><td colspan="2" style="text-align: center;">Overhead</td></tr> <tr><td style="width: 50%;"></td><td style="width: 50%; text-align: center;">Overhead applied using predetermined rate</td></tr> <tr><td colspan="2" style="text-align: center;">Work in Process Inventory</td></tr> <tr><td style="width: 50%;"></td><td style="width: 50%; text-align: center;">Overhead applied using predetermined rate</td></tr> </table>	Overhead			Overhead applied using predetermined rate	Work in Process Inventory			Overhead applied using predetermined rate	<table border="1" style="margin-left: auto; margin-right: auto;"> <tr><td colspan="2" style="text-align: center;">Overhead</td></tr> <tr><td style="width: 50%; text-align: center;">Actual overhead costs recorded</td><td style="width: 50%;"></td></tr> <tr><td colspan="2" style="text-align: center;">Various Asset and Liability Accounts</td></tr> <tr><td style="width: 50%;"></td><td style="width: 50%; text-align: center;">Actual overhead costs recorded</td></tr> </table>	Overhead		Actual overhead costs recorded		Various Asset and Liability Accounts			Actual overhead costs recorded	<table border="1" style="margin-left: auto; margin-right: auto;"> <tr><td colspan="2" style="text-align: center;">Overapplied: Overhead</td></tr> <tr><td style="width: 50%;">Actual overhead costs recorded</td><td style="width: 50%;">Overhead applied using predetermined rate</td></tr> <tr><td colspan="2" style="text-align: center;">Overapplied</td></tr> <tr><td>Bal.</td><td style="text-align: center;">\$0</td></tr> <tr><td colspan="2" style="text-align: center;">Cost of Goods Sold</td></tr> <tr><td>Bal.</td><td style="text-align: center;">Overapplied</td></tr> <tr><td colspan="2" style="text-align: center;">Actual Bal.</td></tr> <tr><td colspan="2" style="text-align: center;">Underapplied: Overhead</td></tr> <tr><td style="width: 50%;">Actual overhead costs recorded</td><td style="width: 50%;">Overhead applied using predetermined rate</td></tr> <tr><td colspan="2" style="text-align: center;">Underapplied</td></tr> <tr><td>Bal.</td><td style="text-align: center;">\$0</td></tr> <tr><td colspan="2" style="text-align: center;">Cost of Goods Sold</td></tr> <tr><td>Bal.</td><td style="text-align: center;">Underapplied</td></tr> <tr><td colspan="2" style="text-align: center;">Actual Bal.</td></tr> </table>	Overapplied: Overhead		Actual overhead costs recorded	Overhead applied using predetermined rate	Overapplied		Bal.	\$0	Cost of Goods Sold		Bal.	Overapplied	Actual Bal.		Underapplied: Overhead		Actual overhead costs recorded	Overhead applied using predetermined rate	Underapplied		Bal.	\$0	Cost of Goods Sold		Bal.	Underapplied	Actual Bal.	
Overhead																																																
	Overhead applied using predetermined rate																																															
Work in Process Inventory																																																
	Overhead applied using predetermined rate																																															
Overhead																																																
Actual overhead costs recorded																																																
Various Asset and Liability Accounts																																																
	Actual overhead costs recorded																																															
Overapplied: Overhead																																																
Actual overhead costs recorded	Overhead applied using predetermined rate																																															
Overapplied																																																
Bal.	\$0																																															
Cost of Goods Sold																																																
Bal.	Overapplied																																															
Actual Bal.																																																
Underapplied: Overhead																																																
Actual overhead costs recorded	Overhead applied using predetermined rate																																															
Underapplied																																																
Bal.	\$0																																															
Cost of Goods Sold																																																
Bal.	Underapplied																																															
Actual Bal.																																																

© Cengage Learning 2014

## Allocating Overhead: The Traditional Approach

The traditional approach to applying overhead costs to a product or service is to use a single plantwide overhead rate. This approach is especially useful when companies manufacture only one product or a few very similar products that require the same production processes and production-related activities, such as setup, inspection, and materials handling. The total overhead costs constitute one cost pool, and a traditional activity base—such as direct labor hours, direct labor costs, machine hours, or units of production—is the cost driver.

## Allocating Overhead: The ABC Approach

**Activity-based costing (ABC)** is a more accurate method of assigning overhead costs to products or services. It categorizes all indirect costs by activity, traces the indirect costs to those activities, and assigns activity costs to products or services using a cost driver related to the cause of the cost. A company that uses ABC identifies production-related activities or tasks and the events that cause, or drive, those activities, such as number of inspections or maintenance hours. As a result, many smaller activity pools are created from the single overhead cost pool used in the traditional method. This means that managers will calculate many rates. There will be an activity cost rate for each activity pool, which must be applied to products or services produced. Managers must select an appropriate number of activity pools instead of the traditional plantwide rate for overhead.

More careful cost allocation means that managers will have better information for decision making. The ABC approach to allocating overhead will be covered in a later chapter.

### APPLY IT!

1. Compute the predetermined overhead rate for Sample Service Company if its estimated overhead costs for the coming year will be \$15,000 and 5,000 direct labor hours will be worked.
2. Calculate the amount of overhead costs applied by Sample Company to one of its jobs if the job required 10 direct labor hours to complete.
3. Compute the total cost of the job if prime (direct material and direct labor) costs incurred by Sample Company to complete it were \$60. If the job contained 5 units of service, what is the unit cost?
4. Using the traditional overhead rate computed in Step 1, determine the total amount of overhead applied to operations during the year if Sample Company compiles a total of 4,900 labor hours worked.
5. If Sample Company's actual overhead costs for the year are \$14,800, compute the amount of under- or overapplied overhead for the year. Will the Cost of Goods Sold account be increased or decreased to correct the under- or overapplication of overhead?

### SOLUTION

1. Predetermined Overhead Rate =  $\frac{\text{Estimated Overhead Costs}}{\text{Estimated Direct Labor Hours (DLH)}}$   
 $= \frac{\$15,000}{5,000 \text{ DLH}} = \$3 \text{ per DLH}$
2. Overhead Costs Applied = Predetermined Overhead Rate  $\times$  Actual Hours Worked  
 $= \$3 \text{ per DLH} \times 10 \text{ Actual Direct Labor Hours Worked}$   
 $= \underline{\$30}$
3. Total Cost = Prime Costs + Applied Overhead Cost  
 $= \$60 + \$30$   
 $= \underline{\$90}$   
 Unit Cost =  $\frac{\text{Total Cost of Job}}{\text{Units Produced}}$   
 $= \frac{\$90}{5 \text{ units}}$   
 $= \underline{\$18 \text{ per unit}}$
4. Overhead Costs Applied = Predetermined Overhead Rate  $\times$  Actual Hours Worked  
 $= \$3 \text{ per DLH} \times 4,900 \text{ Actual Hours Worked}$   
 $= \underline{\$14,700}$
5. Overhead Costs Applied = \$14,700  
 Actual Overhead Costs = 14,800  
 Underapplied Overhead =  $\underline{\$100}$ , which will increase the Cost of Goods Sold account

**TRY IT! SE8, SE9, SE10, E9A, E10A, E11A, E12A, E13A, E14A, E15A, E9B, E10B, E11B, E12B, E13B, E14B, E15B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

**LO 5** Explain why unit cost measurement is important to the management process in producing business results.

## **LO 5** Product Unit Cost Information and the Management Process

Managers depend on relevant and reliable information about costs to manage their organizations. Although they vary in their approaches, managers share the same basic concerns as they move through the management process.

### Planning

Managers' unit cost knowledge helps them set reasonable selling prices and estimate the cost of their products or services.

- In manufacturing companies, such as Custom Golf Carts, **Toyota**, and **Levi Strauss & Co.**, managers use unit cost information to develop budgets, establish product prices, and plan production volumes.
- In service organizations, such as **Google**, **H&R Block**, and **UPS**, managers use cost information to develop budgets, establish prices, set sales goals, and determine human resource needs.

### Performing

Managers make decisions every day about controlling costs, managing the company's activity volume, ensuring quality, and negotiating prices. They use timely cost and volume information and actual unit costs to support their decisions.

- In manufacturing companies, managers use cost information to decide whether to drop a product line, add a production shift, outsource the manufacture of a subassembly to another company, bid on a special order, or negotiate a selling price.
- In service organizations, managers use cost information to make decisions about bidding on jobs, dropping a current service, outsourcing a task to an independent contractor, adding staff, or negotiating a price.

### Evaluating

When managers evaluate results, they watch for changes in cost and quality. They compare actual and targeted total and unit costs, assess relevant price and volume information, and then adjust their planning and decision-making strategies. For example, if a service business's unit cost has risen, managers may break the unit cost down into its many components to analyze where costs can be cut or how the service can be performed more efficiently.

### Communicating

Internal and external users analyze the data in the performance evaluation reports to determine whether the business is achieving cost goals. When managers report to stakeholders, they prepare financial statements.

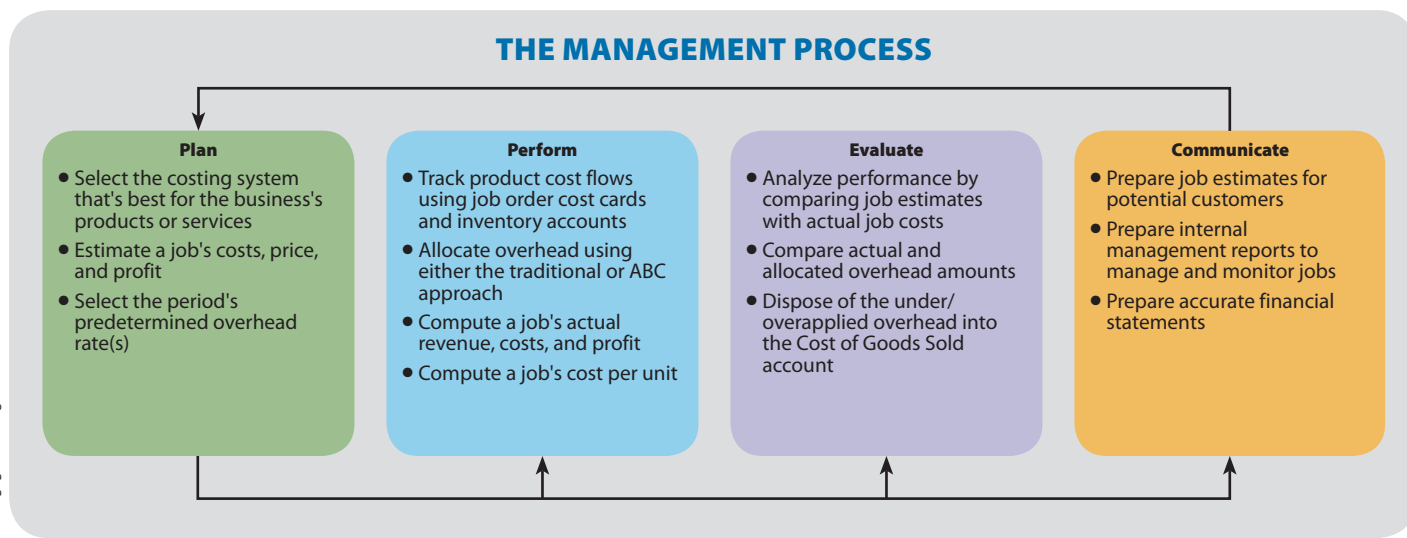
- In manufacturing companies, managers use product unit costs to determine inventory balances and the cost of goods sold.
- In service organizations, managers use unit costs of services to determine the cost of sales.

When managers prepare internal performance evaluation reports, they compare actual unit costs with targeted costs, as well as actual and targeted nonfinancial measures of performance.

### Supporting the Management Process

Exhibit 6 shows how managers use unit cost information throughout the management process to fulfill the management concepts of planning and forecasting operations, organizing and coordinating resources and data, and commanding and controlling the organization’s resources.

**Exhibit 6**  
Job Order Costing and the Management Process



## APPLY IT!

Shelley’s Kennel provides pet boarding. Shelley, the owner, must make several business decisions soon. Write *yes* or *no* to indicate whether knowing the cost to board one animal for one day (i.e., the service unit cost) can help Shelley answer these questions.

- Is the daily boarding fee high enough to cover the kennel’s costs?
- How much profit will the kennel make if it boards an average of 10 dogs per day for 50 weeks?
- What costs can be reduced to make the kennel’s boarding fee competitive with other kennels?

### SOLUTION

a. yes; b. yes; c. yes

### TRY IT! SE11



## TriLevel Problem



Digital Vision/Jupiter Images

**Custom Golf Carts, Inc.**

The beginning of this chapter focused on Custom Golf Carts, Inc., a company that makes both general-purpose and customized golf carts. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*Why is a job order costing system appropriate for Custom Golf Carts to measure and recognize costs?*

### Section 2: Accounting Applications

*How does a product costing system account for costs when made-to-order products or services are produced?*

Suppose Custom Golf Carts owners have formed an independent loyalty owners club. Periodically, golf cart owners gather at the company headquarters for reunion parties complete with an owner golf cart parade and a golf cart-shaped cake. Custom Golf Carts uses a job order costing system to keep track of the costs of each reunion party. Job costs (direct materials and supplies, direct labor, and service overhead) are categorized under three activities: planning and design, reunion, and cleanup. The service overhead charge for planning and design is 30 percent of the party planner's labor costs, and the service overhead charge for the reunion is 50 percent of the cost of the cake created for the party. Custom Golf Carts uses a cost-plus contract with a 20 percent profit guarantee for each party when billing the club sponsors for the parties.

One of Custom's managers has tracked all of the costs of a reunion party that was contracted on May 28, 2014, and scheduled for June 5, 2014. Now that the work is finished, it is time to complete the job order cost card and bill the sponsor. The costs for the reunion party job follow:

<b>Costs during May</b>	
Planning and design:	
Supplies	\$100
Party planner labor	250
<b>Costs during June</b>	
Reunion:	
Cake creation	500
Direct labor	160
Cleanup:	
Janitorial service cost	400

1. Create the job order cost card for the reunion party job.
2. What amount will the manager bill for the job?
3. Using the format of the Work in Process Inventory account in Exhibit 2, reconstruct the beginning balance and costs for the current month. What is the ending balance for the account?

**Section 3: Business Applications**

How does a job order costing system help managers organize and control costs and facilitate management decisions? To answer this question, match this chapter's manager responsibilities with when they occur within the management process.

- |                |  |
|----------------|--|
| a. Plan        | 1. Compute a job's cost per unit                                   |
| b. Perform     | 2. Select the best product costing system                          |
| c. Evaluate    | 3. Compare actual and allocated overhead amounts                   |
| d. Communicate | 4. Compute a job's actual costs, price, and profit                 |
|                | 5. Estimate a job's costs, price, and profit                       |
|                | 6. Prepare accurate financial statements                           |
|                | 7. Compare actual job costs with job estimates                     |
|                | 8. Compute the predetermined overhead rate(s)                      |
|                | 9. Track the flow of product costs                                 |
|                | 10. Prepare job estimates for potential customers                  |
|                | 11. Prepare internal management reports                            |
|                | 12. Dispose of under/overapplied overhead to Cost of Goods Sold    |
|                | 13. Allocate overhead using either the traditional or ABC approach |

**SOLUTION****Section 1: Concepts**

Whether a product costing system is appropriate to *measure* and *recognize* costs depends on the nature of the production process. Because the production of custom-made items and the production of mass-produced items involve different processes, they require different costing systems to measure and recognize product costs. When a product is made to order like the customized golf cart, it is possible to use a job order costing system, which recognizes and collects the costs of each order and *matches* them against the revenue generated by the order. When a product is mass produced, like the general-purpose golf cart, the costs of a specific unit cannot be recognized because there is a continuous flow of similar products. For this reason, a process costing system is used to collect and match a period's costs and revenues for the products sold.

**Section 2: Accounting Applications**

1.

**JOB ORDER COST CARD****Custom Golf Carts, Inc.**

Customer: Loyalty Owners Club Batch:      Custom: X  
 Specifications: Reunion party  
 Date of Order: 5/28/2014 Date of Completion: 6/5/2014

<b>Cost Charged to Job</b>	<b>Previous Month</b>	<b>Current Month</b>	<b>Total Costs</b>
<b>Planning and design:</b>			
Supplies	\$100	\$ —	\$ 100
Party planner labor	250	—	250
Overhead (30% of planning labor costs)	75	—	75
Totals	<u>\$425</u>	<u>\$ —</u>	<u>\$ 425</u>
<b>Reunion:</b>			
Cake creation	\$ —	\$ 500	\$ 500
Direct labor	—	160	160
Overhead (50% of cake creation cost)	—	250	250
Totals	<u>\$ —</u>	<u>\$ 910</u>	<u>\$ 910</u>
<b>Cleanup:</b>			
Janitorial service costs		\$ 400	\$ 400
Total		<u>\$ 400</u>	<u>\$ 400</u>
<b>Cost Summary to Date</b>			
Planning			\$ 425
Reunion			910
Cleanup			400
Total			<u>\$1,735</u>
Profit margin (20% of total cost)			347
Job revenue			<u>\$2,082</u>

2. The manager will bill \$2,082.00 for this job.

3.

**Work in Process Inventory**

Beg. bal.	0	Completed and transferred to Cost of Sales	1,735
<b>Planning and design:</b>			
Supplies	100		
Party planner labor	250		
Overhead	75		
<b>Party:</b>			
Cake creation	500		
Direct labor	160		
Overhead	250		
<b>Cleanup:</b>			
Janitorial service costs	400		
<b>End. bal.</b>	<u>—</u>		

**Section 3: Business Applications**

- |      |       |
|------|-------|
| 1. b | 8. a  |
| 2. a | 9. b  |
| 3. c | 10. d |
| 4. b | 11. d |
| 5. a | 12. b |
| 6. d | 13. b |
| 7. c |       |

**Chapter Review**

**Distinguish between the two basic types of product costing systems, and identify the information that each provides.** **LO 1**

A job order costing system is a product costing system used by companies that make unique, custom, or special-order products. Such a system traces the costs of direct materials, direct labor, and overhead to a specific batch of products or to a specific job order. A job order costing system measures the cost of each complete unit and summarizes the cost of all jobs in a single Work in Process Inventory account that is supported by job order cost cards.

A process costing system is a product costing system used by companies that produce large amounts of similar products or liquid products or that have long, continuous production runs of identical products. Such a system first traces the costs of direct materials, direct labor, and overhead to processes, departments, or work cells and then assigns the costs to the products manufactured by those processes, departments, or work cells. A process costing system uses several Work in Process Inventory accounts, one for each department, process, or work cell.

**Explain the cost flow in a manufacturer's job order costing system.** **LO 2**

In a manufacturer's job order costing system, the costs of materials are first charged to the Materials Inventory account. The actual overhead costs are debited to the Overhead account. As products are manufactured, the costs of direct materials and direct labor are debited to the Work in Process Inventory account and are recorded on each job's job order cost card. Overhead costs are applied and debited to the Work in Process Inventory account and credited to the Overhead account using a predetermined overhead rate. They too are recorded on the job order cost card. When products and jobs are completed, their costs are transferred to the Finished Goods Inventory account. Then, when the products are sold and shipped, their costs are transferred to the Cost of Goods Sold account.

**Prepare a job order cost card, and compute a job order's product or service unit cost.** **LO 3**

All costs of direct materials, direct labor, and overhead for a particular job are accumulated on a job order cost card. When the job has been completed, those costs are totaled. The total is then divided by the number of good units produced to find the product unit cost. The product unit cost is entered on the job order cost card and will be used to value items in inventory.

Many service organizations use a job order costing system to track the costs of labor, materials and supplies, and service overhead to specific customer jobs. Labor is an important cost for service organizations. To cover their costs and earn a profit, service organizations often base jobs on cost-plus contracts, which require the customer to pay all costs incurred plus a predetermined amount of profit.

Explain cost allocation, and describe how allocating overhead costs figures into calculating product or service unit cost. **LO 4**

Cost allocation is the process of assigning indirect costs to a specific cost object using an allocation base known as a cost driver. The allocation of overhead costs requires the pooling of overhead costs that are affected by a common activity and the selection of a cost driver whose activity level causes a change in the cost pool. A cost pool is the collection of overhead costs assigned to a cost object. A cost driver is an activity base that causes the cost pool to increase in amount as the volume of activity increases.

Allocating overhead is a four-step process that involves planning a rate at which overhead costs will be assigned to products or services, assigning overhead costs at this predetermined rate to products or services during production, recording actual overhead costs as they are incurred, and reconciling the difference between the actual and applied overhead costs. The Cost of Goods Sold or Cost of Sales account is corrected for an amount of over- or underapplied overhead costs assigned to the products or services. In manufacturing companies, if the difference is material, adjustments are made to the Work in Process Inventory, Finished Goods Inventory, and Cost of Goods Sold accounts.

The traditional method applies overhead costs by estimating one predetermined overhead rate and multiplying that rate by the actual cost driver level. When the ABC method is used, overhead costs are grouped into a number of cost pools related to specific activities. For each activity pool, cost drivers are identified, and cost driver levels are estimated. Overhead is applied to the product or service by multiplying the various activity rates by their actual cost driver level. The product or service unit cost is computed either by dividing the total product or service cost by the total number of units produced or by determining the cost per unit for each element of the cost and summing those per-unit costs.

Explain why unit cost measurement is important to the management process in producing business results. **LO 5**

When managers plan, information about costs helps them develop budgets, establish prices, set sales goals, plan production volumes, estimate product or service unit costs, and determine human resource needs. Daily, managers use cost information to make decisions about controlling costs, managing the company's volume of activity, ensuring quality, and negotiating prices. When managers evaluate results, they analyze actual and targeted information to evaluate performance and make any necessary adjustments to their planning and decision-making strategies. When managers communicate with stakeholders, they use unit costs to determine inventory balances and the cost of goods or services sold for the financial statements. They also use internal reports that compare the organization's measures of actual and targeted unit costs to determine whether the cost goals for products or services are being achieved. Reports may also contain nonfinancial measures of performance.

## Key Terms

### activity-based costing

(ABC) 817 (LO4)

**cost allocation** 813 (LO4)

**cost driver** 813 (LO4)

**cost object** 813 (LO4)

**cost-plus contracts** 811 (LO3)

**cost pool** 813 (LO4)

**job order** 804 (LO1)

**job order cost card** 804 (LO1)

**job order costing system** 804 (LO1)

**operations costing**

**system** 804 (LO1)

**overapplied overhead**

**costs** 814 (LO4)

**predetermined overhead**

**rate** 814 (LO4)

**process cost report** 804 (LO1)

**process costing system** 804 (LO1)

**product costing system** 804 (LO1)

**underapplied overhead**

**costs** 815 (LO4)

# Chapter Assignments

## DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ▶ Describe the accounting concepts that focus on determining the amount of cost, when costs should be recorded, and to what costs should be compared.
- LO 1 **DQ2. CONCEPT** ▶ What are some of the cost measurement and cost recognition differences between the two basic types of product costing systems?
- LO 2 **DQ3. CONCEPT** ▶ Why does the concept of matching underlie the cost flows in a job order costing system?
- LO 4 **DQ4. CONCEPT** ▶ Why do the concepts of cost recognition and cost measurement underlie the four steps necessary to allocate overhead costs?
- LO 5 **DQ5. BUSINESS APPLICATION** ▶ Why is the determination of unit cost information using job order costing important in the management process?

## SHORT EXERCISES

- LO 1 **Job Order Versus Process Costing Systems**
- SE1.** State whether a job order costing system or a process costing system would typically be used to account for the costs of the following:
- Manufacturing bottles
  - Manufacturing custom-designed swimming pools
  - Manufacturing one-size-fits-all robes
  - Providing babysitting
  - Manufacturing canned food
  - Providing accounting services
- LO 2 **Transactions in a Manufacturer's Job Order Costing System**
- SE2.** For each of the following transactions, state which account(s) would be debited and credited in a job order costing system:
- Purchased materials on account, \$12,000.
  - Charged direct labor to production, \$3,000.
  - Requested direct materials for production, \$6,000.
  - Applied overhead to jobs in process, \$4,000.
- LO 2 **Transactions in a Manufacturer's Job Order Costing System**
- SE3.** Enter the following transactions into T accounts:
- Incurred \$34,000 of direct labor and \$18,000 of indirect labor.
  - Applied overhead based on 12,680 labor hours @ \$6 per labor hour.
- LO 2 **Accounts for Job Order Costing**
- SE4.** Identify the accounts in which each of the following transactions for Oak Leaf Furniture, a custom manufacturer of oak tables and chairs, would be debited and credited:
- Issued oak materials into production for Job ABC.
  - Recorded direct labor time for the first week in February for Job ABC.
  - Purchased indirect materials from a vendor on account.
  - Received a production-related electricity bill.
  - Applied overhead to Job ABC.
  - Completed but did not yet sell Job ABC.

## LO 3 Job Order Cost Card

SE5. Complete the following job order cost card for five custom-built computer systems:

<b>Job Order 16</b>			
<b>JOB ORDER COST CARD</b>			
<b>Custom Computers</b>			
<b>Kowloon, Hong Kong</b>			
Customer: <u>L. Kim</u>	Batch: <u>    </u>	Custom: <u>X</u>	
Specifications: <u>5 Computer Systems</u>			
Date of Order: <u>4/4/2014</u>	Date of Completion: <u>6/8/2014</u>		
Costs Charged to Job	Previous Months	Current Month	Total Cost
Direct materials	\$540	\$820	\$ ?
Direct labor	340	620	?
Overhead applied	880	550	?
Totals	\$ ?	\$ ?	\$ ?
Units completed			÷ ?
Product unit cost			\$ ?

## LO 3 Job Order Costing in a Service Organization

SE6. A desert landscaping business is doing custom landscape work for J. Abbott. For each of the following transactions, state which account(s) would be debited and credited by the landscape business:

- a. Sent J. Abbott a bill for landscape design.
- b. Purchased gravel on credit, which was delivered to J. Abbott's yard.
- c. Paid three employees to prepare soil for gravel.
- d. Paid for cactus plants and planted them in J. Abbott's yard.

## LO 3 Job Order Costing with Cost-Plus Contracts

SE7. Complete the following job order cost card for an individual tax return:

<b>Job Order A7</b>			
<b>JOB ORDER COST CARD</b>			
<b>Doremus Tax Service</b>			
<b>Puyallup, Washington</b>			
Customer: <u>Arthur Farnsworth</u>	Batch: <u>    </u>	Custom: <u>X</u>	
Specifications: <u>Annual Individual Tax Return</u>			
Date of Order: <u>3/24/2014</u>	Date of Completion: <u>4/8/2014</u>		
Costs Charged to Job	Previous Months	Current Month	Total Cost
Client interview:			
Supplies	\$ 10	\$ —	\$ ?
Labor	50	60	?
Overhead (40% of interview labor costs)	20	24	?
Totals	\$ ?	\$ ?	\$ ?
Preparation of return:			
Supplies	\$ —	\$ 16	\$ ?
Computer time	—	12	?
Labor	—	240	?
Overhead (50% of preparation labor costs)	—	120	?
Totals	\$ —	\$ ?	\$ ?
Delivery:			
Postage	\$ —	\$ 8	\$ ?
Total	\$ —	\$ ?	\$ ?



Cost Summary to Date	Total Cost
Client interview	\$ ?
Preparation of return	?
Delivery	?
Total	<u>\$ ?</u>
Profit margin (20% of total cost)	?
Job revenue	<u><u>\$ ?</u></u>

**LO 4 Calculation of Underapplied or Overapplied Overhead**

**SE8.** At year end, records show that actual overhead costs incurred were \$25,870 and the amount of overhead costs applied to production was \$27,000. Identify the amount of under- or overapplied overhead, and indicate whether the Cost of Goods Sold account should be increased or decreased to reflect actual overhead costs.

**LO 4 Computation of Overhead Rate**

**SE9.** Compute the overhead rate per service request for the Maintenance Department if estimated overhead costs are \$18,290 and the number of estimated service requests is 3,100.

**LO 4 Allocation of Overhead to Production**

**SE10.** Calculate the amount of overhead costs applied to production if the predetermined overhead rate is \$4 per direct labor hour and 1,200 direct labor hours were worked.

**LO 5 Uses of Unit Cost Information**

**SE11. ACCOUNTING CONNECTION** ► Doug, the owner of a miniature golf course with 36 holes of miniature golf, must make several business decisions soon. Write *yes* or *no* to indicate whether knowing the cost to provide one golf game (i.e., the service unit cost) can help Doug answer these questions:

- Is the fee for playing a golf game high enough to cover the related cost?
- How much profit will Miniature Golf make if it sells an average of 100 games per day for 50 weeks?
- What costs can be reduced to make the fee more competitive?

## EXERCISES: SET A

**LO 1 Product Costing**

**E1A.** Custom Publishers Company specializes in print-on-demand books. The company needs information to budget next year's activities. Write *yes* or *no* to indicate whether each of the following costs is likely to be available in the company's product costing system:

- |  |  |
|--|--|
| a. cost of paper                       | f. costs to deliver books to customers |
| b. advertising costs                   | g. office supplies costs               |
| c. printing machine setup costs        | h. sales commissions                   |
| d. depreciation of printing machinery  | i. costs to design a book cover        |
| e. repair costs for printing machinery | j. cost of ink                         |

**LO 1 Costing Systems: Industry Linkage**

**E2A.** Which of the following products would typically be accounted for using a job order costing system? Which would typically be accounted for using a process costing system?

- |                                |   |
|--------------------------------|---|
| a. glue                        | f. liquid soap                            |
| b. toothpicks                  | g. propane gas canisters used to barbeque |
| c. restaurant meal             | h. standard compressed-gas cylinders used |
| d. clothing repair by a tailor | by scuba divers                           |
| e. birthday cake               |   |

**LO 1 Costing Systems: Industry Linkage**

**E3A.** Which of the following products would typically be accounted for using a job order costing system? Which would typically be accounted for using a process costing system?

- |                                     |                                 |
|-------------------------------------|---------------------------------|
| a. standard shirt buttons           | e. flea collars for cats        |
| b. printed graduation announcements | f. oatmeal cereal               |
| c. everyday glassware               | g. personal weight loss program |
| d. a limited edition sculpture      | h. an original painting         |

**LO 2 Job Order Cost Flow**

**E4A. ACCOUNTING CONNECTION** ► The three product cost elements—direct materials, direct labor, and overhead—flow through a job order costing system in a structured, orderly fashion. Specific accounts and subsidiary ledgers are used to verify and record cost information. Write a paragraph describing the cost flow in a job order costing system.

**LO 2 Work in Process Inventory: T Account Analysis**

**E5A.** On July 1, Tin Hau Company's Work in Process Inventory account showed a beginning balance of \$9,000. The Materials Inventory account showed a beginning balance of \$40,000. Production activity for July was as follows: (a) Direct materials costing \$28,800 were requested for production; (b) total production-related payroll was \$10,600, of which \$2,600 was used to pay for indirect labor; (c) indirect materials costing \$8,400 were purchased and used; and (d) overhead was applied at a rate of 120 percent of direct labor costs.

1. Record Tin Hau's materials, labor, and overhead costs for July in T accounts.
2. Compute the ending balance in the Work in Process Inventory account. Assume a transfer of \$45,000 to the Finished Goods Inventory account during the period.

**LO 2, 3 T Account Analysis with Unknowns**

**E6A.** Partial operating data for Census Company follow. Management has set the predetermined overhead rate for the current year at 125 percent of direct labor costs.

Account/Transaction	June	July
Beginning Materials Inventory	\$ (a)	\$ (e)
Beginning Work in Process Inventory	8,605	(f)
Beginning Finished Goods Inventory	7,764	6,660
Direct materials requested	5,025	(g)
Materials purchased	5,100	6,216
Direct labor costs	4,760	5,540
Overhead applied	(b)	(h)
Cost of units completed	(c)	21,861
Cost of Goods Sold	16,805	(i)
Ending Materials Inventory	3,014	2,628
Ending Work in Process Inventory	(d)	(j)
Ending Finished Goods Inventory	6,660	3,515

Using T accounts, compute the unknown values. Show all your computations.

**LO 2, 3 T Account Analysis with Unknowns**

**E7A.** Partial operating data for Brent Cross Company follow. Management has set the predetermined overhead rate for the current year at 90 percent of direct labor costs.

Account/Transaction	December
Beginning Materials Inventory	\$142,000
Beginning Work in Process Inventory	66,000
Beginning Finished Goods Inventory	129,000
Direct materials used	256,000
Direct materials purchased	(a)
Direct labor costs	390,000
Overhead applied	(b)
Cost of units completed	(c)
Cost of Goods Sold	953,400
Ending Materials Inventory	50,000
Ending Work in Process Inventory	138,600
Ending Finished Goods Inventory	(d)

Using T accounts and the data provided, compute the unknown values. Show all your computations.

### LO 2, 3 Job Order Costing: T Account Analysis

**E8A.** Custom Floral, Inc., produces special-order artificial flower arrangements, so it uses a job order costing system. Overhead is applied at the rate of 80 percent of direct labor cost. The following is a list of transactions for June:

- June
- 1 Purchased direct materials on account, \$300.
  - 2 Purchased indirect materials on account, \$50.
  - 4 Requested direct materials costing \$250 (\$200 used on Job AX and \$50 used on Job BY) and indirect materials costing \$40 for production.
  - 10 Paid the following overhead costs: utilities, \$40; manufacturing rent, \$300; and maintenance charges, \$10.
  - 15 Recorded the following gross wages and salaries for employees: direct labor, \$1,000 (\$700 for Job AX and \$300 for Job BY); indirect labor, \$300.
  - 15 Applied overhead to production.
  - 16 Completed and transferred Job AX and Job BY to finished goods inventory; total cost of both jobs was \$2,050.
  - 20 Delivered Job AX to the customer; total production cost was \$1,460 and billed customer for the sales price \$2,000.
  - 30 Recorded these overhead costs (adjusting entries): prepaid insurance expired, \$30; and depreciation—machinery, \$150.

#### REQUIRED

1. Record the entries for all transactions in June using T accounts for the following: Materials Inventory, Work in Process Inventory, Finished Goods Inventory, Overhead, Cash, Accounts Receivable, Prepaid Insurance, Accumulated Depreciation—Machinery, Accounts Payable, Payroll Payable, Sales, and Cost of Goods Sold. Determine the partial account balances. Assume no beginning inventory balances. Also assume that when the payroll was recorded, entries were made to the Payroll Payable account.
2. Compute the amount of underapplied or overapplied overhead as of June 30 and transfer it to the Cost of Goods Sold account.

### LO 3, 4 Job Order Cost Card and Computation of Product Unit Cost

**E9A.** In February 2014, Storage Company worked on five job orders for specialty cedar storage cabinets. It began Job Z-6 for Cedar Safe, Inc., on February 10 and completed it on February 24. Partial data for Job Z-6 are as follows.

*(Continued)*

	Costs	Machine Hours Used
Direct materials:		
Cedar	\$8,000	
Pine	6,000	
Hardware	2,000	
Assembly supplies	1,000	
Direct labor:		
Sawing	3,000	120
Shaping	2,000	210
Finishing	2,500	150
Assembly	3,000	50

Storage Company produced a total of 50 cabinets for Job Z-6. Its current predetermined overhead rate is \$20 per machine hour. From the information given, prepare a job order cost card and compute the job order's product unit cost.

**LO 3, 4**    **Computation of Product Unit Cost**

**E10A.** MS Company uses job order costing to determine the product unit cost of one of its products based on the following costs incurred during March: liability insurance, manufacturing, \$3,500; rent, sales office, \$3,000; depreciation, manufacturing equipment, \$5,000; direct materials, \$34,000; indirect labor, manufacturing, \$3,600; indirect materials, \$2,000; heat, light, and power, manufacturing, \$2,500; fire insurance, manufacturing, \$2,400; depreciation, sales equipment, \$5,000; rent, manufacturing, \$4,000; direct labor, \$20,000; manager's salary, manufacturing, \$4,800; president's salary, \$6,000; sales commissions, \$8,000; and advertising expenses, \$3,000. The Inspection Department reported that 40,900 good units were produced during March. Determine the unit product cost.

**LO 3, 4**    **Computation of Product Unit Cost**

**E11A.** China Trade, Inc., manufactures custom-made stuffed animals. Last month the company produced 500 stuffed pandas for the local zoo to sell at a fund-raising event. Using job order costing, determine the product unit cost of a stuffed panda based on the following costs incurred during the month: manufacturing utilities, \$200; depreciation on manufacturing equipment, \$250; indirect materials, \$150; direct materials, \$1,000; indirect labor, \$400; direct labor, \$1,200; sales commissions, \$3,000; president's salary, \$4,000; insurance on manufacturing plant, \$300; advertising expense, \$500; rent on manufacturing plant, \$2,500; rent on sales office, \$4,000; and legal expense, \$250.

**LO 3, 4**    **Computation of Product Unit Cost**

**E12A.** Dude Corporation manufactures specialty lines of men's apparel. During February, the company worked on three special orders: B-2, B-3, and B-4. Cost and production data for each order are as follows.

	Job B-2	Job B-3	Job B-4
Direct materials:			
Fabric Q	\$1,000	\$1,800	\$17,600
Fabric Z	2,000	2,200	13,400
Fabric YB	5,000	6,000	2,000
Direct labor:			
Garment maker	4,500	8,000	10,200
Layout	2,500	7,000	9,800
Packaging	3,000	5,000	5,000
Overhead:			
(150% of direct labor costs)	?	?	?
Number of units produced	500	1,200	500

1. Compute the total cost associated with each job. Show the subtotals for each cost category.
2. Compute the product unit cost for each job.

LO 3, 4 **Job Order Costing in a Service Organization**

**E13A.** A job order cost card for Cloud Storage Services follows. Complete the missing information. The profit factor in the organization's cost-plus contract is 60 percent of total cost.

<b>JOB ORDER COST CARD</b>	
<b>Cloud Storage Services</b>	
Customer:	<u>Jayson Holiday</u>
Job Order No.:	<u>XXYQ</u>
Contract Type:	<u>Cost-Plus</u>
Type of Service:	<u>Annual Internet Storage</u>
Date of Completion:	<u>November 6, 2014</u>
<hr/>	
<b>Costs Charged to Job</b>	<b>Total Cost</b>
<hr/>	
Software installation services:	
Installation labor	\$30
Service overhead (?% of installation labor costs)	?
Total	<u>\$60</u>
Internet services:	
Internet storage	\$10
Service overhead (200% of Internet storage costs)	20
Total	<u>\$ ?</u>
<hr/>	
<b>Cost Summary to Date</b>	<b>Total Cost</b>
<hr/>	
Software installation services	\$ ?
Internet services	?
Total	<u>\$ ?</u>
Profit margin (60% of total cost)	?
Contract revenue	<u>\$ ?</u>

LO 4 **Computation of Overhead Rate**

**E14A.** The overhead costs that Sife Industries, Inc., used to compute its overhead rate for the past year are as follows.

Indirect materials and supplies, repair and maintenance, outside service contracts, indirect labor, factory supervision, factory insurance, heat, light, and power costs	\$222,000
Property taxes and miscellaneous overhead costs	13,000
Depreciation, machinery	<u>85,000</u>
Total overhead costs	<u>\$320,000</u>

The allocation base for the past year was 40,000 total machine hours. For the next year, all overhead costs except depreciation, property taxes, and miscellaneous overhead are expected to increase by 10 percent. Depreciation should increase by 12 percent, and property taxes and miscellaneous overhead are expected to increase by 20 percent. Plant capacity in terms of machine hours used will increase by 10,000 hours.

1. Compute the past year's overhead rate.
2. Compute the overhead rate for next year.

### LO 4 Computation and Application of Overhead Rate

**E15A.** For Road Patch Company, labor is the highest single expense, totaling \$693,000 for 75,000 hours of work last year. Overhead costs for last year were \$900,000 and were applied to specific jobs on the basis of labor hours worked. This year, the company anticipates a 25 percent increase in overhead costs. Labor costs will increase by \$130,000, and the number of hours worked is expected to increase by 20 percent.

1. Determine the total amount of overhead anticipated this year.
2. Compute the overhead rate for this year.
3. At the end of this year, Road Patch had compiled a total of 89,920 labor hours worked. The actual overhead incurred was \$1,143,400.
  - a. Using the overhead rate computed in 2, determine the total amount of overhead applied to operations during the year.
  - b. Compute the amount of under/overapplied overhead for the year.
  - c. **ACCOUNTING CONNECTION** ► Will the Cost of Goods Sold account be increased or decreased to correct the under/overapplication of overhead?

## EXERCISES: SET B

Visit the textbook companion web site at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 2 T Account Analysis with Unknowns

- ✓ d: May ending work in process inventory: \$45,770
- ✓ i: June overhead applied: \$57,800

**P1.** Patriotic Enterprises makes flags. The company's new controller can find only the following partial information for the past two months:

Account/Transaction	May	June
Beginning Materials Inventory	\$ 36,240	\$ (e)
Beginning Work in Process Inventory	56,480	(f)
Beginning Finished Goods Inventory	44,260	(g)
Materials purchased	(a)	96,120
Direct materials requested	82,320	(h)
Direct labor costs	(b)	72,250
Overhead applied	53,200	(i)
Cost of units completed	(c)	221,400
Cost of Goods Sold	209,050	(j)
Ending Materials Inventory	38,910	41,950
Ending Work in Process Inventory	(d)	(k)
Ending Finished Goods Inventory	47,940	51,180

The current year's predetermined overhead rate is 80 percent of direct labor cost.

### REQUIRED

Using T accounts, compute the unknown values.

### LO 2, 3, 4 Job Order Costing: T Account Analysis

- ✓ 2: \$260 underapplied overhead

**P2.** Eagle Carts, Inc., produces special-order golf carts, so Eagle Carts uses a job order costing system. Overhead is applied at the rate of 90 percent of direct labor cost. A list of transactions for January follows.

- Jan. 1 Purchased direct materials on account, \$215,400.  
 2 Purchased indirect materials on account, \$49,500.  
 4 Requested direct materials costing \$193,200 (all used on Job X) and indirect materials costing \$38,100 for production.  
 10 Paid the following overhead costs: utilities, \$4,400; manufacturing rent, \$3,800; and maintenance charges, \$3,900.

- Jan. 15 Recorded the following gross wages and salaries for employees: direct labor, \$120,000 (all for Job X); indirect labor, \$60,620.
- 15 Applied overhead to production.
- 19 Purchased indirect materials costing \$27,550 and direct materials costing \$190,450 on account.
- 21 Requested direct materials costing \$214,750 (Job X, \$178,170; Job Y, \$18,170; and Job Z, \$18,410) and indirect materials costing \$31,400 for production.
- 31 Recorded the following gross wages and salaries for employees: direct labor, \$132,000 (Job X, \$118,500; Job Y, \$7,000; Job Z, \$6,500); indirect labor, \$62,240.
- 31 Applied overhead to production.
- 31 Completed and transferred Job X (375 carts) and Job Y (10 carts) to finished goods inventory; total cost was \$855,990.
- 31 Shipped Job X to the customer; total production cost was \$824,520 and sales price was \$996,800.
- 31 Recorded these overhead costs (adjusting entries): prepaid insurance expired, \$3,700; property taxes (payable at year end), \$3,400; and depreciation—machinery, \$15,500.

**REQUIRED**

- Record the entries for all transactions in January using T accounts for the following: Materials Inventory, Work in Process Inventory, Finished Goods Inventory, Overhead, Cash, Accounts Receivable, Prepaid Insurance, Accumulated Depreciation—Machinery, Accounts Payable, Payroll Payable, Property Taxes Payable, Sales, and Cost of Goods Sold. Prepare job order cost cards for Job X, Job Y, and Job Z. (Round product unit cost to two decimal places.) Determine the partial account balances. Assume no beginning inventory balances. Also assume that when the payroll was recorded, entries were made to the Payroll Payable account.
- Compute the amount of underapplied or overapplied overhead as of January 31 and transfer it to the Cost of Goods Sold account.
- ACCOUNTING CONNECTION** ► Why should the Overhead account's underapplied or overapplied overhead be transferred to the Cost of Goods Sold account?

LO 2, 3, 4

SPREADSHEET

✓ 2: Cost of units completed during the month: \$185,073

**Job Order Cost Flow**

**P3.** On May 31, the inventory balances of Tog Designs, a manufacturer of high-quality children's clothing, were as follows: Materials Inventory, \$21,360; Work in Process Inventory, \$15,112; and Finished Goods Inventory, \$17,120. Job order cost cards for jobs in process as of June 30 had the following totals:

Job No.	Direct Materials	Direct Labor	Overhead
24-A	\$1,593	\$1,290	\$1,677
24-B	1,492	1,380	1,794
24-C	1,987	1,760	2,288
24-D	1,608	1,540	2,002

The predetermined overhead rate is 130 percent of direct labor costs. Materials purchased and received in June were as follows.

June 4	\$33,120
June 16	28,600
June 22	31,920

Direct labor costs for June were as follows.

June 15 payroll	\$23,680
June 29 payroll	25,960

*(Continued)*



Direct materials requested by production during June were as follows.

June 6	\$37,240
June 23	38,960

On June 30, Tog Designs sold on account finished goods with a cost of \$183,000 for \$320,000.

### REQUIRED

- Using T accounts for Materials Inventory, Work in Process Inventory, Finished Goods Inventory, Overhead, Accounts Receivable, Payroll Payable, Sales, and Cost of Goods Sold, reconstruct the transactions in June, including applying overhead to production.
- Compute the cost of units completed during the month.
- Determine the ending inventory balances.
- Jobs 24-A and 24-C were completed during the first week of July. No additional materials costs were incurred, but Job 24-A required \$960 more of direct labor, and Job 24-C needed an additional \$1,610 of direct labor. Job 24-A was composed of 1,800 pairs of trousers; Job 24-C, of 900 shirts. Compute the product unit cost for each job.

### LO 4

#### SPREADSHEET

- ✓ 1: Predetermined overhead rate for this year: \$2.40 per machine hour
- ✓ 3: Overapplied overhead: \$475

### Allocation of Overhead

**P4.** Nature Cosmetics Company applies overhead costs on the basis of machine hours. The overhead rate is computed by analyzing data from the previous year to determine the percentage change in costs. Thus, this year's overhead rate will be based on the percentage change multiplied by last year's costs.

	<b>Last Year</b>
Machine hours	<u>55,360</u>
Overhead costs:	
Indirect labor	\$ 23,500
Employee benefits	28,600
Manufacturing supervision	18,500
Utilities	15,000
Factory insurance	7,800
Janitorial services	12,100
Depreciation, factory and machinery	21,300
Miscellaneous overhead	<u>6,000</u>
Total overhead	<u>\$132,800</u>

This year the cost of utilities is expected to increase by 40 percent over the previous year; the cost of indirect labor, employee benefits, and miscellaneous overhead is expected to increase by 30 percent over the previous year; the cost of insurance and depreciation is expected to increase by 20 percent over the previous year; and the cost of supervision and janitorial services is expected to increase by 10 percent over the previous year. Machine hours are expected to total 68,786.

### REQUIRED

- Compute the projected costs, and use those costs to calculate the overhead rate for this year. (Round the rate to two decimal places.)
- Jobs completed during this year and the machine hours used were as follows.

<b>Job No.</b>	<b>Machine Hours</b>
2214	12,300
2215	14,200
2216	9,800
2217	13,600
2218	11,300
2219	8,100

Determine the amount of overhead to be applied to each job and to total production during this year.

3. Actual overhead costs for this year were \$165,845. Was overhead underapplied or overapplied? By how much? Should the Cost of Goods Sold account be increased or decreased to reflect actual overhead costs?
4. **ACCOUNTING CONNECTION** ► At what point during this year was the overhead rate computed? When was it applied? Finally, when was underapplied or overapplied overhead determined and the Cost of Goods Sold account adjusted to reflect actual costs?

#### LO 4 Allocation of Overhead

✓ Total costs assigned to order: \$71,074

**P5.** Byte Computer Company, a manufacturing organization, has just completed an order that Grater, Ltd., placed for 80 computers. Direct materials, purchased parts, and direct labor costs for the Grater order are as follows.

Cost of direct materials	\$36,750
Cost of purchased parts	\$21,300
Direct labor hours	220
Average direct labor pay rate	\$16

Overhead costs were applied at a single, plantwide overhead rate of 270 percent of direct labor dollars.

#### REQUIRED

Compute the total cost of the Grater order.

## ALTERNATE PROBLEMS

#### LO 2 T Account Analysis with Unknowns

✓ d: July ending work in process inventory: \$38,564  
 ✓ i: August overhead applied: \$48,400

**P6.** Core Enterprises makes peripheral equipment for computers. The company's new controller only has the following partial information for the past two months:

Account/Transaction	July	August
Beginning Materials Inventory	\$52,000	\$ (e)
Beginning Work in Process Inventory	24,000	(f)
Beginning Finished Goods Inventory	36,000	(g)
Materials purchased	(a)	31,000
Direct materials requested	77,000	(h)
Direct labor costs	(b)	44,000
Overhead applied	53,200	(i)
Cost of units completed	(c)	167,000
Cost of Goods Sold	188,000	(j)
Ending Materials Inventory	27,000	8,000
Ending Work in Process Inventory	(d)	(k)
Ending Finished Goods Inventory	12,000	19,000

The current year's predetermined overhead rate is 110 percent of direct labor cost.

#### REQUIRED

Using T accounts, compute the unknown values. (Round to the nearest dollar.)

#### LO 2, 3, 4 Job Order Costing: T Account Analysis

✓ 2: \$4,581 underapplied overhead

**P7.** Rhile Industries, Inc., produces colorful and stylish uniforms to order. During September 2014, Rhile completed the following transactions:

- Sept. 1 Purchased direct materials on account, \$59,400.  
 3 Requested direct materials costing \$26,850 for production (all for Job A).  
 4 Purchased indirect materials for cash, \$22,830.  
 8 Issued checks for the following overhead costs: utilities, \$4,310; manufacturing insurance, \$1,925; and repairs, \$4,640.

(Continued)

- Sept. 10 Requested direct materials costing \$29,510 (all used on Job A) and indirect materials costing \$6,480 for production.
- 15 Recorded the following gross wages and salaries for employees: direct labor, \$62,900 (all for Job A); indirect labor, \$31,610; manufacturing supervision, \$26,900; and sales commissions, \$32,980.
- 15 Applied overhead to production at a rate of 120 percent of direct labor cost.
- 22 Paid the following overhead costs: utilities, \$4,270; maintenance, \$3,380; and rent, \$3,250.
- 23 Recorded the purchase on account and receipt of \$31,940 of direct materials and \$9,260 of indirect materials.
- 27 Requested \$28,870 of direct materials (Job A, \$2,660; Job B, \$8,400; Job C, \$17,810) and \$7,640 of indirect materials for production.
- 30 Recorded the following gross wages and salaries for employees: direct labor, \$64,220 (Job A, \$44,000; Job B, \$9,000; Job C, \$11,220); indirect labor, \$30,290; manufacturing supervision, \$28,520; and sales commissions, \$36,200.
- 30 Applied overhead to production at a rate of 120 percent of direct labor cost.
- 30 Completed and transferred Job A (58,840 units) and Job B (3,525 units) to finished goods inventory; total cost was \$322,400.
- 30 Shipped Job A to the customer; total production cost was \$294,200, and sales price was \$418,240.
- 30 Recorded the following adjusting entries: \$2,680 for depreciation—manufacturing equipment; and \$1,230 for property taxes, manufacturing, payable at month end.

### REQUIRED

- Record the entries for all Rhile's transactions in September using T accounts for the following: Materials Inventory, Work in Process Inventory, Finished Goods Inventory, Overhead, Cash, Accounts Receivable, Accumulated Depreciation—Manufacturing Equipment, Accounts Payable, Payroll Payable, Property Taxes Payable, Sales, Cost of Goods Sold, and Selling and Administrative Expenses. Prepare job order cost cards for Job A, Job B, and Job C. Determine the partial account balances. Assume no beginning inventory balances. Assume also that when payroll was recorded, entries were made to the Payroll Payable account.
- Compute the amount of underapplied or overapplied overhead for September and transfer it to the Cost of Goods Sold account.
- ACCOUNTING CONNECTION** ► Why should the Overhead account's underapplied or overapplied overhead be transferred to the Cost of Goods Sold account?

LO 2, 3, 4

SPREADSHEET

✓ 2: Cost of units completed during the month: \$76,470

### Job Order Cost Flow

**P8.** Tottham Industries is a company that makes special-order sound systems. The chief financial officer has records for February that reveal the following information:

Beginning inventory balances:	
Materials Inventory	\$27,450
Work in Process Inventory	22,900
Finished Goods Inventory	19,200
Direct materials purchased and received:	
February 6	\$ 7,200
February 12	8,110
February 24	5,890
Direct labor costs:	
February 14	\$13,750
February 28	13,230

Direct materials requested for production:

February 4	\$9,080
February 13	5,940
February 25	7,600

Job order cost cards for jobs in process on February 28 had the following totals:

Job No.	Direct Materials	Direct Labor	Overhead
AJ-10	\$3,220	\$1,810	\$2,534
AJ-14	3,880	2,110	2,954
AJ-15	2,980	1,640	2,296
AJ-16	4,690	2,370	3,318

The predetermined overhead rate for the month was 140 percent of direct labor costs. Sales for February totaled \$152,400, the cost of production for the goods sold was \$89,000.

#### REQUIRED

- Using T accounts for Materials Inventory, Work in Process Inventory, Finished Goods Inventory, Overhead, Accounts Receivable, Payroll Payable, Sales, and Cost of Goods Sold, reconstruct the transactions in February, including applying overhead to production.
- Compute the cost of units completed during the month.
- Determine the ending balances in the inventory accounts.
- During the first week of March, Jobs AJ-10 and AJ-14 were completed. No additional direct materials costs were incurred, but Job AJ-10 needed \$720 more of direct labor, and Job AJ-14 needed an additional \$1,140 of direct labor. Job AJ-10 was 40 units; Job AJ-14, 50 units. Compute the product unit cost for each completed job.

LO 4

#### Allocation of Overhead

SPREADSHEET

- ✓ 1: Predetermined overhead rate for this year: \$5.00 per machine hour
- ✓ 3: Underapplied overhead: \$750

**P9.** Gyllstrom Products, Inc., uses a predetermined overhead rate in its production, assembly, and testing departments. One rate is used for the entire company; it is based on machine hours. The rate is determined by analyzing data from the previous year to determine the percentage change in costs. Thus this year's overhead rate will be based on the percentage change multiplied by last year's costs. The following data are available:

Last Year's Costs	
Machine hours	38,000
Overhead costs	
Indirect materials	\$ 58,000
Indirect labor	25,000
Supervision	41,000
Utilities	11,200
Labor-related costs	9,000
Depreciation, factory	10,500
Depreciation, machinery	27,000
Property taxes	3,000
Insurance	2,000
Miscellaneous overhead	5,000
Total overhead	<u>\$191,700</u>

This year the cost of indirect materials is expected to increase by 30 percent over the previous year. The cost of indirect labor, utilities, machinery depreciation, property taxes, and insurance is expected to increase by 20 percent over the previous year. All other expenses are expected to increase by 10 percent over the previous year. Machine hours for this year are estimated at 45,858.

(Continued)

**REQUIRED**

1. Compute the projected costs, and use those costs to calculate the overhead rate for this year.
2. During this year, the company completed the following jobs using the machine hours shown:

Job No.	Machine Hours	Job No.	Machine Hours
H-142	7,840	H-201	10,680
H-164	5,260	H-218	12,310
H-175	8,100	H-304	2,460

Determine the amount of overhead applied to each job. What was the total overhead applied during this year?

3. Actual overhead costs for this year were \$234,000. Was overhead underapplied or overapplied this year? By how much? Should the Cost of Goods Sold account be increased or decreased to reflect actual overhead costs?
4. **ACCOUNTING CONNECTION** ► At what point during this year was the overhead rate computed? When was it applied? Finally, when was underapplied or overapplied overhead determined and the Cost of Goods Sold account adjusted to reflect actual costs?

**LO 4 Allocation of Overhead**

**P10.** Fraser Products, Inc., which produces copy machines, has just completed packaging an order from Kent Company for 150 machines. Direct materials, purchased parts, and direct labor costs for the Kent order are as follows.

Cost of direct materials	\$17,450
Cost of purchased parts	\$14,800
Direct labor hours	140
Average direct labor pay rate	\$16.50

Overhead costs were applied at a single, plantwide overhead rate of 240 percent of direct labor dollars.

**REQUIRED**

Compute the total cost of the Kent order.

**CASES****LO 1, 5 Business Communication: Product Costing Systems**

**C1. BUSINESS APPLICATION** ► Hawk Manufacturing manufactures engine parts for motorcycles. Jordan Smith, Hawk Manufacturing's president, wants to improve the quality of the company's operations and products. She believes waste exists in the design and manufacture of standard engine parts. To begin the improvement process, she has asked you to (1) identify the sources of such waste, (2) develop performance measures to account for the waste, and (3) estimate the current costs associated with the waste. She has asked you to submit a memo of your findings within two weeks so that she can begin strategic planning to revise the price at which Hawk sells engine parts to motorcycle manufacturers.

You have identified two sources of costly waste. The Production Department is redoing work that was not done correctly the first time, and the Engineering Design Department is redesigning products that were not initially designed to customer specifications. Having improper designs has caused the company to buy parts that are not used in production. You have also obtained the following information from the product costing system:

Direct labor costs	\$673,402
Engineering design costs	124,709
Indirect labor costs	67,200
Depreciation on production equipment	84,300
Supervisors' salaries	98,340
Direct materials costs	432,223
Indirect materials costs	44,332

- In preparation for writing your memo, answer the following questions:
  - For whom are you preparing the memo? What is the appropriate length of the memo?
  - Why are you preparing the memo?
  - What information is needed for the memo? Where can you get this information? What performance measure would you suggest for each activity? Is the accounting information sufficient for your memo?
  - When is the memo due? What can be done to provide accurate and timely information?
- Prepare an outline of the sections you would want to include in your memo.

**LO 2, 5 Group Activity: Job Order Costing**

**C2.** Many businesses accumulate costs for each job performed. Examples of businesses that use a job order costing system include print shops, car repair shops, health clinics, and kennels.

Visit a local business that uses job order costing, and interview the owner, manager, or accountant about the job order process and the documents the business uses to accumulate product costs. Write a paper that summarizes the information you obtained. Include the following in your summary:

- The name of the business and the type of operations performed
- The name and position of the individual you interviewed
- A description of the process of starting and completing a job
- A description of the accounting process and the documents used to track a job
- Your responses to these questions:
  - Did the person you interviewed know the actual amount of direct materials, direct labor, and overhead charged to a particular job? If the job includes some estimated costs, how are the estimates calculated? Do the costs affect the determination of the selling price of the product or service?
  - Compare the documents discussed in this chapter with the documents used by the company you visited. How are they similar, and how are they different?
  - In your opinion, does the business record and accumulate its product costs effectively? Explain.

**LO 3, 5 Ethical Dilemma: Costing Procedures and Ethics**

**C3.** Roger Parker, the production manager of Products Company, entered the office of controller Harris Johnson and asked, "Harris, what gives here? I was charged for 330 direct labor hours on Job AD22, and my records show that we spent only 290 hours on that job. That 40-hour difference caused the total cost of direct labor and overhead for the job to increase by over \$5,500. Are my records wrong, or was there an error in the direct labor assigned to the job?"

Harris replied, "Don't worry about it, Roger. This job won't be used in your quarterly performance evaluation. Job AD22 was a federal government job, a cost-plus contract, so the more costs we assign to it, the more profit we make. We decided to add a few hours to the job in case there is some follow-up work to do. You know how fussy the feds are." What should Roger Parker do? Discuss Harris Johnson's costing procedure.



LO 3, 5 **Conceptual Understanding: Role of Cost Information in Software Development**

**C4.** Software development companies frequently have a problem: When is “good enough” good enough? How many hours should be devoted to developing a new product? The industry’s rule of thumb is that developing and shipping new software takes six to nine months. To be the first to market, a company must develop and ship products much more quickly than the industry norm. One performance measure that is used to answer the “good enough” question is a calculation based on the economic value (not cost) of what a company’s developers create. The computation takes the estimated current market valuation of a firm and divides it by the number of product developers in the firm, to arrive at the market value created per developer. Some companies refine this calculation further to determine the value that each developer creates per workday. One company has estimated this value to be \$10,000. Thus, for one software development company, “good enough” focuses on whether a new product’s potential justifies an investment of time by someone who is worth \$10,000 per day.

The salary cost of the company’s developers is not used in the “good enough” calculation. Why is that cost not relevant?

LO 5 **Interpreting Management Reports: Nonfinancial Data**

**C5. BUSINESS APPLICATION** ► Hawk Manufacturing supplies engine parts to Cherokee Cycle Company, a major U.S. manufacturer of motorcycles. Like all of Cherokee’s suppliers, Hawk has always added a healthy profit margin to its cost when quoting selling prices to Cherokee. Recently, however, several companies have offered to supply engine parts to Cherokee for lower prices than Hawk has been charging.

Because Hawk wants to keep Cherokee’s business, a team of Hawk’s managers analyzed their company’s product costs and decided to make minor changes in the company’s manufacturing process. No new equipment was purchased, and no additional labor was required. Instead, the machines were rearranged, and some of the work was reassigned.

To monitor the effectiveness of the changes, Hawk introduced three new performance measures to its information system: inventory levels, lead time (total time required for a part to move through the production process), and productivity (number of parts manufactured per person per day). Hawk’s goal was to reduce the quantities of the first two performance measures and to increase the quantity of the third.

A section of a recent management report, shown below, summarizes the quantities for each performance measure before and after the changes in the manufacturing process were made.

Measure	Before	After	Improvement
Inventory in dollars	\$21,444	\$10,772	50%
Lead time in minutes	17	11	35%
Productivity (parts per person per day)	515	1,152	124%

1. Do you believe that Hawk improved the quality of its manufacturing process and the quality of its engine parts? Explain your answer.
2. Can Hawk lower its selling price to Cherokee? Explain your answer.
3. Did the introduction of the new measures affect the design of the product costing system? Explain your answer.
4. Do you believe that the new measures caused a change in Hawk’s cost per engine part? If so, how did they cause the change?

**Continuing Case: Cookie Company**

**C6.** In the Cookie Company case in the last chapter, your team selected a cookie recipe for your company. In this chapter, your team will use that recipe to bake a batch of cookies, collect cost and time performance data related to the baking, create a marketing display for your company, and vote for the class’s favorite cookie during an in-class



cookie taste test. The goal of the taste test is to have your team's product voted the "best in class." One rule of the contest is that you may not vote for your own team's product.

1. Design a job measurement document that includes at least the following measures: cost per cookie; number of cookies produced (= number meeting specs + number rejected + number sampled for quality control + unexplained differences); size of cookies before baking; size of cookies after baking; and total throughput time (= mix time + [bake time for one cookie sheet × number of cookie sheets processed] + packaging time + downtime + cleanup time).
2. Design a job order cost card for your company that resembles one of those displayed in this chapter.
3. Using the recipe your team selected and assigning duties as described in the last chapter, bake a batch of cookies, and complete the job measurement document and job order cost card.
  - Assume an overhead rate of \$2 for every \$1 of direct material cost.
  - Assign direct labor cost for each production task based on the hourly rate or a monthly salary previously determined by your team.
4. Create a marketing display for your cookie product and bring it to class on the day of the taste test. The marketing display should include 20 cookies on a plate or napkin and a poster that displays your company's name and mission statement, cookie recipe, job measurement document, and job order cost card.
5. During class, each student should look at all of the marketing displays, taste 2 or 3 cookies and, on a ballot provided by your instructor, rank taste test results by giving 1 to the best cookie tasted, 2 to the next best, and so on. Students must sign their ballots before they turn them in to the instructor. (Remember, you cannot cast a vote for your own team's entry.) Your instructor will tabulate the ballots and announce the winning team.
6. Finally, write a review of your team members' efforts and give it to your instructor.



# CHAPTER 19

## Costing Systems: Process Costing

### BUSINESS INSIGHT

#### Milk Products Company

Milk Products Company processes raw milk into homogenized, pasteurized milk. The company's products, which it distributes within the local community, include whole milk, low-fat milk, skim milk, chocolate milk, ice cream, and yogurt. In this chapter, we explain why a company like Milk Products should use a process costing system and how this system provides the information that managers need to make sound product decisions.

- 1. CONCEPT** ▶ *Why is a process costing system appropriate for Milk Products to measure and recognize costs?*
- 2. ACCOUNTING APPLICATION** ▶ *How does a product costing system account for costs when identical products or services are produced?*
- 3. BUSINESS APPLICATION** ▶ *How does a process costing system help managers organize and control costs and facilitate management decisions?*

### LEARNING OBJECTIVES

- LO 1** Describe a process costing system.
- LO 2** Relate the patterns of product flows to the cost flow methods in a process costing environment, and explain the role of the Work in Process Inventory accounts.
- LO 3** Describe equivalent production, and compute equivalent units.
- LO 4** Prepare a process cost report using the FIFO costing method.
- LO 5** Prepare a process cost report using the average costing method.
- LO 6** Explain how managers use a process costing system to produce business results.

## SECTION 1

## CONCEPTS

## CONCEPTS

- Cost measurement
- Cost recognition
- Matching principle

RELEVANT  
LEARNING OBJECTIVE

- Lo 1** Describe a process costing system.

## Lo 1 Concepts Underlying the Process Costing System

Since it is impossible to identify an individual unit of some products until they have been completed (such as a container of milk, a package of jelly beans, or a gallon of ice cream), process costing is used to track and control costs while products are being made. A **process costing system** first *measures* the costs of direct materials, direct labor, and overhead for each process, department, or work cell and then assigns those costs to the products produced during a particular period. Reports prepared at the end of each period *recognize* the costs assigned to products completed and transferred out or to the products remaining in the process, department, or work cell. It provides the cost information for product revenues to be *matched* with the expenses required to generate them. A product costing system, like process costing, provides managers with unit cost information, cost data for management decisions, and ending values for the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts.

Such a system is used for *cost measurement* by companies that make large amounts of similar products or liquid products or that have continuous production runs of identical products. For example, companies that produce paint or chemicals (like **Dow Chemicals**), beverages (like **Coors** and **Coca-Cola**), foods (like **Kellogg Company**), computer chips (like **Apple Computer**), and gallon containers of ice cream are typical users of a process costing system.

In the previous chapter, we focused on job order costing. It's important to note that the difference between job order costing and process costing is that, in process costing, costs are *measured* and *recognized* by production *processes*, such as the Work in Process Inventory account of the Mixing Department, whereas in job order costing, costs are measured and recognized by *jobs* through the job order cost card.

### APPLY IT!

Indicate whether the manufacturer of each of the following products should use a job order costing system or a process costing system to accumulate product costs.

- |                   |                       |
|-------------------|-----------------------|
| a. baby bottles   | c. nuclear submarines |
| b. chocolate milk | d. generic drugs      |

#### SOLUTION

- a. Process
- b. Process
- c. Job order
- d. Process

**TRY IT! SE1, SE2, E1A, E1B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Compute equivalent units
- Prepare a process cost report using the FIFO costing method
- Prepare a process cost report using the average costing method

## RELEVANT LEARNING OBJECTIVES

**LO 2** Relate the patterns of product flows to the cost flow methods in a process costing environment, and explain the role of the Work in Process Inventory accounts.

**LO 3** Describe equivalent production, and compute equivalent units.

**LO 4** Prepare a process cost report using the FIFO costing method.

**LO 5** Prepare a process cost report using the average costing method.

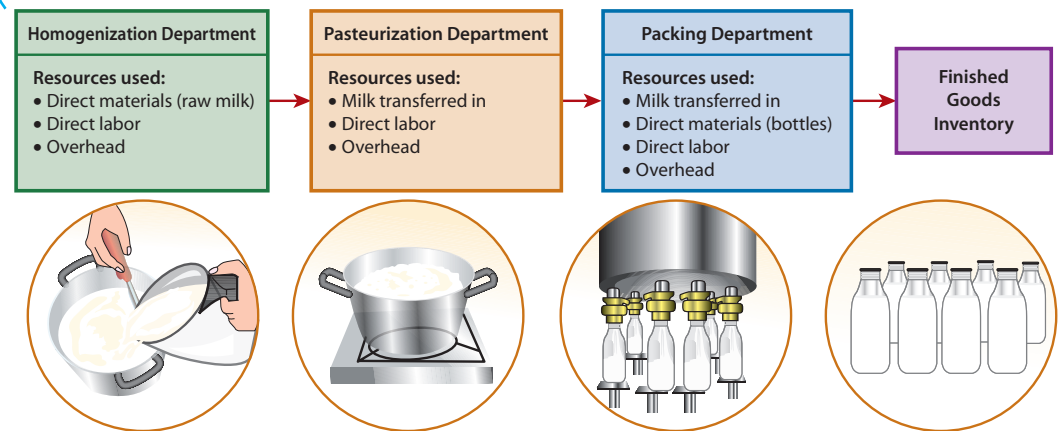
## LO 2 Patterns of Product Flows and Cost Flow Methods

In a process costing environment, products flow in a first-in, first-out (FIFO) fashion through several processes, departments, or work cells and may undergo many different operations. Exhibit 1 illustrates the simple linear production flow of how milk is produced in a series of three processing steps, or departments. Each department has its own Work in Process Inventory account to accumulate the direct materials, direct labor, and overhead costs associated with it.

- **Homogenization Department:** Raw milk from the cow must be mixed to evenly distribute the butterfat. The homogenized milk and its associated cost then become the direct materials for the next department.
- **Pasteurization Department:** The homogenized milk is heated to 145 degrees to kill the bacteria found in raw milk. The homogenized, pasteurized milk and all associated costs are then transferred on to the next department.
- **Packaging Department:** The milk is put into bottles and transferred to Finished Goods Inventory since it is ready for sale.

The product unit cost of a bottle of milk is the sum of the cost elements in all three departments divided by the number of bottles of milk produced.

**Exhibit 1**  
Product Flows in a Process Costing Environment



© Cengage Learning 2014

Even in simple process costing environments, production generally involves a number of separate manufacturing processes, departments, or work cells. For example, the separate processes involved in manufacturing cookies include mixing, baking, and packaging.

To *measure* and *recognize* product costs using process costing requires the preparation of a **process cost report** for each process, department, or work cell as product-related costs flow through the production process. Managers assign these costs to the units that have transferred out of the process and to the units that are still a part of the work in process. They use a cost allocation method, such as the FIFO costing method or the average costing method.

- In the **first-in, first-out (FIFO) costing method**, the cost flow follows the logical physical flow of production—that is, the costs assigned to the first materials processed are the first costs transferred out when those materials flow to the

next process, department, or work cell. Thus, in Exhibit 1, the costs assigned to the homogenized milk would be the first costs transferred to the Pasteurization Department.

- In contrast, the **average costing method** assigns an average cost to all products made during a period. This method thus uses total cost averages and does not try to match cost flow with the physical flow of production.

## Cost Flows Through the Work in Process Inventory Accounts

As discussed in the previous chapter, a job order costing system uses a single Work in Process Inventory account, whereas a process costing system has a separate Work in Process Inventory account for each process, department, or work cell. As shown in Exhibit 1, these accounts are the focal point of process costing. As products move from one process, department, or work cell to the next, the costs of the direct materials, direct labor, and overhead associated with them flow to the next Work in Process Inventory account. The journal entry to record the transfer of costs from one process, department, or work cell to another is:

	<i>Dr.</i>	<i>Cr.</i>
Work in Process Inventory (next department)	XX	
Work in Process Inventory (this department)		XX

Once the products are completed, packaged, and ready for sale, their costs are transferred to the Finished Goods Inventory account. The journal entry to record this transfer out of Work in Process Inventory into Finished Goods Inventory is:

	<i>Dr.</i>	<i>Cr.</i>
Finished Goods Inventory	XX	
Work in Process Inventory (last department)		XX

As you will learn later in this chapter, the costs associated with these entries are calculated in a process cost report for the process, department, or work cell.

### APPLY IT!

Milk Smoothies Inc. uses an automated mixing machine in its Mixing Department to combine three raw materials into a product called Strawberry Smoothie Mix. Total costs charged to the Mixing Department's Work in Process Inventory account during the month were \$210,000. There were no units in beginning or ending work in process inventory. Prepare the journal entry to transfer the units completed to Finished Goods Inventory.

#### SOLUTION

Finished Goods Inventory	210,000	
Work in Process Inventory		210,000

#### TRY IT! SE3, E2A, E3A, E2B, E3B

## LO 3 Computing Equivalent Production

A process costing system does not associate costs with particular job orders. Instead, it assigns the costs incurred in a process, department, or work cell to the units in production during a period by computing an average cost per unit of effort. Unit cost for the period is computed as follows.

$$(\text{Direct Materials} + \text{Direct Labor} + \text{Overhead}) \div \text{Number of Units} = \text{Unit Cost}$$

The number of units in production during the period is a critical question. Do we count only units started and completed during the period? Or should we include partially



Cindy Lee/Shutterstock.com

While direct materials are usually added to production at the beginning of the process, they can be added at other stages. For example, chocolate chips are added at the end of the mixing process for cookie dough.

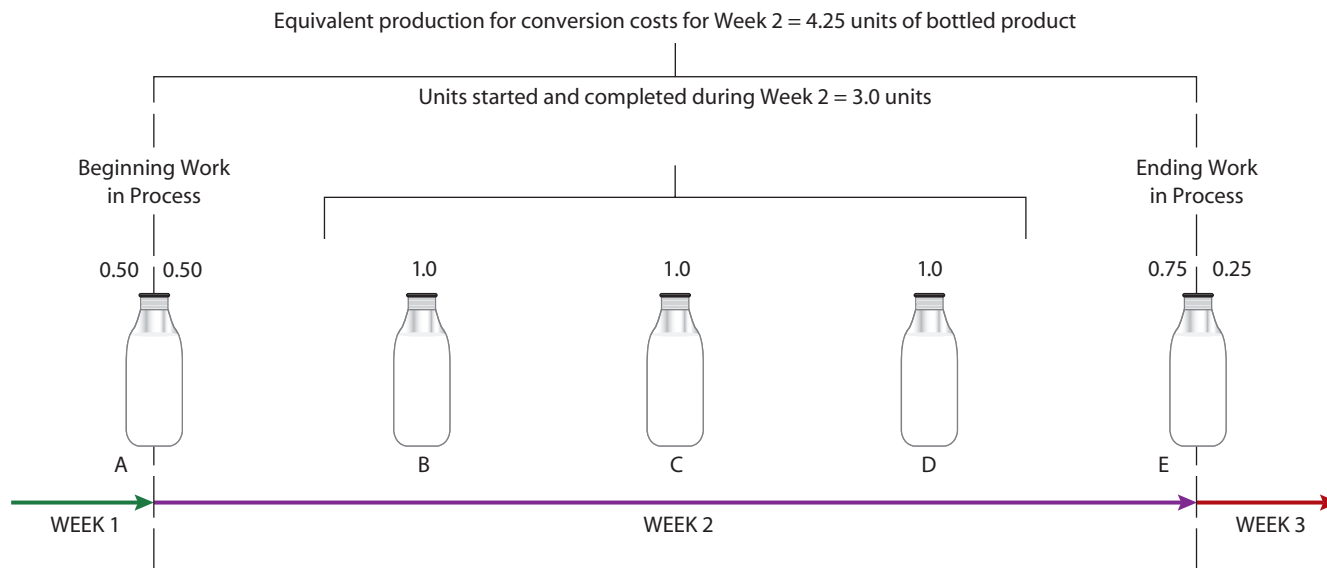
completed units in the beginning work in process inventory? And what about incomplete products in the ending work in process inventory?

These questions relate to the concept of equivalent production. **Equivalent production** (or *equivalent units*) applies a percentage-of-completion factor to partially completed units to calculate the equivalent number of whole units produced during a period for each type of input (i.e., direct materials, direct labor, and overhead). The number of equivalent units produced is (1) the sum of total units started and completed during the period and (2) an amount representing the work done on partially completed products in both the beginning and the ending work in process inventories. Equivalent production must be computed separately for each type of input because of differences in the ways in which costs are incurred.

- Direct materials are usually added to production at the beginning of the process.
- The costs of direct labor and overhead are often incurred uniformly throughout the production process. Thus, it is convenient to combine direct labor and overhead when calculating equivalent units. These combined costs are called **conversion costs** (or *processing costs*).

For example, Milk Products Company makes a pint-sized, bottled milk drink. As shown in Exhibit 2, the company started Week 2 with one half-completed unit in process. During Week 2, it started and completed three units, and at the end of Week 2, it had one unit that was three-quarters completed.

**Exhibit 2**  
Computation of Equivalent Production



Note: Conversion costs (the cost of direct labor and overhead) are incurred uniformly as each physical unit of drink moves through production. Equivalent production for Week 2 is 4.25 units for conversion costs. But direct materials costs are all added to production at the beginning of the process. Because four physical units of drinks entered production in Week 2, equivalent production for the week is 4.0 units of effort for direct materials costs.

© Cengage Learning 2014

**Equivalent Production for Direct Materials**

At Milk Products, all direct materials, including liquids and bottles, are added at the beginning of production. Thus, the unit that was half-completed at the beginning of Week 2 had had all its direct materials added during the previous week. No direct



**STUDY NOTE:** The number of units started and completed is not the same as the total number of units completed during the period. Total units completed include both units in beginning work in process inventory that were completed and units started and completed.

materials costs for this unit are included in the computation of Week 2's equivalent units for the beginning inventory units.

During Week 2, work began on four new units—the three units that were completed and the unit that was three-quarters completed at week's end. Because all direct materials are added at the beginning of the production process, all four units were 100 percent complete with regard to direct materials at the end of Week 2. Thus, for Week 2, the equivalent production for direct materials was 4.0 units. This figure includes direct materials for both the 3.0 units that were started and completed and the 1.0 unit that was three-quarters completed.

## Equivalent Production for Conversion Costs

Because conversion costs at Milk Products are incurred uniformly throughout the production process, the equivalent production for conversion costs during Week 2 consists of the following three components:

- the cost to finish the half-completed unit in beginning work in process inventory (0.50)
- the cost to begin and finish three completed units (3.0)
- the cost to begin work on the three-quarters-completed unit in ending work in process inventory (0.75)

Thus, For Week 2, the total equivalent production for conversion costs in units is computed as follows.

$$\begin{aligned}
 \text{Total Equivalent Units} &= \text{Beginning} + \text{Started and} + \text{Ending} \\
 \text{for Conversion Costs} &= \text{Inventory} + \text{Completed} + \text{Inventory} \\
 &= 0.50 \text{ unit} + 3.0 \text{ units} + 0.75 \text{ unit} \\
 &= 4.25 \text{ units}
 \end{aligned}$$

**STUDY NOTE:** Work in the current period is assigned to three distinct product groups: units in beginning work in process inventory, which must be completed; goods started and completed during the period; and goods started but not completed by the end of the accounting period.

In reality, Milk Products would make many more drinks during an accounting period and would have many more partially completed drinks in its beginning and ending work in process inventories. The number of partially completed drinks would be so great that it would be impractical to take a physical count of them. Instead, Milk Products would estimate an average percentage of completion for all drinks in process.

## Summary of Equivalent Production

The following is a recap of Milk Products's current equivalent production for direct materials and conversion costs for the period:

	Physical Units	Equivalent Units of Effort			
		Direct Materials		Conversion Costs	
Beginning inventory	1.00	—	0%	0.50	50%
Units started this period	4.00	3.00	100%	3.00	100%
Units to be accounted for	5.00	1.00	100%	0.75	75%
Beginning inventory	1.00	—	0%	0.50	50%
Units started and completed	3.00	3.00	100%	3.00	100%
Ending inventory	1.00	1.00	100%	0.75	75%
Units accounted for	5.00	4.00		4.25	

## APPLY IT!

Milk Smoothies, Inc., adds direct materials when it starts its drink mix production process and adds conversion costs uniformly throughout this process. Given the following information from July, compute the current period's equivalent units of production:

- Units in beginning inventory: 2,000
- Units started during the period: 13,000
- Units partially completed: 500
- Percentage of completion of beginning inventory: 100% for direct materials; 40% for conversion costs in previous period
- Percentage of completion of ending work in process inventory: 100% for direct materials; 70% for conversion costs

### SOLUTION

**Milk Smoothies, Inc.**  
**For the Month Ended July 31**

	Physical Units	Equivalent Units of Effort			
		Direct Materials		Conversion Costs	
Beginning inventory	2,000				
Units started this period	13,000				
Units to be accounted for	<u>15,000</u>				
Beginning inventory	2,000	—	0%	1,200	60%
Units started and completed	12,500	12,500	100%	12,500	100%
Ending inventory	500	500	100%	350	70%
Units accounted for	<u>15,000</u>	<u>13,000</u>		<u>14,050</u>	

**TRY IT! SE4, E4A, E5A, E6A, E4B, E5B, E6B**

## Lo 4 Preparing a Process Cost Report Using the FIFO Costing Method

**STUDY NOTE:** The FIFO method focuses on the work done in the current period only.

As mentioned earlier, a *process cost report* is a report that managers use to track and analyze costs for a process, department, or work cell in a process costing system. In a process cost report that uses the FIFO costing method, the cost flow follows the logical physical flow of production—that is, the costs assigned to the first products processed are the first costs transferred out when those products flow to the next process, department, or work cell.

To continue with the Milk Products example, assume the following for February:

- The beginning work in process inventory consists of 6,200 partially completed units (60% processed in the previous period). Beginning inventory cost of \$41,540 consisted of materials cost of \$20,150 and conversion cost of \$21,390.
- During the period, the 6,200 units in beginning inventory were completed, and 57,500 units were started into production. Current period cost of \$510,238 consisted of material cost of \$189,750 and conversion cost of \$320,488.
- Of the 57,500 units started during the period, 52,500 units were completed. The other 5,000 units remain in ending work in process inventory and are 45% complete.

Exhibit 3 presents a process cost report for Milk Products.

**Exhibit 3**  
Process Cost Report: FIFO Costing Method

		<u>Physical Units</u>	<u>Current Equivalent Units of Effort</u>			
<b>Step 1:</b> <i>Account for physical units.</i>	Beginning inventory (units started last period)	6,200				
	Units started this period	57,500				
	Units to be accounted for	<u>63,700</u>				
<b>Step 2:</b> <i>Account for equivalent units.</i>	Beginning inventory (units completed this period)	6,200	<u>Direct Materials</u>	<u>% Incurred During Period</u>	<u>Conversion Costs</u>	<u>% Incurred During Period</u>
	Units started and completed this period	52,500	0	0%	2,480	40%
	Ending inventory (units started but not completed this period)	5,000	52,500	100%	52,500	100%
	Units accounted for	<u>63,700</u>	<u>5,000</u>	100%	<u>2,250</u>	45%
			<u>57,500</u>		<u>57,230</u>	
<b>Step 3:</b> <i>Account for costs.</i>	Beginning inventory	<u>\$ 41,540</u>	= \$ 20,150	+	\$ 21,390	
	Current costs	510,238	= 189,750	+	320,488	
	Total costs	<u>\$551,778</u>				
<b>Step 4:</b> <i>Compute cost per equivalent unit.</i>	<u>Current Costs</u>		<u>\$189,750</u>		<u>\$320,488</u>	
	Equivalent Units		57,500		57,230	
	Cost per equivalent unit	<u>\$8.90</u>	= <u>\$3.30</u>	+	<u>\$5.60</u>	
<b>Step 5:</b> <i>Assign costs to cost of goods manufactured and ending inventory.</i>	Cost of goods manufactured and transferred out:					
	From beginning inventory	<u>\$ 41,540</u>				
	Current costs to complete	13,888	= \$0	+	(2,480 × \$5.60)	
	Units started and completed this period	<u>467,250</u>	= (52,500 × \$3.30)	+	(52,500 × \$5.60)	
	Cost of goods manufactured	<u>\$522,678</u>	<i>(No rounding necessary)</i>			
	Ending inventory	<u>29,100</u>	= (5,000 × \$3.30)	+	(2,250 × \$5.60)	
	Total costs	<u>\$551,778</u>				

**Work in Process Inventory Account: Cost Recap**

Beg. bal.	41,540	Cost of goods	522,678
Direct materials	189,750	manufactured	
Conversion costs	320,488	and transferred out	
<b>End. bal.</b>	<b>29,100</b>		

**Work in Process Inventory Account: Unit Recap**

Beg. bal.	6,200	FIFO units transferred	58,700
Units started	57,500	out (from the 6,200 in	
		beginning inventory	
		plus the 52,500 started	
		and completed)	
<b>End. bal.</b>	<b>5,000</b>		

As shown in Exhibit 3, the preparation of a process cost report involves five steps. The first two steps account for the units of product being processed. The next two steps account for the costs of the direct materials, direct labor, and overhead being incurred. The final step assigns costs to products being transferred out of the area and to those remaining behind in ending work in process inventory.

## Accounting for Units

Managers must account for the physical flow of products through their areas (Step 1) before they can compute equivalent production for the accounting period (Step 2). To continue with the Milk Products example, assume the following for February:

- The beginning work in process inventory consists of 6,200 partially completed units (60 percent processed in the previous period).
- During the period, the 6,200 units in beginning inventory were completed, and 57,500 units were started into production.
- Of the 57,500 units started during the period, 52,500 units were completed. The other 5,000 units remain in ending work in process inventory and are 45 percent complete.

**Step 1: Account for Physical Units** In Step 1 in Exhibit 3, Milk Products’s department manager computes the total units to be accounted for by adding the 6,200 units in beginning inventory to the 57,500 units started into production during this period. These 63,700 units are the actual physical units that the manager is responsible for during the period.

Step 1 continues accounting for physical units. As shown in Exhibit 3, the 6,200 units in beginning inventory that were completed during the period, the 52,500 units that were started and finished in the period, and the 5,000 units remaining in the department at the end of the period are summed, and the total is listed as “units accounted for.” (Note that the “units accounted for” must equal the “units to be accounted for” in Step 1.)

**Step 2: Account for Equivalent Units** The units accounted for in Step 1 are used to compute equivalent production for the department’s direct materials and conversion costs for the month in Step 2.

**STUDY NOTE:** Units in beginning work in process inventory represent work accomplished in the previous period that has already been assigned a certain portion of its total cost. Those units must be completed in the current period, incurring additional costs. Under FIFO, the amount of effort required to complete beginning work in process inventory is the relevant percentage.

**Beginning Inventory.** Because all direct materials are added at the beginning of the production process, the 6,200 partially completed units that began February as work in process were already 100 percent complete in regard to direct materials. They were 60 percent complete in regard to conversion costs on February 1. The remaining 40 percent of their conversion costs were incurred as they were completed during the month. Thus, as shown in the “Conversion Costs” column of Exhibit 3, the current equivalent production for their conversion costs is computed as follows.

$$6,200 \text{ units} \times 40\% = 2,480 \text{ units}$$

**Units Started and Completed During the Period.** All the costs of the 52,500 units started and completed during February were incurred during this period. Thus, the full amount of 52,500 is entered as the equivalent units for both direct materials costs and conversion costs since 100% of the work was completed during the current period.

**Ending Inventory.** Because the materials for the 5,000 drinks still in process at the end of February were added when the drinks went into production during the month, the full amount of 5,000 is entered as the equivalent units for direct materials costs. However, these drinks are only 45 percent complete in terms of conversion costs. Thus, as shown in the Conversion Costs column of Exhibit 3, the equivalent production for their conversion costs is computed as follows.

$$5,000 \text{ units} \times 45\% = 2,250 \text{ units}$$

**Totals.** Step 2 is completed by summing all the physical units to be accounted for, all equivalent units for direct materials costs, and all equivalent units for conversion costs. Exhibit 3 shows that for February, Milk Products accounted for 63,700 units. Equivalent units for direct materials costs totaled 57,500, and equivalent units for conversion costs totaled 57,230. Once Milk Products knows February’s equivalent unit amounts, it can complete the remaining three steps in the preparation of a process cost report.

## Accounting for Costs

Thus far, we have focused on accounting for units of productive output—in our example, bottled milk drinks. We now turn our focus to the cost information portion of preparing a process cost report.

- In Step 3, all costs charged to the Work in Process Inventory account of each production process, department, or work cell are accumulated and analyzed.
- In Step 4, the cost per equivalent unit for direct materials costs and conversion costs is computed.

To continue with the Milk Products example, assume the following for February:

Work in Process Inventory	
Costs from beginning inventory:	
Direct materials costs	20,150
Conversion costs	21,390
Current period costs:	
Direct materials costs	189,750
Conversion costs	320,488

**STUDY NOTE:** The cost per equivalent unit using the FIFO method measures the current cost divided by current effort. Notice in Exhibit 3 that the cost of beginning work in process inventory is omitted.

**Step 3: Account for Costs** As shown in Exhibit 3, all costs for the period are accumulated in the Total Costs column.

$$\begin{array}{l}
 \text{Beginning Material Inventory Cost} + \text{Conversion Cost} = \text{Total Beginning Inventory Cost} \\
 \qquad \qquad \qquad \$20,150 + \$21,390 = \$41,540 \\
 \text{Current Period Material Cost} + \text{Conversion Cost} = \text{Total Current Period Cost} \\
 \qquad \qquad \qquad \$189,750 + \$320,488 = \$510,238 \\
 \text{Beginning Inventory Cost} + \text{Current Period Cost} = \text{Total Cost} \\
 \qquad \qquad \qquad \$41,540 + \$510,238 = \$551,778
 \end{array}$$

Notice that only the Total Costs column is totaled. Because only the current period costs for direct materials and conversion are used in Step 4, there is no need to find the total costs of the direct materials and conversion costs columns in Step 3.

**Step 4: Compute Cost per Equivalent Unit** Exhibit 3 shows the computation of the current cost per current equivalent unit for direct materials and for conversion costs.

$$\begin{aligned}
 \text{Total Cost per Equivalent Unit} &= \left( \frac{\text{Direct Materials Cost}}{\text{Units of Equivalent Production}} \right) + \left( \frac{\text{Conversion Costs}}{\text{Units of Equivalent Production}} \right) \\
 &= (\$189,750 \div 57,500) + (\$320,488 \div 57,230) \\
 &= \$3.30 + \$5.60 \\
 &= \underline{\underline{\$8.90}}
 \end{aligned}$$

Note that the equivalent units are taken from Step 2 of Exhibit 3. Prior period costs attached to units in beginning inventory are not included in these computations because the FIFO costing method uses a separate costing analysis for each accounting period. (The FIFO method treats the costs of beginning inventory separately, in Step 5.)

## Assigning Costs

We have focused on accounting for units of productive output, analyzed the costs accumulated in the production process, department, or work cell, and computed the cost per

**STUDY NOTE:** The process cost report is developed for the purpose of assigning a value to one transaction: the transfer of goods from one department to another or to finished goods inventory. The ending balance in the Work in Process Inventory account represents the costs that remain after this transfer.

equivalent unit for direct material costs and conversion costs. We now turn to the final step, which is to recognize the costs that are transferred out either to the next production process, department, or work cell or to the Finished Goods Inventory account (i.e., the cost of goods manufactured), as well as the costs that remain in the Work in Process Inventory account.

**Step 5: Assign Costs to Cost of Goods Manufactured and Ending Inventory**

Step 5 in the preparation of a process costing report uses information from Steps 2 and 4 to assign costs, as shown in Exhibit 3. This final step determines the costs that are transferred out or remain in the Work in Process Inventory account. The total costs assigned to units completed and transferred out and to ending inventory must equal the total costs in Step 3.

**Cost of Goods Manufactured and Transferred Out.** Step 5 in Exhibit 3 shows that the costs transferred to the Finished Goods Inventory account include the \$41,540 in direct materials and conversion costs for completing the 6,200 units in beginning inventory. Step 2 shows that 2,480 equivalent units of conversion costs were required to complete these 6,200 units. Because the equivalent unit conversion cost for February is \$5.60, the cost to complete the units carried over from January is computed as follows.

$$2,480 \text{ units} \times \$5.60 = \$13,888$$

Each of the 52,500 units started and completed in February cost \$8.90 to produce.

$$52,500 \text{ units} \times \$8.90 = \$467,250$$

To recap the cost assigned to the work completed during the period and transferred to Finished Goods:

$$\$41,540 + \$13,888 + \$467,250 = \$522,678$$

The entry resulting from doing the process cost report for February is:

	Dr.	Cr.
Finished Goods Inventory	522,678	
Work in Process Inventory		522,678

**STUDY NOTE:** All costs must be accounted for, including both costs from beginning inventory and costs incurred during the current period. All costs must be assigned to either ending inventory or the goods transferred out.

**Ending Inventory.** All costs remaining in Milk Products’ Work in Process Inventory account after the cost of goods manufactured has been transferred out represent the costs of the drinks still in production at the end of February. As shown in Step 5 of Exhibit 3, the balance in the ending Work in Process Inventory is computed as follows.

$$(5,000 \text{ units} \times \$3.30 \text{ per unit}) + (2,250 \times \$5.60 \text{ per unit}) = \$29,100$$

**Rounding Differences.** As you perform Step 5 in any process cost report, remember that the total costs in Steps 3 and 5 must always be the same number. In Exhibit 3, for example, they are both \$551,778.

- If the total costs in Steps 3 and 5 are not the same, first check for omission of any costs and for calculation errors.
- If that does not solve the problem, check whether any rounding was necessary in computing the costs per equivalent unit in Step 4. If rounding was done in Step 4, rounding differences will occur when assigning costs in Step 5. In that case, adjust the total costs transferred out for any rounding difference so that the total costs in Step 5 equal the total costs in Step 3.

**STUDY NOTE:** Rounding product unit costs to even dollars may lead to a significant difference in total costs, giving the impression that costs have been miscalculated. Round product unit costs to two decimal places where appropriate.

**Recap of Work in Process Inventory Account** When the process cost report is complete, an account recap will show the effects of the report on the Work in Process Inventory account for the period. Two recaps of Milk Products’ Work in Process Inventory account for February—one for costs and one for units—appear at the end of Exhibit 3.



## Process Costing for Two or More Production Departments

In this example, Milk Products has only one production department for making milk drinks, so it needs only one Work in Process Inventory account. However, a company that has more than one production process or department must have a Work in Process Inventory account for each process or department.

For instance, a milk producer like Milk Products has a production department for homogenization, another for pasteurization, and another for packaging needs—three Work in Process Inventory accounts.

- When products flow from the Homogenization Department to the Pasteurization Department, their costs flow from the Homogenization Department's Work in Process Inventory account to the Pasteurization Department's Work in Process Inventory account.
- The costs transferred into the Pasteurization Department's Work in Process Inventory account are treated in the same way as the cost of direct materials added at the beginning of the production process.
- When production flows to the Packaging Department, the accumulated costs (incurred in the two previous departments) are transferred to that department's Work in Process Inventory account.
- At the end of the period, a separate process cost report is prepared for each department.

### APPLY IT!

Pop Chewing Gum Company produces bubble gum. Direct materials are blended at the beginning of the manufacturing process. No materials are lost in the process, so one kilogram of materials input produces one kilogram of bubble gum. Direct labor and overhead costs are incurred uniformly throughout the blending process.

- On June 30, 16,000 units were in process. All direct materials had been added, but the units were only 70 percent complete in regard to conversion costs in the prior period. Direct materials costs of \$8,100 and conversion costs of \$11,800 were attached to the beginning inventory.
- During July, 405,000 kilograms of materials were used at a cost of \$202,500. Direct labor charges were \$299,200, and overhead costs applied during July were \$284,000.
- The ending work in process inventory was 21,600 kilograms. All direct materials have been added to those units, and 25 percent of the conversion costs have been assigned. Output from the Blending Department is transferred to the Packaging Department.

#### Required

1. Prepare a process cost report using the FIFO costing method for the Blending Department for July.
2. Identify the amount that should be transferred out of the Work in Process Inventory account, state where those dollars should be transferred, and prepare the appropriate journal entry.



**SOLUTION**

1.

**Pop Chewing Gum Company  
Blending Department  
Process Cost Report: FIFO Method  
For the Month Ended July 31**

		<b>Physical Units</b>	<b>Current Equivalent Units of Effort</b>			
			<b>Direct Materials</b>	<b>% Incurred During Period</b>	<b>Conversion Costs</b>	<b>% Incurred During Period</b>
<b>Step 1:</b>						
<i>Account for physical units.</i>	Beginning inventory (units started last period)	16,000				
	Units started this period	405,000				
	Units to be accounted for	421,000				
<b>Step 2:</b>						
<i>Account for equivalent units.</i>	Beginning inventory (units completed this period)	16,000	0	0%	4,800	30%
	Units started and completed this period	383,400	383,400	100%	383,400	100%
	Ending inventory (units started but not completed this period)	21,600	21,600	100%	5,400	25%
	Units accounted for	421,000	405,000		393,600	
<b>Step 3:</b>						
<i>Account for costs.</i>	Beginning inventory	\$ 19,900	= \$ 8,100	+	\$ 11,800	
	Current costs	785,700	= 202,500	+	583,200	
	Total costs	\$805,600				
<b>Step 4:</b>						
<i>Compute cost per equivalent unit.</i>	<u>Current Costs</u>		<u>\$202,500</u>		<u>\$583,200</u>	
	Equivalent Units		405,000		393,600	
	Cost per equivalent unit	<u>\$1.98</u>	= <u>\$0.50</u>	+	<u>\$1.48*</u>	
					<i>*Rounded to nearest cent</i>	
<b>Step 5:</b>						
<i>Assign costs to cost of goods manufactured and ending inventory.</i>	Cost of goods manufactured and transferred out:					
	From beginning inventory	\$ 19,900				
	Current costs to complete	7,104	= \$0	+	(4,800 × \$1.48)	
	Units started and completed this period	759,132	= (383,400 × \$0.50)	+	(383,400 × \$1.48)	
	Cost of goods manufactured	\$786,808	<i>[Cost of goods manufactured must be \$786,808 (add rounding of \$672) since Total costs = Ending inventory + Cost of goods manufactured]</i>			
	Ending inventory	18,792	= (21,600 × \$0.50)	+	(5,400 × \$1.48)	
	Total costs	\$805,600				

**Work in Process Inventory Account: Cost Recap**

Beg. bal.	19,900	Cost of goods manufactured and transferred out	786,808
Direct materials	202,500		
Conversion costs	583,200		
<b>End. bal.</b>	<b>18,792</b>		

**Work in Process Inventory Account: Unit Recap**

Beg. bal.	16,000	FIFO units transferred out (from the 16,000 in beginning inventory plus the 383,400 started and completed)	399,400
Units started	405,000		
<b>End. bal.</b>	<b>21,600</b>		

*(Continued)*

2. The amount of \$786,808 should be transferred to the Work in Process Inventory account of the Packaging Department.

Work in Process Inventory (Packaging Department)	786,808
Work in Process Inventory (Blending Department)	786,808

**TRY IT! SE5, SE6, E7A, E8A, E9A, E10A, E7B, E8B, E9B, E10B**

## Lo 5 Preparing a Process Cost Report Using the Average Costing Method

When a process cost report uses the average costing method, like the one shown in Exhibit 4, cost flows do not follow the logical physical flow of production as they do when the FIFO method is used. Instead, the costs in beginning inventory are combined with current period costs to compute an average product unit cost. Preparing a process cost report using the average costing method involves the same five steps as using the FIFO method, but the procedures for completing the steps differ. Assume that Milk Products uses the average costing method of process costing.

### Accounting for Units

The process cost report accounts for the physical units in a production process, department, or work cell during a period. Managers must account for the physical flow of products through their areas (Step 1) before they can compute equivalent production for the accounting period (Step 2). Units to be accounted for equals the physical units in beginning inventory plus the physical units started during the period.

**STUDY NOTE:** Step 1 (accounting for physical units) is identical for the average costing and FIFO costing methods.

**Step 1: Account for Physical Units** Step 1 of a process cost report accounts for the physical units in a production process, department, or work cell during a period. Units to be accounted for equals the physical units in beginning inventory plus the physical units started during the period. In Step 1 of Exhibit 4, Milk Products' department manager computes the total units to be accounted for as follows.

$$6,200 \text{ units} + 57,500 \text{ units} = 63,700$$

**Step 2: Account for Equivalent Units** Step 2 also accounts for production during the period in terms of units. After the number of units completed and transferred to finished goods inventory and the number of units in ending inventory have been added to arrive at "units accounted for," the equivalent units in terms of direct materials costs and conversion costs are computed.

**STUDY NOTE:** In contrast, as shown in Exhibit 3, the FIFO costing method disregards the previous period costs of units started in the last period and calculates only the equivalent units required in the current period to complete the units in beginning inventory.

**Units Completed and Transferred Out.** In Exhibit 4, the average costing method treats both the direct materials costs and the conversion costs of the 58,700 units completed in February (6,200 units from beginning inventory + 52,500 started this period) as if they were incurred in the current period. Thus, the full amount of 58,700 is entered as the equivalent units for these costs.

**Ending Inventory.** Because all direct materials are added at the beginning of the production process, the full amount of 5,000 is entered as the equivalent units for direct materials cost. Because the 5,000 units in ending inventory are only 45 percent complete in terms of conversion costs, the amount of equivalent units is computed as follows.

$$5,000 \text{ units} \times 45\% = 2,250 \text{ units}$$

**Totals.** When the average costing method is used, Step 2 in a process cost report is completed by summing all the physical units to be accounted for, all equivalent units for direct

**STUDY NOTE:** The average costing method treats ending inventory in exactly the same way as the FIFO costing method.

**Exhibit 4**  
Process Cost Report: Average Costing Method

		<b>Physical Units</b>		<b>Total Equivalent Units of Effort</b>			
<b>Step 1:</b> <i>Account for physical units.</i>	Beginning inventory (units started last period)		6,200				
	Units started this period		57,500				
	Units to be accounted for		<u>63,700</u>				
<b>Step 2:</b> <i>Account for equivalent units.</i>	Units completed and transferred out		58,700	58,700	100%	58,700	100%
	Ending inventory (units started but not completed this period)		5,000	5,000	100%	2,250	45%
	Units accounted for		<u>63,700</u>	<u>63,700</u>		<u>60,950</u>	
<b>Step 3:</b> <i>Account for costs.</i>	Beginning inventory	\$ 41,540	=	\$ 20,150	+	\$ 21,390	
	Current costs	510,238	=	189,750	+	320,488	
	Total costs	<u>\$551,778</u>		<u>\$209,900</u>		<u>\$341,878</u>	
<b>Step 4:</b> <i>Compute cost per equivalent unit.</i>	Total Costs			\$209,900		\$341,878	
	Equivalent Units			63,700		60,950	
	Cost per equivalent unit	<u>\$8.91</u>	=	<u>\$3.30*</u>	+	<u>\$5.61*</u>	
*Rounded to nearest cent							
<b>Step 5:</b> <i>Assign costs to cost of goods manufactured and ending inventory.</i>	Cost of goods manufactured and transferred out	\$522,655	=	(58,700 × \$3.30)	+	(58,700 × \$5.61)	
				<i>(Cost of goods manufactured must be \$522,655 (less rounding of \$362) since Total costs = Ending inventory + Cost of goods manufactured)</i>			
	Ending inventory	29,123*	=	(5,000 × \$3.30)	+	(2,250 × \$5.61)	
*Rounded to nearest whole dollar							
	Total costs	<u>\$551,778</u>					

<b>Work in Process Inventory Account: Cost Recap</b>				<b>Work in Process Inventory Account: Unit Cost Recap</b>			
Beg. bal.	41,540	Cost of goods manufactured and transferred out	522,655	Beg. bal.	6,200	Units transferred out	58,700
Direct materials	189,750			Units started	57,500		
Conversion costs	320,488			<b>End. bal.</b>	<b>5,000</b>		
<b>End. bal.</b>	<b>29,123</b>						

materials costs, and all equivalent units for conversion costs. Exhibit 4 shows that for February, Milk Products accounted for 63,700 physical units. Equivalent units for direct materials costs totaled 63,700, and equivalent units for conversion costs totaled 60,950.

## Accounting for Costs

Step 3 of the report accumulates and analyzes all costs in the Work in Process Inventory account, and Step 4 computes the cost per equivalent unit for direct materials costs and

conversion costs. The costs of Milk Products's beginning inventory were \$20,150 for direct materials and \$21,390 for conversion. Current period costs were \$189,750 for direct materials and \$320,488 for conversion.

**STUDY NOTE:** Comparing Exhibit 4 with Exhibit 3, you will see that the average costing and FIFO costing methods deal with Step 3 in the same manner.

**Step 3: Account for Costs** All direct materials costs and conversion costs for beginning inventory and the current period are accumulated in the Total Costs column. The total of \$551,778 consists of \$209,900 in direct materials costs and \$341,878 in conversion costs.

**Step 4: Compute Cost per Equivalent Unit** Step 4 computes the cost per equivalent unit as follows.

$$\begin{aligned} \text{Total Cost per Equivalent Unit} &= \left( \begin{array}{c} \text{Direct} \\ \text{Materials} \\ \text{Cost} \end{array} \div \begin{array}{c} \text{Units of} \\ \text{Equivalent} \\ \text{Production} \end{array} \right) + \left( \begin{array}{c} \text{Conversion} \\ \text{Costs} \end{array} \div \begin{array}{c} \text{Units of} \\ \text{Equivalent} \\ \text{Production} \end{array} \right) \\ &= (\$209,900 \div 63,700) + (\$341,878 \div 60,950) \\ &= \$3.30 + \$5.61 \\ &= \underline{\underline{\$8.91}} \end{aligned}$$

- Notice that the cost per equivalent unit for both direct materials and conversion costs has been rounded to the nearest cent. In this text, any rounding differences are assigned to the units transferred out in Step 5.
- Notice also that the average costing and FIFO costing methods use different numerators and denominators in Step 4. Average costing divides *total* cost by *total* equivalent units, whereas FIFO divides *current* costs by *current* equivalent units.

## Assigning Costs

We have focused on accounting for units of productive output, analyzed the costs accumulated in the production process, department, or work cell, and computed the cost per equivalent unit for direct material costs and conversion costs. We now turn to the final step, which is to recognize the costs that are transferred out either to the next production process, department, or work cell or to the Finished Goods Inventory account (i.e., the cost of goods manufactured), as well as the costs that remain in the Work in Process Inventory account.

### Step 5: Assign Costs to Cost of Goods Manufactured and Ending Inventory

Using information from Steps 2 and 4, Step 5 of a process cost report assigns direct materials and conversion costs to the units transferred out and to the units still in process at the end of the period. As noted, any rounding issues that arise in completing Step 5 are included in units completed and transferred out. Milk Products completes Step 5 as described next.

**Cost of Goods Manufactured and Transferred Out.** As shown in Exhibit 4, the costs of the units completed and transferred out are assigned by multiplying the equivalent units for direct materials and conversion costs (accounted for in Step 2) by their respective cost per equivalent unit (computed in Step 4) and then totaling these assigned values.

$$\begin{aligned} \text{Cost of Goods Transferred Out} &= (58,700 \times \$3.30) + (58,700 \times \$5.61) - \$362 \\ &= \$193,710 + \$329,307 - \$362 \\ &= \underline{\underline{\$522,655}} \end{aligned}$$

In this case, because the costs per equivalent unit were rounded in Step 4, a rounding difference of \$362 has been deducted from the total cost. The \$522,655 of transferred costs will go to the Finished Goods Inventory account, since the goods are ready for sale. The entry resulting from doing the process cost report for February is:

	<i>Dr.</i>	<i>Cr.</i>
Finished Goods Inventory	522,655	
Work in Process Inventory		522,655

**Ending Inventory.** The costs of the units in ending work in process inventory are assigned in the same way as the costs of cost of goods manufactured and transferred out. In Exhibit 4, the total of costs assigned to ending inventory is computed as follows.

$$(5,000 \times \$3.30) + (2,250 \times \$5.61) = \$29,123$$

The \$29,123 (rounded) will appear as the ending balance in the Work in Process Inventory account.

**Recap of Work in Process Inventory Account** As noted earlier, when a process cost report is complete, an account recap shows the effects of the report on the Work in Process Inventory account for the period. Exhibit 4 includes a cost recap and a unit recap of Milk Products's Work in Process Inventory account for February.

## APPLY IT!

Pop Chewing Gum Company produces several flavors of bubble gum. Direct materials are blended at the beginning of the manufacturing process. No materials are lost in the process, so one kilogram of materials input produces one kilogram of bubble gum. Direct labor and overhead costs are incurred uniformly throughout the blending process.

- On June 30, 16,000 units (kilograms) were in process. All direct materials had been added, but the units were only 70 percent complete in regard to conversion costs in the prior period. Direct materials costs of \$8,100 and conversion costs of \$11,800 were attached to the beginning inventory.
- During July, 405,000 kilograms of materials were used at a cost of \$202,500. Direct labor charges were \$299,200, and overhead costs applied during July were \$284,000.
- The ending work in process inventory was 21,600 kilograms. All direct materials have been added to those units, and 25 percent of the conversion costs have been assigned. Output from the Blending Department is transferred to the Packaging Department.

### Required

1. Prepare a process cost report using the average costing method for the Blending Department for July.
2. Identify the amount that should be transferred out of the Work in Process Inventory account, state where those dollars should be transferred, and prepare the appropriate journal entry.

*(Continued)*

**SOLUTION**

1.

**Pop Chewing Gum Company**  
**Blending Department**  
**Process Cost Report: Average Costing Method**  
**For the Month Ended July 31**

		<u>Physical Units</u>				
<b>Step 1:</b>			<b>Total Equivalent Units of Effort</b>			
<i>Account for physical units.</i>	Beginning inventory (units started last period)	16,000				
	Units started this period	<u>405,000</u>				
	Units to be accounted for	<u>421,000</u>				
			<u>Direct Materials Costs</u>	<u>% Incurred During Period</u>	<u>Conversion Costs</u>	<u>% Incurred During Period</u>
<b>Step 2:</b>						
<i>Account for equivalent units.</i>	Units completed and transferred out	399,400	399,400	100%	399,400	100%
	Ending inventory (units started but not completed this period)	<u>21,600</u>	<u>21,600</u>	100%	<u>5,400</u>	25%
	Units accounted for	<u>421,000</u>	<u>421,000</u>		<u>404,800</u>	
<b>Step 3:</b>		<b>Total Costs</b>				
<i>Account for costs.</i>	Beginning inventory	\$ 19,900	= \$ 8,100	+	\$ 11,800	
	Current costs	<u>785,700</u>	= <u>202,500</u>	+	<u>583,200</u>	
	Total costs	<u>\$805,600</u>	<u>\$210,600</u>		<u>\$595,000</u>	
<b>Step 4:</b>						
<i>Compute cost per equivalent unit.</i>	<u>Total Costs</u>		<u>\$210,600</u>		<u>\$595,000</u>	
	Equivalent Units		421,000		404,800	
	Cost per equivalent unit	<u>\$1.97</u>	= <u>\$0.50*</u>	+	<u>\$1.47*</u>	
			*Rounded to nearest cent			
<b>Step 5:</b>						
<i>Assign costs to cost of goods manufactured and ending inventory.</i>	Cost of goods manufactured and transferred out (Add rounding of \$44)	\$786,862	= (399,400 × \$0.50) +		(399,400 × \$1.47)	
	Ending inventory	<u>18,738</u>	= (21,600 × \$0.50) +		(5,400 × \$1.47)	
	Total costs	<u>\$805,600</u>				

**Work in Process Inventory Account: Cost Recap**

Beg. bal.	19,900	Cost of	786,862
Direct materials	202,500	goods manufactured	
Conversion costs	583,200	and transferred out	
<b>End. bal.</b>	<b>18,738</b>		

**Work in Process Inventory Account: Unit Recap**

Beg. bal.	16,000	Units	399,400
Units started	405,000	transferred out	
<b>End. bal.</b>	<b>21,600</b>		

2. The amount of \$786,862 should be transferred to the Work in Process Inventory account of the Packaging Department.

Work in Process Inventory (Packaging Department)	786,862
Work in Process Inventory (Blending Department)	786,862

**TRY IT! SE7, SE8, SE9, SE10, E11A, E12A, E13A, E14A, E15A, E11B, E12B, E13B, E14B, E15B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

**LO 6** Explain how managers use a process costing system to produce business results.

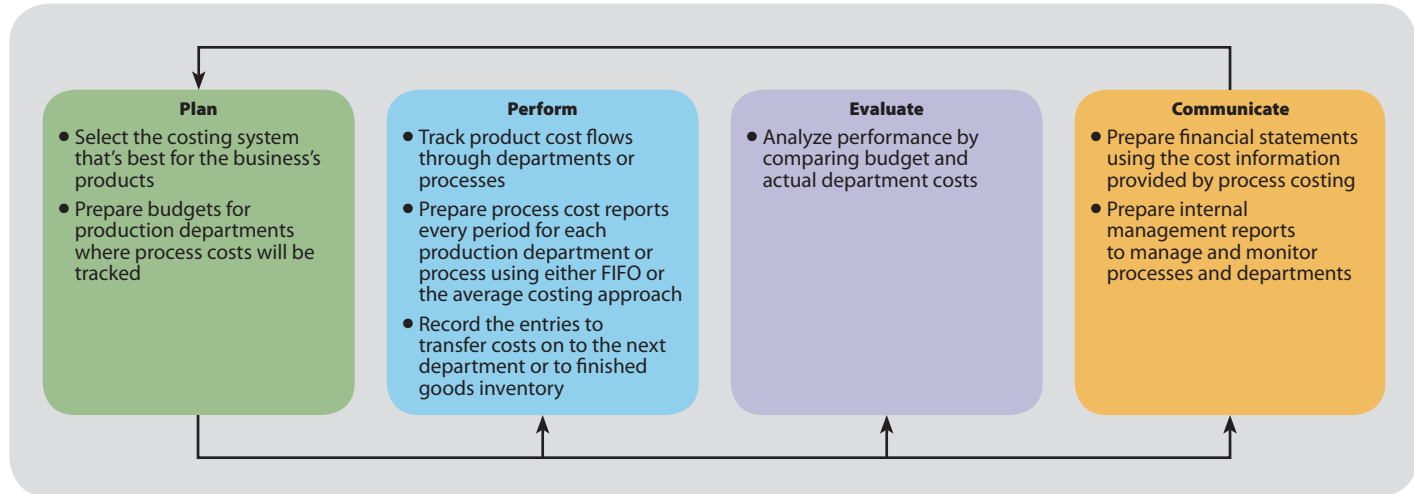
## **LO 6** The Management Process and the Process Costing System

As noted in the previous chapter, a product costing system provides managers with unit cost information, cost data for management decisions, and ending values for the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts. In this chapter, we focused on a process costing system, the product costing system used by managers at companies that make large amounts of similar products or liquid products. To use process costing, managers must understand product and cost flow patterns, equivalent production, and the preparation of process cost reports. Managers use process costing information in every stage of the management process.

- **Planning:** Managers use information about past and projected product costing and customer preferences to decide what a product should cost. After they have determined a target number of units to be sold, all product-related costs for that targeted number of units can be computed and used in the budget.
- **Performing:** During the period, managers control costs by tracking product and cost flows through their departments or processes and prepare process cost reports to assign production costs to the products manufactured.
- **Evaluating:** Managers evaluate performance by comparing targeted costs with actual costs. If costs have exceeded expectations, managers analyze why this has occurred and adjust their planning and decision-making strategies.
- **Communicating:** Managers use actual units and costs to value inventory on the balance sheet and cost of goods sold on the income statement. Managers are also interested in whether goals for product costs are being achieved.

Notice how managers use process costing throughout the management process to fulfill the management process of planning and forecasting operations, organizing and coordinating resources and data, and commanding and controlling the organization's resources, as illustrated in Exhibit 5.



**Exhibit 5****The Management Process and the Process Costing System****APPLY IT!**

Match the activities that follow with one of the stages in the management process.

- Planning
- Performing
- Evaluating
- Reporting

- Track the flow of product costs
- Prepare process cost reports
- Record entries to transfer costs on to the next department or finished goods inventory
- Select either the FIFO or weighted average method for process costing

**SOLUTION**

- b
- b
- b
- a

**TriLevel Problem**

Lasse Kristensen/Shutterstock.com

**Milk Products Company**

The beginning of this chapter focused on Milk Products Company, a company that provides its local community with milk and other dairy products. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

**Section 1: Concepts**

*Why is a process costing system appropriate for Milk Products to measure and recognize costs?*

**Section 2: Accounting Applications**

*How does a product costing system account for costs when identical products or services are produced?*

Milk Products makes and distributes chocolate milk. To produce chocolate milk, the Mixing Department uses two basic direct materials: milk and chocolate syrup. No materials are lost in the process, so one gallon of material input produces one gallon of chocolate milk. Direct labor and overhead costs are incurred uniformly throughout the mixing process. How does a product costing system account for costs when identical products like chocolate milk are produced? To answer this question, work the problem that follows.

Assume that 15,000 units of chocolate milk were in process at the beginning of the month. All direct materials had been added, but the units were only two-thirds complete in regard to conversion costs in the prior period. Direct materials costs of \$19,200 and conversion costs of \$14,400 were attached to the beginning inventory.

During the month, 435,000 gallons of materials were used at a cost of \$426,300. Direct labor charges were \$100,000, and overhead costs applied during the month were \$312,000. The ending work in process inventory was 50,000 gallons. All direct materials have now been added to those units, and 20 percent of the conversion costs have been assigned. Output from the Mixing Department has been transferred to the Packaging Department.

1. Using the FIFO costing method, prepare a process cost report for the Mixing Department for the month.
2. What amount should be transferred out of the Work in Process Inventory account, and to where should those dollars be transferred? Prepare the appropriate journal entry.
3. Using the average costing method, repeat requirement 1.
4. Answer the questions in requirement 2 as they apply to the process cost report that you prepared in requirement 3.

### Section 3: Business Applications

*How does a process costing system help managers organize and control costs and facilitate management decisions? To answer this question, match this chapter's manager responsibilities with when they occur within the management process.*

- |                |   |
|----------------|---|
| a. Plan        | 1. Track the flow of product costs  |
| b. Perform     | 2. Compare actual and budgeted departmental costs   |
| c. Evaluate    | 3. Prepare financial statements   |
| d. Communicate | 4. Prepare process cost reports   |
|                | 5. Prepare budgets  |
|                | 6. Prepare internal management reports  |
|                | 7. Record entries to transfer costs on to the next department or finished goods inventory |
|                | 8. Select the best product costing system   |

## SOLUTION

### Section 1: Concepts

Because the processing of milk and the production of dairy products involve a continuous flow of similar products, the process costing system is the most appropriate for a company like Milk Products. Such a system *measures* costs by process, department, or work cell and assigns them to products as they pass through. Companies like Milk Products can use either the FIFO method or the average costing method of process costing. The process cost report prepared at the end of each period *recognizes* the cost assigned to products completed and transferred out and to the products remaining in the process, department, or work cell. It provides the cost information needed to *match* product revenues to the expenses required to generate them. A product costing system, like process costing, provides managers with unit cost information, cost data for management decisions, and ending values for the Materials Inventory, Work in Process, and Finished Goods Inventory accounts.

## Section 2: Accounting Applications

1.

**Mixing Department  
Process Cost Report—FIFO Costing Method  
For the Month**

	<u>Physical Units</u>	<u>Current Equivalent Units of Effort</u>			
		<u>Direct Materials Costs</u>	<u>% Incurred During Period</u>	<u>Conversion Costs</u>	<u>% Incurred During Period</u>
Beginning inventory	15,000				
Units started this period	<u>435,000</u>				
Units to be accounted for	<u>450,000</u>				
Beginning inventory	15,000	—	0%	5,000	1/3
Units started and completed	385,000	385,000	100%	385,000	100%
Ending inventory	<u>50,000</u>	<u>50,000</u>	100%	<u>10,000</u>	20%
Units accounted for	<u>450,000</u>	<u>435,000</u>		<u>400,000</u>	
	<b>Total Costs</b>				
Beginning inventory	\$ 33,600	= \$ 19,200	+	\$ 14,400	
Current costs	<u>838,300</u>	= 426,300	+	412,000	
Total costs	<u>\$871,900</u>				
	<u>Current Costs</u>	<u>426,300</u>		<u>412,000</u>	
	Equivalent Units	435,000		400,000	
Cost per equivalent unit	<u>\$2.01</u>	= <u>\$0.98</u>	+	<u>\$1.03</u>	
Cost of goods manufactured and transferred out:					
From beginning inventory	\$ 33,600				
Current costs to complete	5,150	= \$0	+	(5,000 × \$1.03)	
Units started and completed	<u>773,850</u>	= (385,000 × \$0.98)	+	(385,000 × \$1.03)	
Cost of goods manufactured	\$812,600				
Ending inventory	<u>59,300</u>	= (50,000 × \$0.98)	+	(10,000 × \$1.03)	
Total costs	<u>\$871,900</u>				

2. The amount of \$812,600 should be transferred to the Work in Process Inventory account of the Packaging Department.

Work in Process (Packaging Inventory Department)	812,600	
Work in Process (Mixing Inventory Department)		812,600



batch of products or a specific job order. A process costing system accumulates the costs of direct materials, direct labor, and overhead for each process, department, or work cell and assigns those costs to the products as they are produced during a particular period.

Relate the patterns of product flows to the cost flow methods in a process costing environment, and explain the role of the Work in Process Inventory accounts. **LO 2**

During production in a process costing environment, products flow in a first-in, first-out (FIFO) fashion through several processes, departments, or work cells. The process costing system accumulates their costs and passes them on to the next process, department, or work cell. A process cost report may assign costs by using the FIFO costing method, in which the costs assigned to the first products processed are the first costs transferred out, or the average costing method, which assigns an average cost to all products made during a period.

The Work in Process Inventory accounts are the focal point of a process costing system. Each production process, department, or work cell has its own Work in Process Inventory account to which costs are charged. A process cost report assigns the costs that have accumulated during the period to the units that have flowed out of the process, department, or work cell (the cost of goods transferred out) and to the units that are still in process (the cost of ending inventory).

Describe equivalent production, and compute equivalent units. **LO 3**

Equivalent production measures the equivalent number of whole units produced in an accounting period for each type of input. Equivalent units are computed from (1) units in the beginning work in process inventory and their percentage of completion, (2) units started and completed during the period, and (3) units in the ending work in process inventory and their percentage of completion. The computation of equivalent units differs depending on whether the FIFO method or the average costing method is used.

Prepare a process cost report using the FIFO costing method. **LO 4**

In a process cost report that uses the FIFO costing method, the costs assigned to the first products processed are the first costs transferred out. Preparing a process cost report involves five steps. Steps 1 and 2 account for the physical flow of products and compute the equivalent units of production. In Step 3, all direct materials costs and conversion costs for the current period are added to arrive at total costs. In Step 4, the cost per equivalent unit for both direct materials costs and conversion costs is found by dividing those costs by their respective equivalent units. In Step 5, costs are assigned to the units completed and transferred out during the period, as well as to the ending work in process inventory. These costs include the costs incurred in the preceding period and the conversion costs that were needed to complete those units during the current period. That amount is added to the total cost of producing all units started and completed during the period. The result is the total cost transferred out for the units completed during the period. Step 5 also assigns costs to units still in process at the end of the period by multiplying their direct materials costs and conversion costs by their respective equivalent units. The total equals the balance in the Work in Process Inventory account at the end of the period.

Prepare a process cost report using the average costing method. **LO 5**

The average costing method is an alternative method of accounting for production costs. A process costing report that uses the average costing method does not differentiate when work was done on inventory. The costs in the beginning inventory are averaged with the current period costs to compute the product unit costs. These unit costs are used to value the ending balance in Work in Process Inventory and the goods completed and transferred out of the process.

Explain how managers use a process costing system to produce business results. **LO 6**

The product costs provided by a process costing system play a key role in the management process. Managers use past and projected information about product costs to set selling prices and prepare budgets. Each day, managers use cost information to make decisions about controlling costs, the company's volume of activity, ensuring quality, and negotiating prices. They evaluate performance results by comparing targeted costs with actual costs. They use actual units produced and costs incurred to value inventory

and the cost of goods sold. They also analyze internal reports that compare the organization's measures of actual and targeted performance to determine whether cost goals for products or services are being achieved.

## Key Terms

**average costing method** 846 (LO2)  
**conversion costs** 847 (LO3)

**equivalent production** 847 (LO3)  
**first-in, first-out (FIFO) costing method** 845 (LO2)

**process cost report** 845 (LO2)  
**process costing system** 844 (LO1)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 2, 3 **DQ1. CONCEPT** ► Explain why equivalent units are a measure of production effort instead of a physical unit measure of performance.
- LO 2, 4, 5 **DQ2. CONCEPT** ► Does the concept of cost recognition underlie why a process cost report is prepared every period for each production department?
- LO 4, 5 **DQ3. CONCEPT** ► Why does the concept of cost measurement underlie the five steps in preparing a process cost report?
- LO 4, 5 **DQ4. CONCEPT** ► What is the primary cost measurement and cost recognition differences between the FIFO and average costing methods of preparing a process cost report?
- LO 6 **DQ5. CONCEPT** ► **BUSINESS APPLICATION** ► Why does process costing in the management process reinforce the concepts of cost recognition and cost measurement to produce business results?

### SHORT EXERCISES

#### LO 1 Accounting Concepts

**SE1. CONCEPT** ► Match the following statements about process costing with its associated accounting concept:

- |   |  |
|---|--|
| <ul style="list-style-type: none"> <li>a. Cost measurement</li> <li>b. Cost recognition</li> <li>c. Matching concept</li> </ul> | <ul style="list-style-type: none"> <li>1. Because the processing of a continuous flow of similar products makes it difficult to track costs to individual units, the process costing system provides the cost information for product revenues to be measured against the expenses required to generate them. It provides managers with unit cost information, cost data for management decisions, and ending values for the Materials Inventory, Work in Process, and Finished Goods Inventory accounts.</li> <li>2. Costs are tracked and accumulated by process, department, or work cell.</li> <li>3. The report prepared at the end of each period assigns costs to products completed and transferred out and to the products remaining in the process, department, or work cell.</li> </ul> |
|---|--|

**LO 1 Process Costing Versus Job Order Costing**

**SE2.** Indicate whether each of the following is a characteristic of job order costing or process costing:

1. Several Work in Process Inventory accounts are used, one for each department or work cell in the process.
2. Costs are measured for each completed job.
3. Costs are grouped by process or department.
4. Costs are measured in terms of units completed in specific time periods.
5. Only one Work in Process Inventory account is used.
6. Costs are assigned to specific jobs or batches of product.

**LO 2 Process Costing and a Work in Process Inventory Account**

**SE3.** Pro Chemicals uses an automated mixing machine in its Mixing Department to combine three raw materials into a product called Trio. On average, each unit of Trio contains \$3 of Material X, \$6 of Material Y, \$9 of Material Z, \$2 of direct labor, and \$10 of overhead. Total costs charged to the Mixing Department's Work in Process Inventory account during the month were \$210,000. There were no units in beginning or ending work in process inventory. How many units were completed and transferred to finished goods inventory during the month?

**LO 3 Equivalent Production: FIFO Costing Method**

**SE4.** Pearl Glaze adds direct materials at the beginning of its production process and adds conversion costs uniformly throughout the process. Given the following information from Pearl's records for July and using Steps 1 and 2 of the FIFO costing method, compute the equivalent units of production:

Units in beginning inventory	3,000
Units started during the period	17,000
Units partially completed in prior period	2,500
Percentage of completion of ending work in process inventory	100% for direct materials; 70% for conversion costs
Percentage of completion of beginning inventory in prior period	100% for direct materials; 40% for conversion costs

**LO 4 Determining Unit Cost: FIFO Costing Method**

**SE5.** Using the information from **SE4** and the data that follow, compute the total cost per equivalent unit.

	<b>Beginning Work in Process</b>	<b>Costs for the Period</b>
Direct materials	\$7,600	\$20,400
Conversion costs	2,545	32,490

**LO 4 Assigning Costs: FIFO Costing Method**

**SE6.** Using the data in **SE4** and **SE5**, assign costs to the units transferred out and to the units in ending inventory for July.

**LO 5 Equivalent Production: Average Costing Method**

**SE7.** Using the same data as in **SE4** but Steps 1 and 2 of the average costing method, compute the equivalent units of production for the month.

**LO 5 Determining Unit Cost: Average Costing Method**

**SE8.** Using the average costing method and the information from **SE4**, **SE5**, and **SE7**, compute the total cost per equivalent unit.



**LO 5 Assigning Costs: Average Costing Method**

**SE9.** Using the data in SE4, SE5, SE7, and SE8 and assuming that Pearl Glaze uses the average costing method, assign costs to the units completed and transferred out and to the units in ending inventory for July.

**LO 5 Equivalent Production: Average Costing Method**

**SE10.** Real Company adds direct materials at the beginning of its production process and adds conversion costs uniformly throughout the process. Given the following information from Real's records for July, compute the current period's equivalent units of production for direct materials and conversion costs using the average costing method.

Units in beginning inventory	2,000
Units started during the period	13,000
Units partially completed in prior period	500
Percentage of completion of beginning inventory	100% for direct materials; 40% for conversion costs
Percentage of completion of ending work in process inventory	100% for direct materials; 70% for conversion costs

**EXERCISES: SET A****LO 1 Process Costing Versus Job Order Costing**

**E1A.** Indicate whether the manufacturer of each of the following products should use a job order costing system or a process costing system to accumulate product costs:

- |                       |   |
|-----------------------|---|
| 1. paint              | 5. cups printed with your school insignia |
| 2. tailor-made tuxedo | 6. water slide for a theme park           |
| 3. soft drinks        | 7. plastic                                |
| 4. soy milk           | 8. posters for a concert                  |

**LO 2 Use of Process Costing Information**

**E2A. ACCOUNTING CONNECTION** ► Mom's Bakery makes a variety of baked goods for distribution to grocery stores in the area. The company uses a standard manufacturing process for all items except special-order birthday cakes. It currently uses a process costing system. The owner of the company has the following questions:

- Did the cost of making special-order birthday cakes exceed the cost budgeted for this month?
- How much does it cost to make one cheesecake?
- What is the value of the cupcake inventory at the end of May?
- What were the costs of the cookies sold during May?
- At what price should Mom's Bakery sell its famous sweet rolls to the grocery store chains?
- Were the planned production costs of \$3,000 for making pies in May exceeded?

Which of these questions can be answered using information from a process costing system? Which can be best answered using information from a job order costing system? Explain your answers.

**LO 2 Work in Process Inventory Accounts in Process Costing Systems**

**E3A.** Chemical, Inc., which uses a process costing system, makes a chemical used as a preservative. The manufacturing process involves Departments A and B. The company had the following total costs and unit costs for completed production last month, when it manufactured 10,000 pounds of the chemical. Neither Department A nor Department B had any beginning or ending work in process inventories:

*(Continued)*

	Total Cost	Unit Cost
Department A:		
Direct materials	\$ 9,000	\$0.90
Direct labor	2,600	0.26
Overhead	1,300	0.13
Total costs	<u>\$12,900</u>	<u>\$1.29</u>
Department B:		
Direct materials	\$ 3,000	\$0.30
Direct labor	700	0.07
Overhead	1,000	0.10
Total costs	<u>\$ 4,700</u>	<u>\$0.47</u>
Totals	<u>\$17,600</u>	<u>\$1.76</u>

1. How many Work in Process Inventory accounts would Chemical, Inc. use?
2. What dollar amount of the chemical's production cost was transferred from Department A to Department B last month?
3. What dollar amount was transferred from Department B to the Finished Goods Inventory account?
4. What dollar amount is useful in determining a selling price for 1 pound of the chemical?

**LO 3 Equivalent Production: FIFO Costing Method**

**E4A.** Brick Company produces bricks. During its first 12 months, it put 600,000 bricks into production and completed and transferred 580,000 bricks to finished goods inventory. The remaining bricks were still in process at the end of the year and were 60 percent complete.

The company's process costing system adds all direct materials costs at the beginning of the production process; conversion costs are incurred uniformly throughout the process. Using the FIFO costing method, compute the equivalent units of production for direct materials and conversion costs for the company's first year, which ended December 31.

**LO 3 Equivalent Production: FIFO Costing Method**

**E5A.** Suds Enterprises makes Perfecto Shampoo for professional hair stylists. On July 31, it had 5,000 liters of shampoo in process that were 80 percent complete in regard to conversion costs and 100 percent complete in regard to direct materials costs. During August, it put 210,000 liters of direct materials into production. Data for Work in Process Inventory on August 31 were as follows: shampoo, 10,000 liters; stage of completion, 60 percent for conversion costs and 100 percent for direct materials. Using the FIFO costing method, compute the equivalent units of production for direct materials and conversion costs for the month.

**LO 3 Equivalent Production: FIFO Costing Method**

**E6A.** Eco Savers Corporation produces wood pulp that is used in making paper. The data that follow pertain to the company's production of pulp during September.

	Percentage Complete		
	Tons	Direct Materials	Conversion Costs
Work in process, Aug. 31	50,000	100%	60%
Placed into production	250,000	—	—
Work in process, Sept. 30	80,000	100%	40%

Compute the equivalent units of production for direct materials and conversion costs for September using the FIFO costing method.

**LO 4 Work in Process Inventory Accounts: Total Unit Cost**

**E7A.** Scientists at Amazing Laboratories, Inc., have just perfected Sparkle, a liquid substance that dissolves silver tarnish. The substance, which is generated by a complex process involving five departments, is very expensive. Cost and equivalent unit data for the latest week follow (units are in ounces).

Dept.	Direct Materials		Conversion Costs	
	Cost	Equivalent Units	Cost	Equivalent Units
A	\$12,000	2,000	\$33,825	4,100
B	21,835	1,985	14,070	1,005
C	24,102	1,030	20,972	2,140
D	—	—	22,000	2,000
E	—	—	15,560	1,945

Compute the unit cost for each department and the total unit cost of producing 1 ounce of Sparkle.

**LO 4 Determining Unit Cost: FIFO Costing Method**

**E8A.** Cookware, Inc., manufactures sets of heavy-duty pans. It has just completed production for August. At the beginning of August, its Work in Process Inventory account showed direct materials costs of \$31,000 and conversion costs of \$29,000. The cost of direct materials used in August was \$280,000; conversion costs were \$120,000. During the month, the company started and completed 10,000 sets. For August, a total of 14,000 equivalent sets for direct materials and 12,000 equivalent sets for conversion costs have been computed. Using the FIFO costing method, determine the cost per equivalent set for August.

**LO 4 Assigning Costs: FIFO Costing Method**

**E9A.** The Bakery produces cupcakes. It uses a process costing system. In March, its beginning inventory was 450 units, which were 100 percent complete for direct materials costs and 10 percent complete for conversion costs. The cost of beginning inventory was \$655. Units started and completed during the month totaled 14,200. Ending inventory was 410 units, which were 100 percent complete for direct materials costs and 70 percent complete for conversion costs. Costs per equivalent unit for March were \$1.40 for direct materials costs and \$1.00 for conversion costs. Using the FIFO costing method, compute the cost of goods transferred to the Finished Goods Inventory account, the cost remaining in the Work in Process Inventory account, and the total costs to be accounted for.

**LO 4 Process Cost Report: FIFO Costing Method**

**E10A.** Toy Truck Corporation produces children's toy trucks using a continuous production process. All direct materials are added at the beginning of the process. In November, the beginning work in process inventory was 420 units, which were 50 percent complete; the ending balance was 400 units, which were 70 percent complete.

During November, 15,000 units were started into production. The Work in Process Inventory account had a beginning balance of \$937 for direct materials costs and \$370 for conversion costs. In the course of the month, \$35,300 of direct materials were added to the process, and \$31,689 of conversion costs were assigned. Using the FIFO costing method, prepare a process cost report that computes the equivalent units for November, the product unit cost for the toys, and the ending balance in the Work in Process Inventory account. (Round cost per equivalent unit to the nearest cent.)

**LO 5 Equivalent Production: Average Costing Method**

**E11A.** Using the data given for Brick Company in **E4A** and assuming that the company uses the average costing method, compute the equivalent units of production for direct materials and conversion costs for the company's first year ended December 31.

**LO 5 Equivalent Production: Average Costing Method**

**E12A.** Using the data given for Suds Enterprises in **E5A** and assuming that the company uses the average costing method, compute the equivalent units of production for direct materials and conversion costs for August.

**LO 5 Equivalent Production: Average Costing Method**

**E13A.** Using the data given for Eco Savers Corporation in **E6A** and assuming that the company uses the average costing method, compute the equivalent units of production for direct materials and conversion costs for September.

**LO 5 Determining Unit Cost: Average Costing Method**

**E14A.** Using the data given for Cookware, Inc., in **E8A** and assuming that the company uses the average costing method, determine the cost per equivalent set for August. Assume equivalent sets are 15,550 for direct materials costs and 14,900 for conversion costs.

**LO 5 Process Cost Report: Average Costing Method**

**E15A.** Using the data given for Toy Truck Corporation in **E10A** and assuming that the company uses the average costing method, prepare a process cost report that computes the equivalent units for November, the product unit cost for the toys, and the ending balance in the Work in Process Inventory account. (Round cost per equivalent unit to the nearest cent.)

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS****LO 4 Process Costing: FIFO Costing Method**

✓ 1: Total cost of goods manufactured and transferred: \$125,013

**P1.** Juice Extracts Company produces a line of fruit extracts for home use in making wine, jams and jellies, pies, and meat sauces. Fruits enter the production process in pounds, and the product emerges in quarts (1 pound of input equals 1 quart of output). On May 31, 4,250 units were in process. All direct materials had been added, and the units were 70 percent complete for conversion costs. Direct materials costs of \$4,607 and conversion costs of \$3,535 were attached to the units in beginning work in process inventory. During June, 61,300 pounds of fruit were added at a cost of \$71,108. Direct labor for the month totaled \$19,760, and overhead costs applied were \$31,375. On June 30, 3,400 units remained in process. All direct materials for these units had been added, and 50 percent of conversion costs had been incurred.

**REQUIRED**

- Using the FIFO costing method, prepare a process cost report for June.
- From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.

## LO 4

✓ 3: August total cost of goods manufactured and transferred: \$120,737

### Process Costing: One Process and Two Time Periods—FIFO Costing Method

**P2.** Clean Laboratories produces biodegradable liquid detergents that leave no soap film. The production process has been automated, so the product can now be produced in one operation instead of in a series of heating, mixing, and cooling operations. All direct materials are added at the beginning of the process, and conversion costs are incurred uniformly throughout the process. Operating data for July and August follow.

	July	August
Beginning work in process inventory:		
Units (pounds)	2,300	3,050
Direct materials	\$4,699	?*
Conversion costs	\$1,219	?*
Production during the period:		
Units started (pounds)	31,500	32,800
Direct materials	\$65,520	\$66,912
Conversion costs	\$54,213	\$54,774
Ending work in process inventory:		
Units (pounds)	3,050	3,600

\*From calculations at end of July.

The beginning work in process inventory was 30 percent complete for conversion costs. The ending work in process inventory for July was 60 percent complete; for August, it was 50 percent complete. Assume that the loss from spoilage and evaporation was negligible.

#### REQUIRED

- Using the FIFO costing method, prepare a process cost report for July.
- From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.
- Repeat requirements 1 and 2 for August.

## LO 5

SPREADSHEET

✓ 1: May total cost of goods manufactured and transferred: \$120,100

✓ 1: June total cost of goods manufactured and transferred: \$185,280

### Process Costing: Average Costing Method and Two Time Periods

**P3.** Top Corporation produces a line of beverage lids. The production process has been automated, so the product can now be produced in one operation rather than in the three operations that were needed before the company purchased the automated machinery. All direct materials are added at the beginning of the process, and conversion costs are incurred uniformly throughout the process. Operating data for May and June follow.

	May	June
Beginning work in process inventory:		
Units (May: 40% complete)	220,000	?
Direct materials	\$3,440	\$400
Conversion costs	\$6,480	\$420
Production during the month:		
Units started	24,000,000	31,000,000
Direct materials	\$45,000	\$93,200
Conversion costs	\$66,000	\$92,796
Ending work in process inventory:		
Units (May: 70% complete; June: 60% complete)	200,000	320,000

- Using the average costing method, prepare process cost reports for May and June. (Round unit costs to three decimal places.)

(Continued)

- From the information in the process cost report for May, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.
- ACCOUNTING CONNECTION** ▶ Compare the product costing results for June with the results for May. What is the most significant change? What are some of the possible causes of this change?

## LO 5

✓ 1: Total cost of goods manufactured and transferred: \$552,720

### Process Costing: Average Costing Method

**P4.** Energy Products, Inc., makes high-vitamin, calorie-packed wafers that are popular among professional athletes because they supply quick energy. The company produces the wafers in a continuous flow, and it uses a process costing system based on the average costing method. It recently purchased several automated machines so that the wafers can be produced in a single department. All direct materials are added at the beginning of the process. The costs for the machine operators' labor and production-related overhead are incurred uniformly throughout the process.

In February, the company put a total of 231,200 liters of direct materials into production at a cost of \$294,780. Two liters of direct materials were used to produce one unit of output (one unit = 144 wafers). Direct labor costs for February were \$60,530, and overhead was \$181,590. The beginning work in process inventory for February was 14,000 units, which were 100 percent complete for direct materials and 20 percent complete for conversion costs. The total cost of those units was \$55,000, \$48,660 of which was assigned to the cost of direct materials. The ending work in process inventory of 12,000 units was fully complete for direct materials but only 30 percent complete for conversion costs.

#### REQUIRED

- Using the average costing method and assuming no loss due to spoilage, prepare a process cost report for February.
- From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.

## LO 4, 5

✓ 1: Total cost of goods manufactured and transferred: \$82,280

### Process Costing: FIFO Costing and Average Costing Methods

**P5.** Goofy Industries specializes in making Go, a high-moisture, low-alkaline wax used to protect and preserve snowboards. The company began producing a new, improved brand of Go on January 1. Materials are introduced at the beginning of the production process. During January, 15,300 pounds were used at a cost of \$46,665. Direct labor of \$17,136 and overhead costs of \$25,704 were incurred uniformly throughout the month. By January 31, 13,600 pounds of Go had been completed and transferred to the finished goods inventory (1 pound of input equals 1 pound of output). Since no spoilage occurred, the leftover materials remained in production and were 40 percent complete on average.

#### REQUIRED

- Using the FIFO costing method, prepare a process cost report for January.
- From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.
- Repeat requirements 1 and 2 using the average costing method.

## ALTERNATE PROBLEMS

## LO 4

✓ 1: Total cost of goods manufactured: \$627,790

### Process Costing: FIFO Costing Method

**P6.** Canned fruits and vegetables are the main products made by Yummy Foods, Inc. All direct materials are added at the beginning of the Mixing Department's process. When the ingredients have been mixed, they go to the Cooking Department. There the mixture is heated to 100° Celsius and simmered for 20 minutes. When cooled, the



mixture goes to the Canning Department for final processing. Throughout the operations, direct labor and overhead costs are incurred uniformly. No direct materials are added in the Cooking Department. Cost data and other information for the Mixing Department for January are as follows.

<b>Production Cost Data</b>	<b>Direct Materials</b>	<b>Conversion Costs</b>
Mixing Department:		
Beginning inventory	\$ 28,560	\$ 5,230
Current period costs	450,000	181,200
Work in process inventory:		
Beginning inventory (40% complete in prior period)	5,000 liters	
Ending inventory (60% complete)	6,000 liters	
Unit production data:		
Units started during January	90,000 liters	
Units transferred out during January	89,000 liters	

Assume that no spoilage or evaporation loss took place during January.

#### REQUIRED

- Using the FIFO costing method, prepare a process cost report for the Mixing Department for January.
- ACCOUNTING CONNECTION** ► Explain how the analysis for the Cooking Department will differ from the analysis for the Mixing Department.

#### LO 4

#### SPREADSHEET

- ✓ 1: April total cost of goods manufactured and transferred: \$353,368
- ✓ 3: May total cost of goods manufactured and transferred: \$390,668

#### Process Costing: One Process and Two Time Periods—FIFO Costing Method

**P7.** Doover Company produces organic honey, which it sells to health food stores and restaurants. The company owns thousands of beehives. No direct materials other than honey are used. The production operation is a simple one. Impure honey is added at the beginning of the process and flows through a series of filters, leading to a pure finished product. Costs of labor and overhead are incurred uniformly throughout the filtering process. Production data for April and May follow.

	<b>April</b>	<b>May</b>
Beginning work in process inventory:		
Units (liters)	7,100	12,400
Direct materials	\$2,480	?*
Conversion costs	\$5,110	?*
Production during the period:		
Units started (liters)	288,000	310,000
Direct materials	\$100,800	\$117,800
Conversion costs	\$251,550	\$277,281
Ending work in process inventory:		
Units (liters)	12,400	16,900

\*From calculations at end of April.

The beginning work in process inventory for April was 80 percent complete for conversion costs, and ending work in process inventory was 20 percent complete. The ending work in process inventory for May was 30 percent complete for conversion costs. Assume no loss from spoilage or evaporation.

#### REQUIRED

- Using the FIFO method, prepare a process cost report for April.
- From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.
- Repeat requirements 1 and 2 for May.



### LO 5 Process Costing: Average Costing Method and Two Time Periods

- ✓ 1: July total cost of goods manufactured and transferred: \$168,000
- ✓ 1: August total cost of goods manufactured and transferred: \$162,750

**P8.** Box Corporation produces a line of beverage boxes. The production process has been automated, so the product can now be produced in one operation rather than in the three operations that were needed before the company purchased the automated machinery. All direct materials are added at the beginning of the process, and conversion costs are incurred uniformly throughout the process. Operating data for July and August follow.

	July	August
Beginning work in process inventory:		
Units (July: 20% complete)	20,000	?
Direct materials	\$20,000	\$6,000
Conversion costs	\$30,000	\$6,000
Production during the month:		
Units started	70,000	90,000
Direct materials	\$34,000	\$59,000
Conversion costs	\$96,000	\$130,800
Ending work in process inventory:		
Units (July: 40% complete; August: 60% complete)	10,000	25,000

- Using the average costing method, prepare process cost reports for July and August.
- From the information in the process cost report for July, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.
- ACCOUNTING CONNECTION** ▶ Compare the product costing results for August with the results for July. What is the most significant change? What are some of the possible causes of this change?

### LO 5 Process Costing: Average Costing Method

- ✓ 1: Total cost of goods manufactured and transferred: \$5,463,040

**P9.** Many of the products made by Plastics Company are standard telephone replacement parts that require long production runs and are produced continuously. A unit for Plastics is a box of parts. During April, direct materials for 25,250 units were put into production. The total cost of direct materials used during April was \$2,273,000. Direct labor costs totaled \$1,135,000, and overhead was \$2,043,000. The beginning work in process inventory contained 1,600 units, which were 100 percent complete for direct materials costs and 60 percent complete for conversion costs. Costs attached to the units in beginning inventory totaled \$232,515, which included \$143,500 of direct materials costs. At the end of the month, 1,250 units were in ending inventory; all direct materials had been added, and the units were 70 percent complete for conversion costs.

#### REQUIRED

- Using the average costing method and assuming no loss due to spoilage, prepare a process cost report for April.
- From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.

### LO 4, 5 Process Costing: FIFO Costing and Average Costing Methods

#### SPREADSHEET

- ✓ 1: FIFO total cost of goods manufactured and transferred: \$140,892
- ✓ 3: Average costing total cost of goods manufactured and transferred: \$140,892

**P10.** Sunny Company manufactures and sells several different kinds of soft drinks. Direct materials (sugar syrup and artificial flavor) are added at the beginning of production in the Mixing Department. Direct labor and overhead costs are applied to products throughout the process. For August, beginning inventory for the citrus flavor was 2,400 gallons, 80 percent complete. Ending inventory was 3,600 gallons, 50 percent complete. Production data show 240,000 gallons started during August. A total of 238,800

gallons was completed and transferred to the Bottling Department. Beginning inventory costs were \$576 for direct materials and \$672 for conversion costs. Current period costs were \$57,600 for direct materials and \$83,538 for conversion costs.

#### REQUIRED

1. Using the FIFO costing method, prepare a process cost report for the Mixing Department for August.
2. From the information in the process cost report, identify the amount that should be transferred out of the Work in Process Inventory account, and state where those dollars should be transferred.
3. Repeat requirements 1 and 2 using the average costing method.

## CASES

### LO 1, 6 Conceptual Understanding: Process Costing Systems

**C1.** For more than 60 years, **Dow Chemical Company** has made and sold a tasteless, odorless, and calorie-free substance called Methocel. When heated, this liquid plastic (methyl cellulose) has the unusual characteristic (for plastics) of becoming a gel that resembles cooked egg whites. It is used in over 400 food products, including gravies, soups, and puddings. It was also used as wampa drool in *The Empire Strikes Back* and dinosaur sneeze in *Jurassic Park*. What kind of costing system is most appropriate for the manufacture of Methocel? Why is this system most appropriate? Describe the system, and include in the description a general explanation of how costs are determined.

### LO 1, 2, 6 Ethical Dilemma: Continuing Professional Education

**C2. BUSINESS APPLICATION** ▶ Paula Woodward is the head of the Information Systems Department at Mo Manufacturing Company. Roland Randolph, the company's controller, is meeting with her to discuss changes in data gathering that relate to the company's new flexible manufacturing system. Woodward opens the conversation by saying, "Roland, the old job order costing methods just will not work with the new flexible manufacturing system. The new system is based on continuous product flow, not batch processing. We need to change to a process costing system for both data gathering and product costing. Otherwise, our product costs will be way off, and it will affect our pricing decisions. I found out about this at a professional seminar I attended last month. You should have been there."

Randolph responds, "Job order costing has provided accurate information for this product line for more than 15 years. Why should we change just because we've purchased a new machine? We've purchased several machines for this line over the years. And as for your seminar, I don't need to learn about costing methods. I was exposed to them all when I studied management accounting in the 1970s."

Is Randolph's behavior ethical? If not, what has he done wrong? What can Woodward do if Randolph continues to refuse to update the product costing system?

### LO 3, 4, 6 Interpreting Managerial Reports: Analysis of Product Cost

SPREADSHEET

**C3. BUSINESS APPLICATION** ▶ Road Tire Corporation makes several lines of automobile and truck tires. The company operates in a competitive marketplace, so it relies heavily on cost data from its FIFO-based process costing system. It uses that information to set prices for its most competitive tires. The company's radial line has lost some of its market share during each of the past four years. Management believes that price breaks allowed by the company's three biggest competitors are the main reason for the decline in sales.

The company controller has been asked to review the product costing information that supports pricing decisions on the radial line. In preparing her report, she collected the following data for last year, the most recent full year of operations:

(Continued)

	Units	Dollars
Equivalent units:		
Direct materials	84,200	
Conversion costs	82,800	
Manufacturing costs:		
Direct materials		\$1,978,700
Direct labor		800,400
Overhead		1,600,800
Unit cost data:		
Direct materials		23.50
Conversion costs		29.00
Work in process inventory:		
Beginning (70% complete)	4,200	
Ending (30% complete)	3,800	

Units started and completed last year totaled 80,400. Attached to the beginning Work in Process Inventory account were direct materials costs of \$123,660 and conversion costs of \$57,010. A review of the conversion costs revealed, however, an error in the production account. The correct conversion cost being charged to the production account should have been \$2,129,616 instead of \$2,401,200. This resulted in overly high overhead costs being charged to the production account.

The radial has been selling for \$92 per tire. This price was based on last year's unit data plus a 75 percent markup to cover operating costs and profit. The company's three main competitors have been charging about \$87 for a tire of comparable quality. The company's process costing system adds all direct materials at the beginning of the process, and conversion costs are incurred uniformly throughout the process.

1. Identify what inaccuracies in costs, inventories, and selling prices result from the company's cost-charging error.
2. Prepare a revised process cost report for 2014. (Round total costs to whole dollars.)
3. What should have been the minimum selling price per tire this year?
4. Suggest ways of preventing such errors in the future.

LO 3, 4, 6

### Interpreting Managerial Reports: Setting a Selling Price

**C4. BUSINESS APPLICATION** ► For the past four years, three companies have dominated the soft drink industry, holding a combined 85 percent of market share. Won Cola, Inc., ranks second nationally in soft drink sales. Its management is thinking about introducing a new low-calorie drink called Uncalorie Cola.

Won soft drinks are processed in a single department. All ingredients are added at the beginning of the process. At the end of the process, the beverage is poured into bottles that cost \$0.24 per case produced. Direct labor and overhead costs are applied uniformly throughout the process.

Corporate controller Adam Daneen believes that costs for the new cola will be very much like those for the company's Cola Plus drink. Last year, he collected the data that follow about Cola Plus.

	Units*	Costs
Work in process inventory:		
January 1**	2,200	
Direct materials costs		\$ 2,080
Conversion costs		620
December 31***	2,000	
Direct materials costs		1,880
Conversion costs		600
Units started during year	458,500	
Costs for year:		
Liquid materials added		430,990
Direct labor and overhead		229,400
Bottles		110,088

\* Each unit is a 24-bottle case.

\*\* 50% complete.

\*\*\* 60% complete.

The company's variable general administrative and selling costs are \$1.10 per unit. Fixed administrative and selling costs are assigned to products at the rate of \$0.50 per unit. Each of Won Cola's two main competitors is already marketing a diet cola. Company A's product sells for \$4.10 per unit; Company B's, for \$4.05. All costs are expected to increase by 10 percent in the next three years. Won Cola tries to earn a profit of at least 15 percent on the total unit cost.

1. What factors should Won Cola, Inc., consider in setting a unit selling price for a case of Uncalorie Cola?
2. Using the FIFO costing method, compute (a) equivalent units for direct materials, cases of bottles, and conversion costs; (b) the total production cost per unit; and (c) the total cost per unit of Cola Plus for the year.
3. What is the expected unit cost of Uncalorie Cola for the year? (Round unit costs to the nearest cent.)
4. Recommend a unit selling price range for Uncalorie Cola, and give the reason(s) for your choice. (Round to the nearest cent.)

LO 2, 3, 4, 6

### Business Communications: Using the Process Costing System

**C5. BUSINESS APPLICATION** ► You are the production manager for Breakfast Grain Corporation, a manufacturer of four cereal products. The company's best-selling product is Sugaros, a sugar-coated puffed rice cereal. Yesterday, Clark Winslow, the controller, reported that the production cost for each box of Sugaros has increased approximately 22 percent in the last four months. Because the company is unable to increase the selling price for a box of Sugaros, the increased production costs will reduce profits significantly.

Today, you received a memo from Gilbert Rom, the company president, asking you to review your production process to identify inefficiencies or waste that can be eliminated. Once you have completed your analysis, you are to write a memo presenting your findings and suggesting ways to reduce or eliminate the problems. The president will use your information during a meeting with the top management team in ten days.

You are aware of previous problems in the Baking Department and the Packaging Department. Winslow has provided you with process cost reports for the two departments. He has also given you the following detailed summary of the cost per equivalent unit for a box of Sugaros cereal:

*(Continued)*

	April	May	June	July
Baking Department:				
Direct materials	\$1.25	\$1.26	\$1.24	\$1.25
Direct labor	0.50	0.61	0.85	0.90
Overhead	<u>0.25</u>	<u>0.31</u>	<u>0.34</u>	<u>0.40</u>
Department totals	<u>\$2.00</u>	<u>\$2.18</u>	<u>\$2.43</u>	<u>\$2.55</u>
Packaging Department:				
Direct materials	\$0.35	\$0.34	\$0.33	\$0.33
Direct labor	0.05	0.05	0.04	0.06
Overhead	<u>0.10</u>	<u>0.16</u>	<u>0.15</u>	<u>0.12</u>
Department totals	<u>\$0.50</u>	<u>\$0.55</u>	<u>\$0.52</u>	<u>\$0.51</u>
Total cost per equivalent unit	<u>\$2.50</u>	<u>\$2.73</u>	<u>\$2.95</u>	<u>\$3.06</u>

- In preparation for writing your memo, answer the following questions:
  - For whom are you preparing the memo? Does this affect the length of the memo? Explain.
  - Why are you preparing the memo?
  - What actions should you take to gather information for the memo? What information is needed? Is the information that Winslow provided sufficient for analysis and reporting?
  - When is the memo due? What can be done to provide accurate, reliable, and timely information?
- Based on your analysis of the information that Winslow provided, where is the main problem in the production process?
- Prepare an outline of the sections you would want in your memo.

### Continuing Case: Cookie Company

**C6.** In this segment of our continuing case, you are considering whether process costing is more appropriate for your cookie company than job order costing. List reasons why your company may choose to use process costing instead of job order costing.



# CHAPTER 20

## Value-Based Systems: Activity-Based Costing and Lean Accounting

### BUSINESS INSIGHT

#### Bean Bag Convertibles, Inc.

Bean Bag Convertibles, Inc., produces comfortable sofas that can be easily converted to beds, which makes them ideal for college dorm rooms and studio apartments. Each month, the company assembles thousands of these built-to-order sofas by filling durable mattress-shaped bags with shredded foam and inserting them into different-shaped slipcovers in a variety of fabrics. It generally delivers them in less than a week after customers have placed their orders. Because of the efficiency with which it assembles and delivers its products, Bean Bag Convertibles has an advantage over its competitors. The company's use of activity-based systems and the speed of its supply chain are critical factors in maintaining this competitive edge.

- 1. CONCEPT** ► *What underlying accounting concepts support the use of value-based systems like activity-based management and lean accounting?*
- 2. ACCOUNTING APPLICATION** ► *How can activity-based costing and lean operations help businesses like Bean Bag Convertibles improve business processes and eliminate waste?*
- 3. BUSINESS APPLICATION** ► *How can managers of companies like Bean Bag Convertibles plan to remain competitive in a challenging business environment?*

### LEARNING OBJECTIVES

- LO 1** Describe value-based systems, and discuss their relationship to the supply chain and the value chain.
- LO 2** Define *activity-based costing*, and explain how a cost hierarchy and a bill of activities are used.
- LO 3** Define the elements of a lean operation, and identify the changes in inventory management that result when a firm adopts its just-in-time operating philosophy.
- LO 4** Define and apply *backflush costing*, and compare the cost flows in traditional and backflush costing.
- LO 5** Identify the management tools used for continuous improvement, and compare ABM and lean operations.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Relevance
- Reliability

RELEVANT  
LEARNING OBJECTIVE

**LO 1** Describe value-based systems, and discuss their relationship to the supply chain and the value chain.

## LO 1 Concepts Underlying Value-Based Systems

Managers operating in volatile business environments that are strongly influenced by customer demands realize that value-based systems, instead of traditional cost-based systems, provide the *relevant* information they need. The information has more relevance because it is predictive and directly relates to the decisions made. **Value-based systems** provide customer-related, activity-based information. They focus on eliminating waste as companies produce and deliver quality products and services. *Reliability* also is important as it assures users that the value-based information is complete, neutral, and free from material error. It is all the information needed for a reliable decision. Managers can use value-based information reliably to compare the value created by products or services with the **full product cost**, which includes not only the costs of direct materials and direct labor, but also the costs of all production and nonproduction activities required to satisfy the customer. For example, the full product cost of a Bean Bag sofa includes the cost of the shredded foam and upholstery, as well as the costs of taking the sales order, processing the order, packaging and shipping the sofa, and providing subsequent customer service for warranty work.

### Value Chain Analysis

Each step in making a product or delivering a service is a link in a chain that adds value to the product or service. This sequence of activities inside the organization that adds value to a company's product or service is known as the **value chain** (illustrated in Exhibit 1). The steps that add value to a product or service—which range from research and development to customer service—are known as **primary processes**. The sequence of primary processes varies, depending on such factors as the size of the company and the types of products or services offered.

The value chain also includes **support services**, such as legal services, human resources, information technology, and management accounting. These services facilitate the primary processes by providing business infrastructure but do not add value to the final product or service. Their roles are critical, however, to making the primary processes as efficient and effective as possible.

Value chain analysis allows a company to focus on its core competencies. A **core competency** is the activity that a company does best. It is what gives a company an advantage over its competitors. For example, **Wal-Mart's** core competency is achieving the lowest prices, whereas **The Four Seasons Hotel** is known for providing exceptional guest service.

A common result of value chain analysis is outsourcing, which can also be of benefit to a business. **Outsourcing** is the engagement of other companies to perform a process or service in the value chain that is not among an organization's core competencies. For instance, **Wal-Mart** outsources its inventory management to its vendors, who monitor and stock Wal-Mart's stores and warehouses.

### Supply Chains

Managers see their organization's internal value chain as part of a larger system. This larger system is the **supply chain** (or the *supply network*)—the path that leads from the suppliers of the materials from which a product is made to the final customer. The supply chain includes both suppliers and suppliers' suppliers, and customers and



**Exhibit 1**  
The Value Chain in a Furniture Company



© Cengage Learning 2014

customers’ customers. It links business to business to business and ultimately to the final consumer.

As Exhibit 2 shows, in the supply chain for a furniture company like Bean Bag Convertibles, a farmer supplies cotton to the upholstery manufacturer, which supplies upholstery to the furniture manufacturer. The manufacturer supplies furniture to furniture stores, which in turn supply furniture to the final consumers. Each organization in this supply chain is a customer of an earlier supplier, and each has its own value chain.

**Exhibit 2**  
The Supply Chain in a Furniture Company



© Cengage Learning 2014

## Using Information from Value Chains and Supply Chains

Understanding value chains and supply chains gives managers a better grasp of their company’s internal and external operations. Managers who understand how their company’s value-adding activities fit into their suppliers’ and customers’ value chains can see their company’s role in the overall process of creating and delivering products or services. When organizations work cooperatively with others in their supply chain, they can develop new processes that reduce the total costs of their products or services. For example, Bean Bag Convertibles places computers for online order entry in its sofa kiosks located in shopping malls. The computers streamline order processing and make the orders more accurate. Even though Bean Bag incurs the cost of the computers, the total cost of making and delivering furniture decreases because the cost of order processing decreases.

## Process Value Analysis

To improve the *relevance* and *reliability* of information for decision making, managers use **process value analysis (PVA)** to identify and link all the activities involved in the value chain. It analyzes business processes by relating activities to the events that prompt those activities and to the resources that the activities consume. PVA forces managers to look critically at all phases of their operations. PVA improves cost traceability and results in significantly more complete accurate product costs, which in turn improves management decisions and increases profitability. By using PVA to identify non-value-adding activities, companies can improve the relevance and reliability of their data to reduce their costs and redirect their resources to value-adding activities.

## Value-Adding and Non-Value-Adding Activities

A **value-adding activity** is one that adds value to a product or service as perceived by the customer. In other words, if customers are willing

Each company in a supply chain is a customer of an earlier supplier. An upholstery company, for example, would be a customer of a cotton farmer and fabric supplier. Its customers might include furniture manufacturers or automobile companies.



juthathip tybon/iStockphoto.com

**STUDY NOTE:** Customer perspective determines whether an activity adds value to a product or service.

to pay for the activity, it adds value to the product or service. Examples include designing the components of a new bean bag convertible and assembling it.

A **non-value-adding activity** is one that adds cost to a product or service but does not increase its market value. Managers eliminate non-value-adding activities that are not essential and reduce the costs of those that are, such as legal services, management accounting, machine repair, materials handling, and building maintenance. For example, inspection costs can be reduced if an inspector samples one of every three bolts of upholstery fabric received from a supplier rather than inspecting every one. If the supplier is a reliable source of high-quality upholstery, such a reduction in inspection activity is appropriate.

## APPLY IT!

Sort the following product unit costs to determine the relevant total cost per unit of primary processes and the total cost per unit of support services. (These unit costs were reliably determined by dividing the total costs of each component by the number of products produced.)

Research and development	\$ 1.25
Human resources	1.35
Design	0.15
Supply	1.10
Legal services	0.40
Production	4.00
Marketing	0.80
Distribution	0.90
Customer service	0.65
Information systems	0.75
Management accounting	0.10
Total cost per unit	<u>\$11.45</u>

### SOLUTION

Primary processes:

Research and development	\$1.25
Design	0.15
Supply	1.10
Production	4.00
Marketing	0.80
Distribution	0.90
Customer service	0.65
Total cost per unit	<u>\$8.85</u>

Support services:

Human resources	\$1.35
Legal services	0.40
Information systems	0.75
Management accounting	0.10
Total cost per unit	<u>\$2.60</u>

**TRY IT! SE1, SE2, SE3, E1A, E2A, E3A, E4A, E5A, E1B, E2B, E3B, E4B, E5B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Classify activities using a cost hierarchy
- Prepare a bill of activities
- Understand the elements of a lean operation
- Apply backflush costing

RELEVANT  
LEARNING OBJECTIVE

**LO 2** Define *activity-based costing*, and explain how a cost hierarchy and a bill of activities are used.

**LO 3** Define the elements of a lean operation, and identify the changes in inventory management that result when a firm adopts its just-in-time operating philosophy.

**LO 4** Define and apply *backflush costing*, and compare the cost flows in traditional and backflush costing.

## LO 2 Activity-Based Management

**Activity-based management (ABM)** identifies all major operating activities, determines the resources consumed by each activity and the cause of the resource usage, and categorizes the activities as adding value to a product or service or not adding value. ABM focuses on reducing or eliminating non-value-adding activities.

Because it provides financial and performance information at the activity level, ABM is useful both for strategic planning and for making tactical and operational decisions about business segments, such as product lines, market segments, and customers. It also helps managers eliminate waste and inefficiencies and redirect resources to activities that add value to the product or service.

### Activity-Based Costing

Activity-based costing (ABC) is the tool used in an ABM environment to assign activity costs to cost objects. As access to value chain data has improved, managers have refined the procedures for assigning costs fairly to determine unit costs. Traditional methods of allocating overhead costs to products use such cost drivers as direct labor hours, direct labor costs, or machine hours and one overhead rate. More than 20 years ago, organizations began realizing that these methods did not assign overhead costs accurately and that the resulting inaccuracy in unit costs was causing poor pricing decisions and poor control of overhead costs. In their search for more accurate product costing, many organizations embraced activity-based costing.

**Activity-based costing (ABC)** calculates a more accurate product cost than traditional methods. It does so by categorizing all indirect costs by activity, tracing the indirect costs to those activities, and assigning those costs to products or services using a cost driver related to the cause of the cost. In other words, ABC reflects the cause-and-effect relationships between costs and individual processes, products, services, or customers.

ABC improves the accuracy in allocating activity-driven costs to cost objects (i.e., products or services). To implement ABC, managers complete the following steps:

- **Step 1.** Identify and classify each activity.
- **Step 2.** Estimate the cost of resources for each activity.
- **Step 3.** Identify a cost driver for each activity, and estimate the quantity of each cost driver.
- **Step 4.** Calculate an activity cost rate for each activity.
- **Step 5.** Assign costs to cost objects based on the level of activity required to make the product or provide the service.

While ABC gives managers greater control over the costs they manage, it has limitations, including the following:

- High measurement costs of collecting accurate data from many activities instead of using just one overhead account may make ABC too costly.
- Some costs are difficult to assign to a specific activity or cost object since they benefit the business in general (e.g., the president's salary) and should not be arbitrarily allocated.
- ABC allocations may add undue complexity to controlling costs.

### The Cost Hierarchy and the Bill of Activities




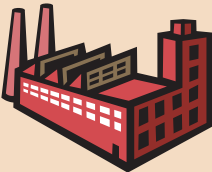
Two tools used in implementing ABC are cost hierarchy and the bill of activities.

**Cost Hierarchy** A **cost hierarchy** is a framework for classifying activities according to the level at which their costs are incurred. In a manufacturing company, the cost hierarchy typically has four levels, as shown in Exhibit 3.

- **Unit-level activities** are performed each time a unit is produced and are generally considered variable costs. For example, when a furniture manufacturer like **La-Z-Boy** installs a recliner mechanism in a chair, unit-level activities involve the direct material cost of the recliner mechanism, materials handling, and the direct labor cost incurred with connecting the mechanism to the chair frame. Because each chair contains only one mechanism, these activities have a direct correlation to the number of chairs produced.
- **Batch-level activities** are performed each time a batch or production run of goods is produced. Examples of batch-level activities include setup and moving and inspecting mechanisms for the production run of a certain style of furniture. These activities vary with the number of batches prepared or production runs completed.
- **Product-level activities** are performed to support a particular product line. Examples include implementing design, engineering, or marketing changes for a particular brand of product. These activities vary with the number of brands or product designs a company has.
- **Facility-level activities** are performed to support a facility's general manufacturing process and are generally fixed costs. Examples for a furniture manufacturer include maintaining, lighting, securing, and insuring the factory. These activities are generally a fixed amount for a certain time period.

Note that the frequency of activities varies across levels and that the cost hierarchy includes both value-adding and non-value-adding activities.

**Exhibit 3**  
Sample Activities  
in Cost Hierarchies

	<p><b>Unit Level</b> Activities performed each time a unit is produced</p>	<p><b>Examples</b></p> <ul style="list-style-type: none"> <li>• Install mechanism</li> <li>• Test mechanism</li> </ul>
	<p><b>Batch Level</b> Activities performed each time a batch or production run of goods is produced</p>	<p><b>Examples</b></p> <ul style="list-style-type: none"> <li>• Set up installation process</li> <li>• Move mechanisms</li> <li>• Inspect mechanisms</li> </ul>
	<p><b>Product Level</b> Activities performed to support a particular product line</p>	<p><b>Example</b></p> <ul style="list-style-type: none"> <li>• Redesign installation process</li> </ul>
	<p><b>Facility Level</b> Activities performed to support a facility's general manufacturing process</p>	<p><b>Examples</b></p> <ul style="list-style-type: none"> <li>• Provide facility maintenance</li> <li>• Provide lighting</li> <li>• Provide security</li> </ul>

© Cengage Learning 2014

Service organizations can also use a cost hierarchy to group their activities. The four levels typically are the unit level, the batch level, the service level, and the operations level.

**STUDY NOTE:** A bill of activities summarizes costs relating to a product or service and supports the calculation of the product or service unit cost.

**Bill of Activities** A **bill of activities** is a list of activities and related costs that is used to compute the costs assigned to activities and the product unit cost. More complex bills of activities group activities into activity pools and include activity cost rates and the cost driver levels used to assign costs to cost objects. A bill of activities may be used as the primary document or as a supporting schedule to calculate the product unit cost in both job order and process costing systems and in both manufacturing and service businesses. Exhibit 4 shows a bill of activities for a furniture manufacturer completing an order for 100 chairs.

**Exhibit 4**  
**Bill of Activities**

<b>Sample Furniture Corporation</b>			
<b>Bill of Activities</b>			
<b>Chair Order 1.1.12</b>			
<b>Activity</b>	<b>Activity Cost Rate</b>	<b>Cost Driver Level</b>	<b>Activity Cost</b>
<b>Unit level:</b>			
Parts production	\$40 per machine hour	20 machine hours	\$ 800
Assembly	\$35 per direct labor hour	10 direct labor hours	350
Packaging and shipping	\$10 per unit	100 units	1,000
<b>Batch level:</b>			
Setup	\$100 per setup	5 setups	500
<b>Product level:</b>			
Product design	\$60 per engineering hour	9 engineering hours	540
Product simulation	\$30 per testing hour	3 testing hours	90
<b>Facility level:</b>			
Building occupancy	200% of assembly labor cost	\$350 assembly labor cost	700
Total activity costs assigned to order			<u>\$3,980</u>
Total units			<u>÷ 100</u>
Activity costs per unit (total activity costs ÷ total units)			<u>\$39.80</u>
<b>Cost summary:</b>			
Direct materials			\$2,000
Purchased parts			1,000
Activity costs			3,980
Total cost of order			<u>\$6,980</u>
Product unit cost (total cost of order ÷ 100 units)			<u>\$69.80</u>

## APPLY IT!

Bean Bag Convertibles, Inc. has received an order for 100 bean bag sofa convertibles from Furniture Town, LLC. A partially complete bill of activities for that order follows. Fill in the missing data.

<b>Bean Bag Convertibles, Inc. Bill of Activities Furniture Town, LLC, Order</b>			
<b>Activity</b>	<b>Activity Cost Rate</b>	<b>Cost Driver Level</b>	<b>Activity Cost</b>
Unit level:			
Parts production	\$50 per machine hour	5 machine hours	\$ ?
Assembly	\$30 per DLH	10 DLH	?
Packing	\$3.50 per unit	100 units	?
Batch level:			
Work setup	\$25 per setup	4 setups	?
Product level:			
Product design	\$160 per design hour	2 design hours	?
Facility level:			
Building occupancy	200% of assembly labor cost	?	?
Total activity costs assigned to job			\$ ?
Total job units			100
Activity costs per unit (total activity costs ÷ total units)			<u>\$ ?</u>
<b>Cost summary:</b>			
Direct materials			\$1,000
Purchased parts			500
Activity costs			?
Total cost of order			<u>\$ ?</u>
Product unit cost (total cost ÷ 100 units)			<u>\$ ?</u>

### SOLUTION

<b>Bean Bag Convertibles, Inc. Bill of Activities Furniture Town, LLC Order</b>			
<b>Activity</b>	<b>Activity Cost Rate</b>	<b>Cost Driver Level</b>	<b>Activity Cost</b>
Unit level:			
Parts production	\$50 per machine hour	5 machine hours	\$ 250
Assembly	\$30 per DLH	10 DLH	300
Packing	\$3.50 per unit	100 units	350
Batch level:			
Work setup	\$25 per setup	4 setups	100
Product level:			
Product design	\$160 per design hour	2 design hours	320
Facility level:			
Building occupancy	200% of assembly labor cost	\$300	600
Total activity costs assigned to job			\$1,920
Total job units			÷ 100
Activity costs per unit (total activity costs ÷ total units)			<u>\$19.20</u>
<b>Cost summary:</b>			
Direct materials			\$1,000
Purchased parts			500
Activity costs			1,920
Total cost of order			<u>\$3,420</u>
Product unit cost (total cost ÷ 100 units)			<u>\$34.20</u>

### TRY IT! SE4, SE5, E6A, E7A, E8A, E6B, E7B, E8B



## LO 3 The New Operating Environment and Lean Operations

**STUDY NOTE:** *ABM and lean operations focus on value-adding activities—not costs—to increase income.*

A **lean operation** focuses on eliminating waste in an organization and on what a customer is willing to pay for. Lean operations emphasize waste that can be eliminated by management analysis of the actions of workers and machines in the process of making products and services.

To achieve lean operations, a company must redesign its operating systems, plant layout, and basic management methods to conform to several basic concepts:

- Simple is better.
- The quality of the product or service is critical from product design to customer satisfaction.
- The work environment must emphasize continuous improvement.
- Maintaining large inventories wastes resources and may hide poor work.
- Activities or functions that do not add value to a product or service should be eliminated or reduced.
- Goods should be produced only when needed.
- Workers must be multiskilled and must participate in eliminating waste.
- Building and maintaining long-term relationships with suppliers is important.

**STUDY NOTE:** *Traditional environments emphasize functional departments that tend to group similar activities together (e.g., repairs and maintenance).*

Application of these lean elements creates a lean operation throughout the company's value chain and guides all employees' work. Piecemeal attempts at lean operations have proved disastrous when the implementation focused on a few lean tools and methodologies instead of understanding how to think lean throughout the organization.

### Just-in-Time (JIT)

Managers determined that changes in how inventory was processed traditionally were necessary because:

- Large amounts of an organization's space and money were tied up in inventory.
- The source of poor-quality materials, products, or services was hard to pinpoint.
- The number of non-value-adding activities was growing.
- Accounting for the manufacturing process was becoming ever more complex.

Just-in-time (JIT) is one of the key strategies of a lean operation to reorganize production activities and manage inventory. In a lean operation, the **just-in-time (JIT) operating philosophy** requires that all resources—materials, personnel, and facilities—be acquired and used only as needed to create value for customers. A JIT environment reveals waste and eliminates it by using the principles discussed in the sections that follow.



## Business Perspective

### The Evolution to Lean Operations

- Eli Whitney perfected the concept of interchangeable parts in 1799, when he produced 10,000 muskets for the U.S. Army for the low price of \$13.40 per musket.
- In the late 1890s, Frederick W. Taylor used his ideas of scientific management to standardize work through time studies.
- In the early twentieth century, Frank and Lillian Gilbreth (parents of the authors of *Cheaper by the Dozen*) focused on eliminating waste by studying worker motivation and using motion studies and process charting.
- Starting in 1910, Henry Ford and Charles E. Sorensen arranged all the elements of manufacturing into a continuous system called the *production line*.
- After World War II, Taiichi Ohno and Shigeo Shingo recognized the importance of inventory management, and they perfected the Toyota production system, from which lean operations developed.<sup>1</sup>



**Minimum Inventory Levels** In the traditional manufacturing environment, parts, materials, and supplies are purchased far in advance and stored until the production department needs them. In contrast, in a JIT environment, materials and parts are purchased and received only when they are needed. The JIT approach lowers costs by reducing the space needed for inventory storage, the amount of materials handling, and the amount of inventory obsolescence. It also reduces the need for inventory control facilities, personnel, and recordkeeping. In addition, it significantly decreases the amount of work in process inventory and the amount of working capital tied up in all inventories.

**STUDY NOTE:** Pull-through production represents a change in concept. Instead of producing goods in anticipation of customers' needs, customers' orders trigger the production process.

**Pull-Through Production** In **pull-through production**, a customer's order triggers the purchase of materials and the scheduling of production for the products that have been ordered. In contrast, with the **push-through production** method used in traditional manufacturing operations, products are manufactured in long production runs and stored in anticipation of customers' orders. With pull-through production, the size of a customer's order determines the size of a production run, and the company purchases materials and parts as needed. Inventory levels are kept low and machines must be set up more frequently as different jobs enter production.

**Quick Setup and Flexible Work Cells** By placing machines in more efficient locations and standardizing setups, setup time can be minimized in a JIT environment.

**STUDY NOTE:** In the JIT environment, normal operating activities—setup, production, and maintenance—still take place. But the timing of those activities is altered to promote smoother operations and to minimize downtime.

In a traditional factory layout, similar machines are grouped together, forming functional departments. Products are routed through these departments in sequence, so that all necessary operations are completed in order. This process can take several days or weeks, depending on the size and complexity of the job. By changing the factory layout so that all the machines needed for sequential processing are placed together, JIT may cut the manufacturing time of a product from days to hours, or from weeks to days. The new cluster of machinery forms a flexible **work cell**, an autonomous production line that can perform all required operations efficiently and continuously. The flexible work cell handles a “family of products”—that is, products of similar shape or size. Product families require minimal setup changes as workers move from one job to the next. The more flexible the work cell is, the greater its potential to minimize total production time.

**A Multiskilled Workforce** In flexible work cells, one worker may be required to operate several types of machines simultaneously. The worker may have to set up and retool the machines and even perform routine maintenance on them. Under a JIT operating philosophy, multiskilled workers have been very effective in contributing to high levels of productivity.

**STUDY NOTE:** Although separate inspection costs are reduced in a JIT operating environment, some additional time is added to production because the machine operator is now performing the inspection function.

**High Levels of Product Quality** A JIT environment results in high-quality products, since high-quality direct materials are used and inspections are made throughout the production process. In a JIT environment, inspection as a separate step does not add value to a product, so inspection is incorporated into ongoing operations. A JIT machine operator inspects the products as they pass through the manufacturing process. If the operator detects a flaw, he or she shuts down the work cell to prevent the production of similarly flawed products while the cause of the problem is being determined. The operator either fixes the problem or helps others find a way to correct it. This integrated inspection procedure, combined with high-quality materials, produces high-quality finished goods.

**Effective Preventive Maintenance** When a company rearranges its machinery into flexible work cells, each machine becomes an integral part of its cell. If one machine breaks down, the entire work cell stops functioning, and the product cannot easily be routed to another machine while the malfunctioning machine is being repaired. Continuous JIT operations therefore require an effective system of preventive maintenance. Preventing machine breakdowns is considered more important and more cost effective than keeping machines running continuously. Machine operators are trained to perform minor repairs when they detect problems. Machines are serviced regularly—much as



© Alija / iStockphoto.com

## Business Perspective

### Lean Operations Improve Hospital Safety and Efficiency

Many hospitals around the country use lean tools to enhance laboratory performance when drawing and processing blood samples, administering patient medications, or supplying sterile IV equipment to operating rooms. Staff participate in value stream mapping to optimize work flows, kaizen (meaning suggest improvements for) different processes to achieve rapid operations, and use JIT principles when managing inventory.

© Cengage Learning 2014

automobiles are—to help guarantee continued operation. The machine operator conducts routine maintenance during downtime periods between orders.

## Continuous Improvement of the Work Environment

A JIT operating philosophy fosters loyalty among workers, who are likely to see themselves as part of a team that is deeply involved in the production process. Machine operators must have the skills to run several types of machines, detect defective products, suggest measures to correct problems, and maintain the machinery within their work cells. In addition, each worker is encouraged to suggest improvements to the production process. In Japanese, this is called **kaizen**, meaning “good change.” Companies with a JIT operating philosophy receive thousands of employee suggestions and implement a high percentage of them, and they reward workers for suggestions that improve the process. Such an environment fosters workers’ initiative and benefits the company.

## Accounting for Product Costs in a JIT Operating Environment

When a firm like Bean Bag Convertibles, Inc., shifts to lean operations and adopts a JIT operating philosophy, the changes in the operations will affect how costs are determined and what measures are used to monitor performance. The work cells and the goal of reducing or eliminating non-value-adding activities change the way costs are classified and assigned.

**Classifying Costs** The traditional production process can be divided into five time frames:

- **Processing time:** The actual amount of time spent working on a product
- **Inspection time:** The time spent looking for product flaws or reworking defective units
- **Moving time:** The time spent moving a product from one operation or department to another
- **Queue time:** The time a product spends waiting to be worked on once it arrives at the next operation or department
- **Storage time:** The time a product spends in materials inventory, work in process inventory, or finished goods inventory

In product costing under JIT, costs associated with processing time are relevant, but costs associated with inspection, moving, queue, and storage time should be reduced or eliminated because they do not add value to the product.

**Assigning Costs** In a JIT operating environment, managers focus on **throughput time**, the time it takes to move a product through the entire production process. Sophisticated computer monitoring of the work cells allows many costs to be traced directly to the cells in which products are manufactured. As Exhibit 5 shows, several costs that in

a traditional environment are treated as indirect costs and applied to products using an overhead rate are treated as the direct costs of a JIT work cell.

- The costs of repairs and maintenance, materials handling, operating supplies, utilities, employee benefits, and indirect labor and supervision can be traced directly to work cells as they are incurred.
- Depreciation charges on machinery are based on units of output, not on time, so depreciation can be charged directly to work cells based on the number of units produced.
- Building occupancy costs, insurance premiums, and property taxes remain indirect costs and must be assigned to the work cells.

### Exhibit 5 Direct and Indirect Costs in Traditional and JIT Environments

	Costs in a Traditional Environment	Costs in a JIT Environment
Direct materials	Direct	Direct to work cell
Direct labor	Direct	Direct to work cell
Repairs and maintenance	Indirect	Direct to work cell
Materials handling	Indirect	Direct to work cell
Operating supplies	Indirect	Direct to work cell
Utilities costs	Indirect	Direct to work cell
Supervision	Indirect	Direct to work cell
Depreciation—machinery	Indirect	Direct to work cell
Depreciation—plant	Indirect	Indirect
Supporting service functions	Indirect	Mostly direct to work cell
Building occupancy	Indirect	Indirect
Insurance and taxes	Indirect	Indirect
President's salary	Indirect	Indirect

© Cengage Learning 2014

## APPLY IT!

The cost categories in the following list are typical of a furniture manufacturer like Bean Bag Convertibles, Inc. Identify each cost as direct or indirect, assuming that it was incurred in (1) a traditional manufacturing setting and (2) a JIT environment.

- |                         |                               |
|-------------------------|-------------------------------|
| a. Direct materials     | f. Purchased parts            |
| b. Direct labor         | g. Employee benefits          |
| c. Supervisory salaries | h. Indirect labor             |
| d. Electrical power     | i. Insurance and taxes, plant |
| e. Operating supplies   |                               |

### SOLUTION

	1. Traditional Setting	2. JIT Setting
a. Direct materials	Direct	Direct
b. Direct labor	Direct	Direct
c. Supervisory salaries	Indirect	Direct
d. Electrical power	Indirect	Direct
e. Operating supplies	Indirect	Direct
f. Purchased parts	Direct	Direct
g. Employee benefits	Indirect	Direct
h. Indirect labor	Indirect	Direct
i. Insurance and taxes—plant	Indirect	Indirect

**TRY IT! SE6, SE9, E10A, E11A, E10B, E11B**

## LO 4 Backflush Costing

We have focused on how managers can trim waste from operations. However, they can also reduce waste in other areas, including the accounting process. Because a lean operation reduces labor costs, the accounting system can combine the costs of direct labor and overhead into the single category of conversion costs. Also, because materials arrive

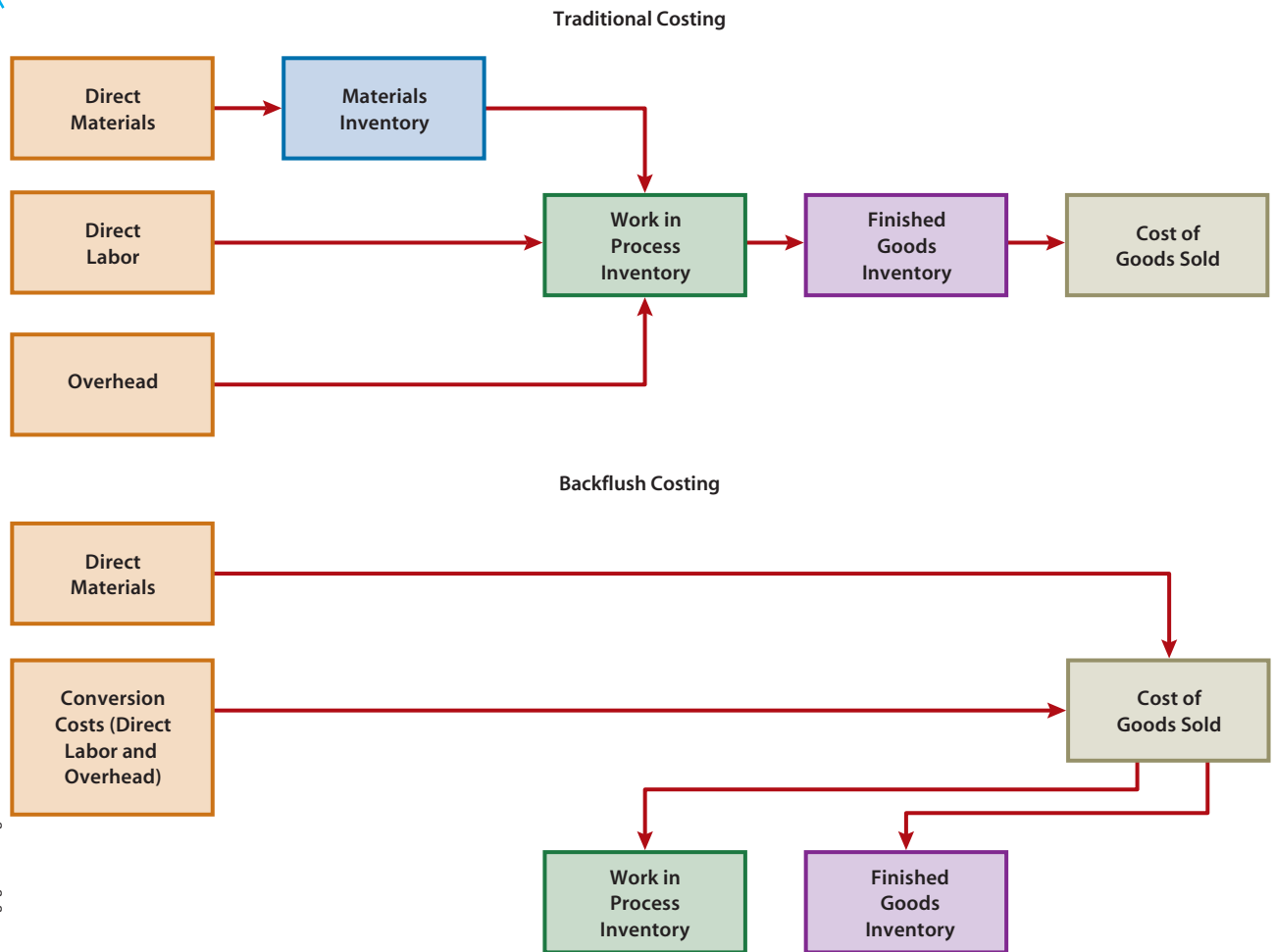
just in time to be used in the production process, there is little reason to maintain a separate Materials Inventory account. Thus, by simplifying cost flows through the accounting records, it is possible to reduce the time it takes to record and account for the costs of the manufacturing process.

### Cost Flows in Traditional and Backflush Costing

**STUDY NOTE:** Backflush costing eliminates the need to make journal entries during the period to track cost flows through the production process.

A lean organization can also streamline its accounting process by using backflush costing. In **backflush costing**, all product costs are first accumulated in the Cost of Goods Sold account. At the end of the period, they are “flushed back,” or worked backward, into the appropriate inventory accounts. By having all product costs flow straight to a final destination and working back to determine the proper balances for the inventory accounts, this method saves recording time. As shown in Exhibit 6, it eliminates the need to record several transactions that must be recorded in traditional operating environments.

**Exhibit 6**  
Comparison of Cost Flows in  
Traditional and Backflush Costing



© Cengage Learning 2014

Cost flows differ depending on whether a company is using a traditional costing method or backflush costing.

**Traditional Costing Method** When a traditional costing method is used:

- Direct materials costs are entered into the Materials Inventory account upon arrival at the factory.
- Direct materials costs flow into the Work in Process Inventory account as materials are requisitioned into production. When direct labor is used, its costs are added to

the Work in Process Inventory account. Overhead is applied to production using a base like direct labor hours, machine hours, or number of units produced and is added to the other costs in the Work in Process Inventory account.

- The costs of the finished units are transferred to the Finished Goods Inventory account at the end of the manufacturing process. When the units are sold, their costs are transferred to the Cost of Goods Sold account.

**Backflush Costing Method** When the backflush costing method is used:

- Direct materials arrive just in time to be placed into production. The direct materials costs and the **conversion costs** (direct labor and overhead) are immediately charged to the Cost of Goods Sold account.
- The costs of goods in work in process inventory and in finished goods inventory are determined at the end of the period, and those costs are flushed back to the Work in Process Inventory account and the Finished Goods Inventory account. Once those costs have been flushed back, the Cost of Goods Sold account contains only the costs of units completed and sold during the period.

Assume that the following transactions occurred at one of Bean Bag Convertibles's production facilities last month:

1. Purchased \$20,000 of direct materials on account.
2. Used all of the direct materials in production.
3. Incurred direct labor costs of \$8,000.
4. Applied \$24,000 of overhead to production.
5. Completed units costing \$51,600.
6. Sold units costing \$51,500.

Exhibit 7 shows how these transactions would be entered in T accounts when traditional product costing is used and then shows how backflush costing in a JIT environment would treat the same transactions. You can trace the flow of each cost by following its transaction number.

**JIT Costing Method** In backflush costing, the cost of direct materials (Transaction 1) is charged directly to the Cost of Goods Sold account. Transaction 2, which is included in the traditional method, is not included when backflush costing is used because there is no Materials Inventory account. The costs of direct labor (Transaction 3) and overhead (Transaction 4) are combined and transferred to the Cost of Goods Sold account. The total in the Cost of Goods Sold account is then \$52,000 (\$20,000 for direct materials + \$32,000 for conversion costs).

Once all product costs for the period have been entered in the Cost of Goods Sold account, the amounts to be transferred back to the inventory accounts are calculated. The amount transferred to the Finished Goods Inventory account is computed as follows.

$$\begin{aligned}\text{Finished Goods Inventory} &= \text{Cost of Completed Units} - \text{Cost of Units Sold} \\ &= \$51,600 - \$51,500 \\ &= \$100\end{aligned}$$

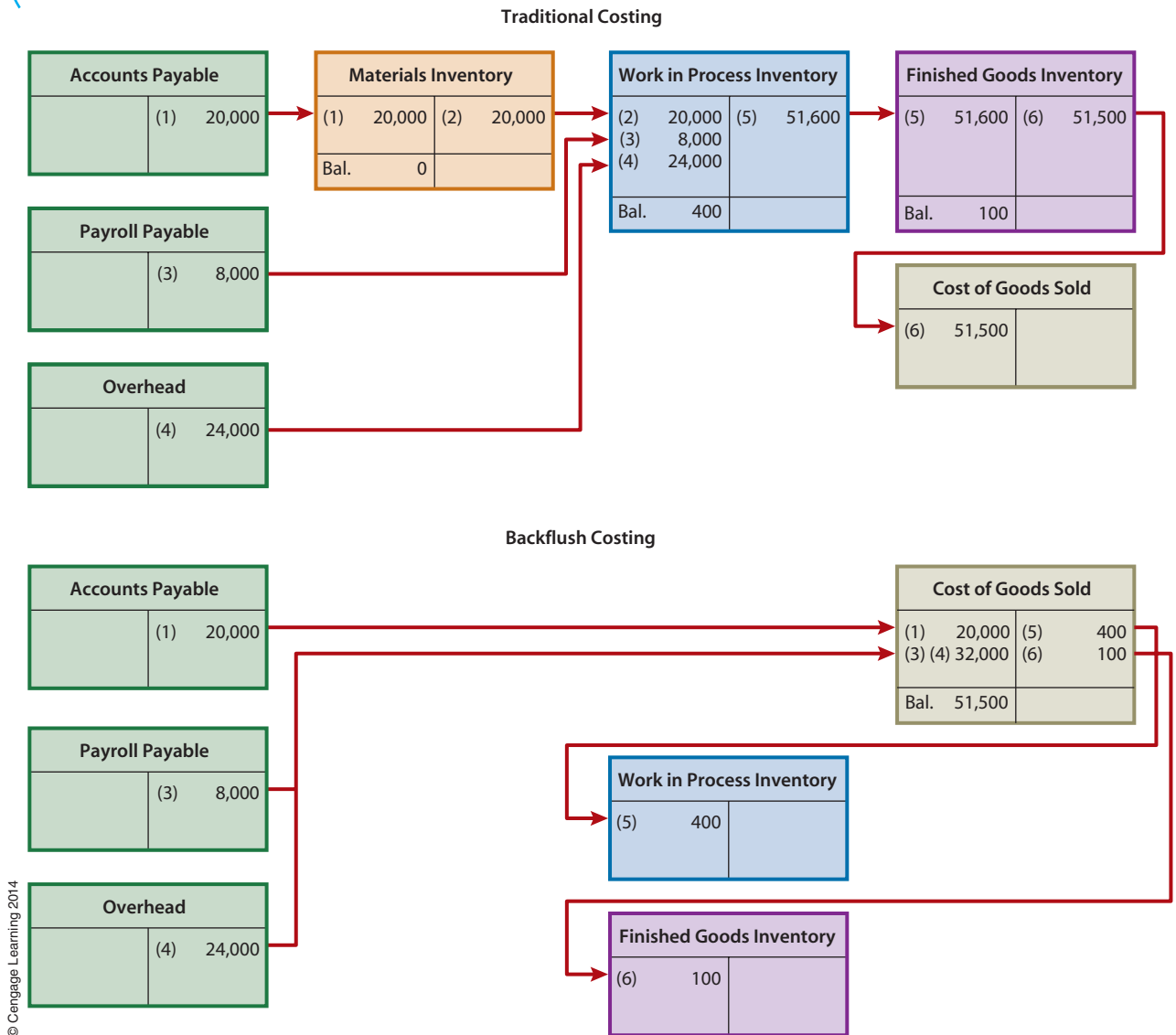
The remaining difference in the Cost of Goods Sold account represents the cost of the work that is still in production at the end of the period. The amount transferred to the Work in Process Inventory account is computed as follows.

$$\begin{aligned}\text{Work in Process Inventory} &= \text{Costs Charged to Cost of Goods Sold} - \text{Cost of Completed Units} \\ &= (\$20,000 + \$8,000 + \$24,000) - \$51,600 \\ &= \$400\end{aligned}$$

The ending balance in the Cost of Goods Sold account, \$51,500, is the same as the ending balance when traditional costing is used. The difference is that backflush costing uses fewer accounts and avoids recording several transactions.

**STUDY NOTE:** In backflush costing, entries to the Work in Process Inventory and Finished Goods Inventory accounts are made at the end of the period.

**Exhibit 7**  
Comparison of Cost Flows Through T Accounts  
with Traditional and Backflush Costing



© Cengage Learning 2014

**APPLY IT!**

For work done during August, Bean Bag Convertibles incurred direct materials costs of \$123,450 and conversion costs of \$265,200. The company employs a just-in-time operating environment and backflush costing.

At the end of August, the Work in Process Inventory account had been assigned \$980 of costs, and the ending balance of the Finished Goods Inventory account was \$1,290. There were no beginning inventory balances.

1. How much was charged to the Cost of Goods Sold account during August?
2. What was the ending balance of the Cost of Goods Sold account?

**SOLUTION**

1.  $\$123,450 + \$265,200 = \underline{\$388,650}$
2.  $\$388,650 - \$980 - \$1,290 = \underline{\$386,380}$

**TRY IT! SE7, E12A, E13A, E12B, E13B**



## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Total quality management
- Theory of constraints
- Activity-based management
- Lean accounting
- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

- LO 5** Identify the management tools used for continuous improvement, and compare ABM and lean operations.

## LO 5 Management Tools for Continuous Improvement

Today managers have ready access to international markets and to current information for informed decision making. As a result, global competition has increased significantly. One of the most valuable lessons gained from this increase in competition is that management cannot afford to become complacent. Organizations that adhere to **continuous improvement** are never satisfied with what is. They constantly seek improved quality and lower cost through better methods, products, services, processes, or resources. In response to this concept, several important management tools have emerged.

### Total Quality Management

**Total quality management (TQM)** requires that all parts of a business focus on quality. TQM's goal is the improved quality of products or services and the work environment. Workers are empowered to make operating decisions that improve quality in both areas. All employees are tasked to spot possible causes of poor quality, use resources efficiently and effectively to improve quality, and reduce the time needed to complete a task or provide a service.

To determine the impact of poor quality on profits, TQM managers use information about the **costs of quality**. The costs of quality include both the costs of achieving quality (such as training costs and inspection costs) and the costs of poor quality (such as the costs of rework and of handling customer complaints). Managers use information about the costs of quality to:

- relate their organization's business plan to its daily operating activities.
- stimulate improvement by sharing this information with all employees.
- identify opportunities for reducing costs and customer dissatisfaction.
- determine the costs of quality relative to net income.

### Theory of Constraints

According to the **theory of constraints (TOC)**, limiting factors, or bottlenecks, occur during the production of any product or service. Once managers identify such a constraint, they can focus their attention and resources on it and achieve significant improvements. TOC thus helps managers set priorities for how they spend their time and resources.

### Comparison of ABM and Lean Operations

ABM and lean have several things in common as value-based systems:

- Both analyze processes and identify value-adding and non-value-adding activities.
- Both seek to eliminate waste and reduce non-value-adding activities to improve product or service quality, reduce costs, and improve an organization's efficiency and productivity.
- Both improve the quality of the information that managers use to make decisions about bidding, pricing, product lines, and outsourcing.

The two systems differ in their methods of costing and cost assignment. ABM's tool, ABC, calculates product or service cost by using cost drivers to assign the indirect costs of production to cost objects. ABC is often a fairly complex accounting



method used with job order and process costing systems. Note that the ABC method can also be used to examine nonproduction-related activities, such as marketing and shipping.

A lean operation uses JIT and reorganizes many activities so that they are performed within work cells. The costs of those activities become direct costs of the work cell and of the products made in that cell. The total production costs within the cell can then be assigned by using simple cost drivers, such as process hours or direct materials cost. Companies that have implemented lean operations may use backflush costing rather than job order costing or process costing. This approach focuses on the output at the end of the production process and simplifies the accounting system.

Exhibit 8 summarizes the characteristics of ABM and lean operations. A company can use both ABM and lean. ABM and ABC will improve the accuracy of the company's product or service costing and help it to reduce or eliminate business activities that do not add value for its customers. At the same time, the company can apply lean thinking to simplify processes, use resources effectively, and eliminate waste.

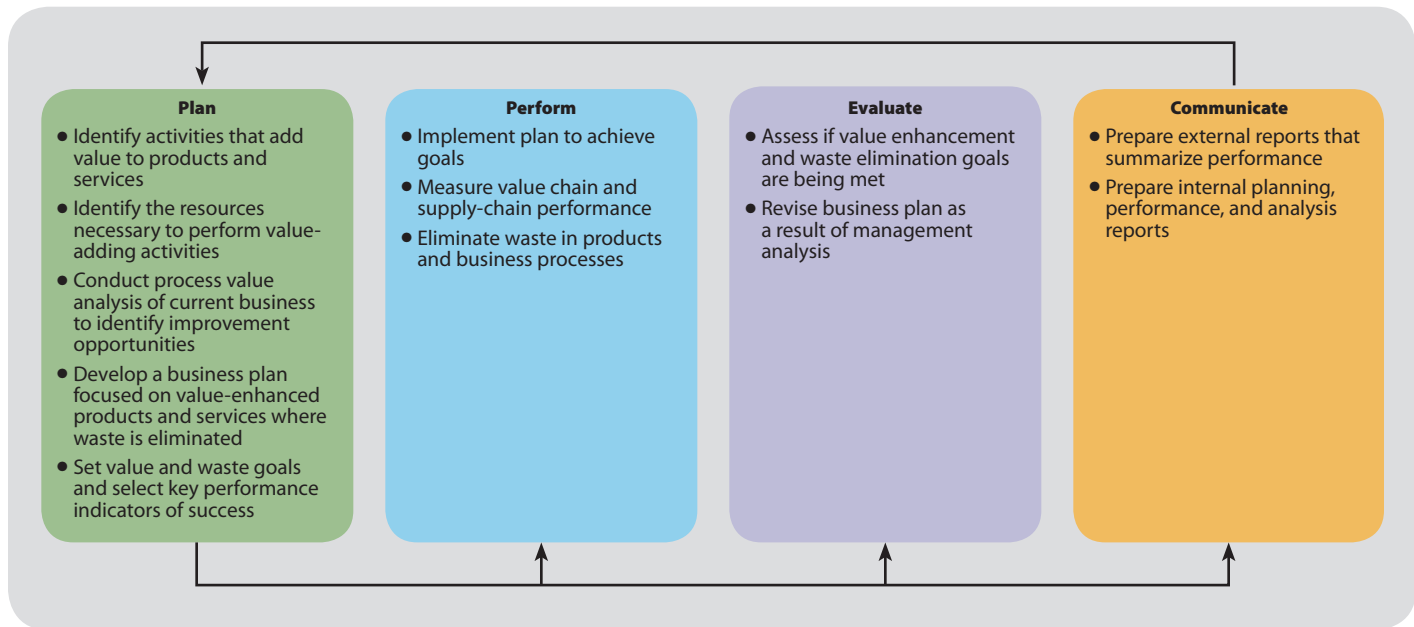
**STUDY NOTE:** ABM's primary goal is to calculate product or service cost accurately. The primary goal of lean operations is to eliminate waste in business processes.

**Exhibit 8**  
Comparison of ABM and Lean Operations

	ABM	Lean Operations
Primary purpose	To eliminate or reduce non-value-adding activities	To eliminate or reduce waste in all aspects of a business, including its processes and products or services
Cost assignment	Uses ABC to assign overhead costs to the product by using appropriate cost drivers	Uses JIT and reorganizes production activities into work cells; overhead costs incurred in the work cell become direct costs of the cell's products
Costing method	Integrates ABC with job order or process costing to calculate product costs	May use backflush costing to calculate product costs
Limitation	ABC can involve costly data collection and complex allocations	Requires management to think differently and use different performance measures

© Cengage Learning 2014

To remain competitive in today's business environment, companies have had to rethink their organizational processes and basic operating methods. Managers now focus on creating value for their customers as well as controlling costs throughout their management process. They design their internal value chain and external supply chain to provide customer-related, activity-based information; to track costs; and to eliminate waste and inefficiencies. In this chapter, two value-based systems that help managers improve operating processes and make better decisions as they plan, perform, evaluate, and report were discussed: activity-based management and lean operations. Exhibit 9 summarizes the steps managers take during the management process to manage for value and control costs.

**Exhibit 9****Managing for Value and Controlling Costs**

© Cengage Learning 2014

**APPLY IT!**

Recently, you had dinner with four chief financial officers (CFOs) who were attending a seminar on management tools and approaches to improving operations. The CFOs shared information about their organizations' current operating environments. Excerpts from the conversation appear below. Indicate whether each CFO describes activity-based management (ABM), lean operations, total quality management (TQM), or the theory of constraints (TOC).

- **CFO 1:** We think quality can be achieved through carefully designed production processes. We focus on minimizing the time needed to move, store, queue, and inspect our materials and products. We've reduced inventories by purchasing and using materials only when they're needed.
- **CFO 2:** Your approach is good. But we're more concerned with our total operating environment, so we have a strategy that asks all employees to contribute to the quality of both our products and our work environment. We focus on eliminating poor product quality by reducing waste and inefficiencies in our current operating methods.
- **CFO 3:** Our organization has adopted a strategy for producing high-quality products that incorporates many of your approaches. We also want to manage our resources effectively, and we do it by monitoring operating activities. We analyze all activities to eliminate or reduce the ones that don't add value to products.
- **CFO 4:** But how do you set priorities for your management efforts? We find that we achieve the greatest improvements by focusing our time and resources on the bottlenecks in our production processes.

**SOLUTION**

CFO 1: Lean operations; CFO 2: TQM;  
CFO 3: ABM; CFO 4: TOC

**TRY IT! SE8, SE9, SE10, E14A, E15A,  
E14B, E15B**

## TriLevel Problem



sturtiv/Stockphoto

**Bean Bag Convertibles, Inc.**

The beginning of this chapter focused on Bean Bag Convertibles, Inc., a company that produces sofas that can be converted into beds. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*What underlying accounting concepts support the use of value-based systems like activity-based management and lean accounting?*

### Section 2: Accounting Applications

*How can activity-based costing and lean operations help businesses like Bean Bag Convertibles improve business processes and eliminate waste?*

1. Assume that one of Bean Bag Convertibles' production facilities produces more than a dozen styles of convertible sofas. The convertible sofa/single bed is the easiest to produce. The other styles increase in difficulty of production as the number of pieces increases. The six-piece modular seating/sleeping style is the most difficult to produce and the most expensive. Campus Stores recently ordered 350 six-piece modular sets. The production facility at Bean Bag that received this order has been using a traditional costing system, but its controller is considering a shift to activity-based costing. He therefore wants to use the order from Campus Stores to compare ABC with traditional costing. Costs directly traceable to the order follow.

Direct materials	\$57,290
Purchased parts	\$76,410
Direct labor hours	1,320
Average direct labor pay rate per hour	\$14.00

With the traditional costing approach, the controller applies overhead costs at a rate of 320 percent of direct labor costs.

For activity-based costing of the Campus Stores order, the controller uses the following data:

Activity	Cost Driver	Activity Cost Rate	Activity Usage
Product design	Engineering hours	\$62 per engineering hour	76 engineering hours
Work cell setup	Number of setups	\$90 per setup	16 setups
Parts production	Machine hours	\$38 per machine hour	380 machine hours
Assembly	Assembly labor hours	\$40 per assembly labor hour	500 assembly labor hours
Product simulation	Testing hours	\$90 per testing hour	28 testing hours
Packaging and shipping	Product units	\$13 per unit	350 units
Building occupancy	Direct labor cost	125% of direct labor cost	\$18,480 direct labor cost

- a. Use the traditional costing approach to compute the total cost and product unit cost of the Campus Stores order.
- b. Using the cost hierarchy for manufacturing companies, classify each activity of the Campus Stores order according to the level at which it occurs.
- c. Prepare a bill of activities for the operating costs. (Round to the nearest cent.)
- d. Use ABC to compute the total cost and product unit cost. (Round to the nearest cent.)
- e. What is the difference between the product unit cost you computed using the traditional approach and the one you computed using ABC? Does the use of ABC guarantee cost reduction for every order?

2. Assume that one of Bean Bag Convertibles' production facilities is a lean operation and uses backflush costing in its management of bean bag chair inventory. At the beginning of the month, Work in Process Inventory and Finished Goods Inventory had zero balances. During the month, the following transactions took place:
- Ordered, received, and used materials costing \$11,000.
  - Direct labor costs incurred, \$6,000.
  - Overhead costs incurred, \$3,000.
  - Completed bean bag chairs costing \$19,000.
  - Sold bean bag chairs costing \$18,500.

Using backflush costing, calculate the ending balance in the Work in Process Inventory and Finished Goods Inventory accounts.

### Section 3: Business Applications

*How can managers of companies like Bean Bag Convertibles plan to remain competitive in a challenging business environment? To answer this question, match this chapter's manager responsibilities with when they occur within the management process.*

- |                |   |
|----------------|---|
| a. Plan        | 1. Identify value-adding activities   |
| b. Perform     | 2. Prepare external reports   |
| c. Evaluate    | 3. Conduct process value analysis to identify improvement opportunities       |
| d. Communicate | 4. Assess if value and waste goals are met                                    |
|                | 5. Prepare internal reports   |
|                | 6. Identify the resources necessary to perform value-adding activities        |
|                | 7. Develop a business plan  |
|                | 8. Implement plan to achieve goals  |
|                | 9. Set value and waste goals and select key performance indicators of success |
|                | 10. Revise business plan as a result of management analysis                   |
|                | 11. Manage and measure value chain and supply chain performance.              |
|                | 12. Eliminate waste in products and business processes.                       |

## SOLUTION

### Section 1: Concepts

The concepts of *relevance* and *reliability* underlie value-based systems like activity-based management and lean operations. Value-based systems add relevance since they categorize activities as either adding value to a product or service or not adding value. It enables managers to see their organization as a collection of value-creating activities (a value chain) that operates as part of a larger system that includes suppliers' and customers' value chains (a supply chain). This perspective has a direct bearing on a manager's ability to work with reliable information that is free from material error, complete, and neutral to reduce costs by eliminating waste and inefficiencies and by redirecting resources toward value-adding activities.

### Section 2: Accounting Applications

1. a.

Direct materials	\$ 57,290
Purchased parts	76,410
Direct labor (1,320 × \$14.00)	18,480
Overhead (320% of direct labor cost)	59,136
Total cost of order	<u>\$211,316</u>
Product unit cost (total costs ÷ 350 units)	<u>\$ 603.76</u>

- b.
- |                 |  |
|-----------------|--|
| Unit level:     | Parts production<br>Assembly<br>Packaging and shipping |
| Batch level:    | Work cell setup  |
| Product level:  | Product design<br>Product simulation                   |
| Facility level: | Building occupancy                                     |

c. and d.

**Bean Bag Convertibles, Inc.  
Bill of Activities  
Campus Stores Order**

Activity	Activity Cost Rate	Cost Driver Level	Activity Cost
Unit level:			
Parts production	\$38 per machine hour	380 machine hours	\$ 14,440
Assembly	\$40 per assembly labor hour	500 assembly labor hours	20,000
Packaging and shipping	\$13 per unit	350 units	4,550
Batch level:			
Work cell setup	\$90 per setup	16 setups	1,440
Product level:			
Product design	\$62 per engineering hour	76 engineering hours	4,712
Product simulation	\$90 per testing hour	28 testing hours	2,520
Facility level:			
Building occupancy	125% of direct labor cost	\$18,480 direct labor cost	<u>23,100</u>
Total activity costs assigned to job			\$ 70,762
Total job units			÷ 350
Activity costs per unit (total activity costs ÷ total units)			<u>\$ 202.18*</u>
<b>Cost summary:</b>			
Direct materials			\$ 57,290
Purchased parts			76,410
Activity costs (includes labor and overhead)			<u>70,762</u>
Total cost of order			<u>\$204,462</u>
Product unit cost (total cost of order ÷ 350 units)			<u>\$ 584.18*</u>

\*Rounded

e. Product unit cost using traditional costing approach	\$603.76
Product unit cost using activity-based costing approach	<u>584.18</u>
Difference	<u>\$ 19.58</u>

Although the product unit cost computed using ABC is lower than the one computed using the traditional costing approach, ABC does not guarantee cost reduction for every product. It does improve cost traceability, which often identifies products that are “under-costed” or “overcosted” by a traditional product costing system.

2. Costs added to the Cost of Goods Sold account:	
Direct materials	\$ 11,000
Conversion costs (direct labor and overhead)	<u>9,000</u>
Total manufacturing costs	\$ 20,000
Less: Cost of goods completed	<u>(19,000)</u>
Ending balance of Work in Process Inventory	<u>\$ 1,000</u>
Cost of goods completed	\$ 19,000
Less: Cost of goods sold	<u>(18,500)</u>
Ending balance of Finished Goods Inventory	<u>\$ 500</u>

**Section 3: Business Applications**

- |      |       |
|------|-------|
| 1. a | 7. a  |
| 2. d | 8. b  |
| 3. a | 9. a  |
| 4. c | 10. c |
| 5. d | 11. b |
| 6. a | 12. b |

**Chapter Review**

**Describe value-based systems, and discuss their relationship to the supply chain and the value chain.** **Lo 1**

Value-based systems add relevance and reliability since they categorize activities as either adding value to a product or service or not adding value. They enable managers to see their organization as a collection of value-creating activities (a value chain) that operates as part of a larger system that includes suppliers' and customers' value chains (a supply chain). This perspective helps managers work cooperatively both inside and outside their organizations to reduce costs by eliminating waste and inefficiencies and by redirecting resources toward value-adding activities. Process value analysis (PVA) is a technique for analyzing business processes by relating activities to the events that prompt the activities and to the resources that the activities consume. A value-adding activity adds value to a product or service as perceived by the customer. A non-value-adding activity adds cost to a product or service but does not increase its market value.

**Define activity-based costing, and explain how a cost hierarchy and a bill of activities are used.** **Lo 2**

To implement activity-based costing (ABC), managers (1) identify and classify each activity, (2) estimate the cost of resources for each activity, (3) identify a cost driver for each activity and estimate the quantity of each cost driver, (4) calculate an activity cost rate for each activity, and (5) assign costs to cost objects based on the level of activity required to make the product or provide the service. ABC's primary disadvantage is that it is costly to implement.

A cost hierarchy and a bill of activities help in the implementation of ABC. To create a cost hierarchy, managers classify activities into four levels. Unit-level activities are performed each time a unit is produced. Batch-level activities are performed each time a batch of goods is produced. Product-level activities are performed to support a particular product line or brand. Facility-level activities are performed to support a facility's general manufacturing process. A bill of activities is then used to compute the costs assigned to activities and the product or service unit cost.

**Define the elements of a lean operation, and identify the changes in inventory management that result when a firm adopts its just-in-time operating philosophy.** **Lo 3**

One of the primary elements of a lean operation is to produce on a just-in-time (JIT) basis. The elements of a JIT environment are minimum inventory levels, pull-through production, quick setup and flexible work cells, a multiskilled work force, high levels of product quality, effective preventive maintenance, and continuous improvement of the work environment.

In product costing under JIT, processing costs are classified as either direct materials costs or conversion costs. The costs associated with inspection time, moving time, queue time, and storage time are reduced or eliminated. With computerized monitoring of the work cells, many costs that are treated as indirect or overhead costs in traditional manufacturing settings become direct costs since they can be traced directly to work cells. The only costs that remain indirect costs and must be assigned to the work cells are those that cannot be linked to a specific work cell, such as building occupancy, insurance, and property taxes.

**Define and apply backflush costing, and compare the cost flows in traditional and backflush costing.** **Lo 4**

In backflush costing, all product costs are first accumulated in the Cost of Goods Sold account. At the end of the period, they are "flushed back" into the appropriate inventory accounts. Backflush costing is commonly used to account for product costs in a JIT operating environment. It differs from the traditional costing approach, which records



Identify the management tools used for continuous improvement, and compare ABM and lean operations. **LO 5**

the costs of materials purchased in the Materials Inventory account and uses the Work in Process Inventory account to record the costs of direct materials, direct labor, and overhead during the production process. The objective of backflush costing is to save recording time, which cuts costs.

Management tools for continuous improvement include total quality management (TQM), the theory of constraints (TOC), activity-based management (ABM), and lean operations. These tools are designed to help businesses meet the demands of a challenging business environment by reducing resource waste and costs and by improving product or service quality, thereby increasing customer satisfaction. As value-based systems, both ABM and lean operations enhance the relevance and reliability of cost information as they seek to eliminate waste and reduce non-value-adding activities. However, ABM uses ABC to assign indirect costs to products using cost drivers, while lean uses JIT to reorganize activities so that they are performed within work cells. The overhead costs incurred in a work cell become direct costs of the products made in that cell. ABM uses job order or process costing to calculate product costs, whereas lean operations may use backflush costing.

## Key Terms

**activity-based costing (ABC)** 885 (LO2)

**activity-based management (ABM)** 885 (LO2)

**backflush costing** 893 (LO4)

**batch-level activities** 886 (LO2)

**bill of activities** 887 (LO2)

**continuous improvement** 896 (LO5)

**conversion costs** 894 (LO4)

**core competency** 882 (LO1)

**cost hierarchy** 886 (LO2)

**costs of quality** 896 (LO5)

**facility-level activities** 886 (LO2)

**full product cost** 882 (LO1)

**inspection time** 891 (LO3)

**just-in-time (JIT) operating philosophy** 889 (LO3)

**kaizen** 891 (LO3)

**lean operation** 889 (LO3)

**moving time** 891 (LO3)

**non-value-adding activity** 884 (LO1)

**outsourcing** 882 (LO1)

**primary processes** 882 (LO1)

**process value analysis (PVA)** 883 (LO1)

**processing time** 891 (LO3)

**product-level activities** 886 (LO2)

**pull-through production** 890 (LO3)

**push-through production** 890 (LO3)

**queue time** 891 (LO3)

**storage time** 891 (LO3)

**supply chain** 882 (LO1)

**support services** 882 (LO1)

**theory of constraints (TOC)** 896 (LO5)

**throughput time** 891 (LO3)

**total quality management (TQM)** 896 (LO5)

**unit-level activities** 886 (LO2)

**value-adding activity** 883 (LO1)

**value-based systems** 882 (LO1)

**value chain** 882 (LO1)

**work cell** 890 (LO3)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1** **DQ1. CONCEPT** ► Discuss how differentiating between activities that add value and those that do not add value enhance the relevance and reliability of manager information.
- LO 2** **DQ2. CONCEPT** ► Why do the concepts of relevance and reliability underlie the five steps in implementing activity-based costing (ABC)?
- LO 2** **DQ3. CONCEPT** ► Describe how a cost hierarchy and a bill of activities can improve the relevance and reliability of an ABC implementation.
- LO 3, 4** **DQ4. CONCEPT** ► Why does the classification of costs in lean operations improve the relevance and reliability of product costs?



- LO 1,5 **DQ5. CONCEPT ► BUSINESS APPLICATION ►** Why do value-based systems in the management process reinforce the concepts of relevance and reliability to lead to better business operations?

## SHORT EXERCISES

### LO 1 Concepts

**SE1. CONCEPT ►** Indicate whether each of the following pertains to the accounting concept of reliability or relevance.

- |                            |                                       |
|----------------------------|---------------------------------------|
| a. Predictive value        | c. Free from material error           |
| b. Faithful representation | d. Has a direct bearing on a decision |

### LO 1 The Value Chain

**SE2.** The unit costs that follow were determined by dividing the total costs of each component by the number of products produced. From these unit costs, determine the total cost per unit of primary processes and the total cost per unit of support services.

Research and development	\$ 1.00
Human resources	1.45
Design	0.55
Supply	1.10
Legal services	0.60
Production	4.00
Marketing	0.80
Distribution	0.90
Customer service	0.65
Information systems	0.75
Management accounting	0.20
Total cost per unit	<u>\$12.00</u>

### LO 1 Value-Adding and Non-Value-Adding Activities

**SE3.** Indicate whether the following activities of a gourmet sandwich shop are value-adding (VA) or non-value-adding (NVA).

- |                                    |                                   |
|------------------------------------|-----------------------------------|
| a. Purchasing sandwich ingredients | d. Cleaning up the shop           |
| b. Storing condiments              | e. Making home deliveries         |
| c. Making sandwiches               | f. Accounting for sales and costs |

### LO 2 The Cost Hierarchy

**SE4.** Engineering design is an activity that is vital to the success of any motor vehicle manufacturer. Identify the level at which engineering design would be classified in the cost hierarchy used with ABC for each of the following:

- A maker of unique editions of luxury automobiles
- A maker of built-to-order city and county emergency vehicles (orders are usually placed for 10 to 12 identical vehicles)
- A maker of a line of automobiles sold throughout the world

### LO 2 The Cost Hierarchy

**SE5.** Match the four levels of the cost hierarchy to the following activities of a jeans manufacturer that uses activity-based management:

- Routine maintenance of sewing machines
- Designing a pattern for a new style
- Sewing seams on a garment
- Producing 100 jeans of a certain style in a certain size

**LO 3 Product Costing Changes in a JIT Environment**

**SE6.** Beauty Products Company is in the process of adopting the JIT operating environment for its lotion-making operations. Indicate which of the following overhead costs are non-value-adding costs (NVA) and which can be traced directly to the new lotion-making work cell (D):

- a. Storage containers for work in process inventory
- b. Insurance on the storage warehouse
- c. Machine electricity
- d. Machine repairs
- e. Depreciation of the storage container moving equipment
- f. Machine setup labor

**LO 4 Backflush Costing**

**SE7.** For work done during August, Ohir Company incurred direct materials costs of \$120,000 and conversion costs of \$260,000. The company employs a JIT operating philosophy and backflush costing. At the end of August, the Work in Process Inventory account had been assigned \$900 of costs, and the ending balance of the Finished Goods Inventory account was \$1,300. There were no beginning inventory balances. How much was charged to the Cost of Goods Sold account during August? What was the ending balance of that account?

**LO 5 Comparison of ABM and Lean**

**SE8. ACCOUNTING CONNECTION** ► Hong Corp. recently installed three just-in-time work cells in its screen-making division. The work cells will make large quantities of similar products for major window and door manufacturers. Should Hong use lean operations with JIT and backflush costing or ABM and ABC to account for product costs? Defend your choice of activity-based system.

**LO 5 TQM and Value**

**SE9.** Petal Dry Cleaners recently adopted total quality management. The owner has hired you as a consultant. Classify each of the following activities as either value-adding (VA) or non-value-adding (NVA):

- a. Providing same-day service
- b. Closing the store on weekends
- c. Providing free delivery service
- d. Having a seamstress on site
- e. Making customers pay for parking

**LO 5 Activity-Based Systems**

**SE10. ACCOUNTING CONNECTION** ► Bob Lillie started a retail clothing business two years ago. Lillie's first year was very successful, but sales dropped 50 percent in the second year. A friend who is a business consultant analyzed Lillie's business and came up with two basic reasons for the decline in sales: (1) Lillie has been placing orders late in each season, and (2) shipments of clothing have been arriving late and in poor condition. What measures can Lillie take to improve his business and persuade customers to return?

## EXERCISES: SET A

### LO 1 The Supply Chain and Value Chain

**E1A.** Indicate which of the following items associated with a hotel are part of the supply chain (S) and which are part of the value chain (V):

- |                                  |                          |
|----------------------------------|--------------------------|
| a. Travel agency                 | d. Customer service      |
| b. Housekeeping supplies         | e. Travel bureau website |
| c. Special events and promotions | f. Tour agencies         |

### LO 1 The Value Chain

**E2A.** As shown in the data that follow, a producer of ceiling fans has determined the unit cost of its most popular model. From these unit costs, determine the total cost per unit of primary processes and the total cost per unit of support services.

Research and development	\$ 5.00
Human resources	4.50
Design	1.50
Supply	1.00
Legal services	0.50
Production	4.50
Marketing	2.00
Distribution	2.50
Customer service	6.50
Information systems	1.80
Management accounting	0.20
Total cost per unit	<u>\$30.00</u>

### LO 1 Management Reports

**E3A. ACCOUNTING CONNECTION** ► The reports that follow are from a grocery store. Which report would be used for financial purposes, and which would be used for activity-based decision making? Why?

Salaries	\$ 1,000	Scan grocery purchases	\$ 3,000
Equipment	2,200	Stock fruit	1,000
Freight	5,000	Bake rye bread	500
Supplies	800	Operate salad bar	2,500
Use and occupancy	1,000	Stock can goods	2,000
Total	<u>\$10,000</u>	Collapse cardboard boxes	1,000
		Total	<u>\$10,000</u>

### LO 1 The Value Chain

**E4A.** Edwin Cortez recently opened his own company. In order to improve the business, he will be undertaking the following actions:

- Engaging an accountant to help analyze progress in meeting the objectives of the company
- Hiring a company to handle payroll records and employee benefits
- Developing a logo for labeling and packaging the ceramics
- Making gift packages by placing gourmet food products in ceramic pots and wrapping them in plastic
- Engaging an attorney to write contracts
- Traveling to Mexico himself to arrange for the purchase of products and their shipment back to the company
- Arranging new ways of taking orders over the Internet and shipping the products
- Keeping track of the characteristics of customers and the number and types of products they buy

- i. Following up with customers to see if they received the products and if they are happy with them
  - j. Arranging for an outside firm to keep the accounting records
  - k. Distributing brochures that display the ceramics and refer to the website
1. Classify each of Cortez's actions as one of the value chain's primary processes—research and development, design, supply, production, marketing, distribution, or customer service—or as a support service—human resources, legal services, information systems, or management accounting.
  2. **ACCOUNTING CONNECTION** ► Of these actions, which are the most likely candidates for outsourcing? Why?

### LO 1 Value-Adding and Non-Value-Adding Activities

**E5A.** When Cornelia Tyson prepared a process value analysis for her company, she identified the following primary activities. Identify the value-adding activities (VA) and the non-value-adding activities (NVA).

- |                       |                      |
|-----------------------|----------------------|
| a. Engineering design | c. Product sales     |
| b. Product marketing  | d. Materials storage |

### LO 2 The Cost Hierarchy

**E6A.** Topa Electronics makes speaker systems. Its customers range from new hotels and restaurants that need specifically designed sound systems to nationwide retail outlets that order large quantities of similar products. The following activities are part of the company's operating process:

- |                             |                         |
|-----------------------------|-------------------------|
| a. Retail sales commissions | d. Assembly line setup  |
| b. Product design           | e. Building security    |
| c. Assembly labor           | f. Facility supervision |

Classify each activity as unit level (UL), batch level (BL), product level (PL), or facility level (FL).

### LO 2 Bill of Activities

**E7A.** Ohfir Corporation has received an order for handheld computers from Townsend, LLC. A partially complete bill of activities for that order follows. Fill in the missing data.

**Ohfir Corporation**  
**Bill of Activities for Townsend, LLC**  
**Handheld Computers Order**

Activity	Activity Cost Rate	Cost Driver Level	Activity Cost
Unit level:			
Parts production	\$50 per machine hour	200 machine hours	\$ ?
Assembly	\$20 per DLH	100 DLH	?
Packaging and shipping	\$12.50 per unit	400 units	?
Batch level:			
Work cell setup	\$100 per setup	16 setups	?
Product level:			
Product design	\$60 per engineering hour	80 engineering hours	?
Product simulation	\$80 per testing hour	30 testing hours	?
Facility level:			
Building occupancy	200% of direct labor cost	?	?
Total activity costs assigned to job			\$ ?
Total job units			400
Activity costs per unit (total activity costs ÷ total units)			\$ ?
<b>Cost summary:</b>			
Direct materials			\$60,000
Purchased parts			80,000
Activity costs			?
Total cost of order			\$ ?
Product unit cost (total cost of order ÷ 400 units)			\$ ?

### LO 2 Activity Cost Rates

**E8A.** Compute the activity cost rates for materials handling, assembly, and design based on the data that follow.

Materials:	
Cloth	\$26,000
Fasteners	4,000
Purchased parts	40,000
Materials handling:	
Labor	8,000
Equipment depreciation	5,000
Electrical power	2,000
Maintenance	6,000
Assembly:	
Machine operators	5,000
Design:	
Labor	5,000
Electrical power	1,000
Overhead	8,000

Output totaled 40,000 units. Each unit requires three machine hours of effort. Materials handling costs are allocated to the products based on direct materials cost. Design costs are allocated based on units produced. Assembly costs are allocated based on 500 machine operator hours. (*Hint:* Activity cost rate = Total activity costs ÷ Total allocation base. Examples of an allocation base include total dollars of materials, total machine operator hours, or total units of output.)

### LO 3 Elements of a Lean Operating Environment

**E9A.** The numbered items that follow are concepts that underlie value-based systems, such as ABM and lean operations. Match each concept to the related lettered element(s) of a lean operating environment.

- |   |   |
|---|---|
| 1. Business processes are simplified.                       | a. Minimum inventory levels                     |
| 2. The quality of the product or service is critical.       | b. Pull-through production                      |
| 3. Employees are cross-trained.                             | c. Quick machine setups and flexible work cells |
| 4. Large inventories waste resources and may hide bad work. | d. A multiskilled work force                    |
| 5. Goods should be produced only when needed.               | e. High levels of product quality               |
| 6. Equipment downtime is minimized.                         | f. Effective preventive maintenance             |

### LO 3 Comparison of Traditional and JIT Manufacturing Environments

**E10A.** Identify which of the following exist in a traditional manufacturing environment and which exist in a JIT operating environment:

- Large amounts of inventory
- Complex manufacturing processes
- A multiskilled labor force
- Flexible work cells
- Push-through production methods
- Materials purchased infrequently but in large lot sizes
- Infrequent setups

**LO 3 Direct and Indirect Costs in JIT and Traditional Manufacturing Environments**

**E11A.** The cost categories in the following list are typical of many manufacturing operations:

- |                      |                              |
|----------------------|------------------------------|
| a. Direct materials: | f. Operating supplies        |
| (1) Sheet steel      | g. Small tools               |
| (2) Iron castings    | h. Depreciation—plant        |
| b. Assembly parts:   | i. Depreciation—machinery    |
| (1) Part 24          | j. Supervisory salaries      |
| (2) Part 15          | k. Electrical power          |
| c. Direct labor      | l. Insurance and taxes—plant |
| d. Engineering labor | m. President's salary        |
| e. Indirect labor    | n. Employee benefits         |

Identify each cost as direct or indirect, assuming that it was incurred in (1) a traditional manufacturing setting and (2) a JIT environment.

**LO 4 Backflush Costing**

**E12A.** Telluride Products Company implemented a JIT work environment in its shovel division eight months ago, and the division has been operating at near capacity since then. At the beginning of May, Work in Process Inventory and Finished Goods Inventory had zero balances. The following transactions took place during the month:

- Ordered, received, and used handles and sheet metal costing \$11,340.
- Direct labor costs incurred, \$5,400.
- Overhead costs incurred, \$8,100.
- Completed shovels costing \$24,800.
- Sold shovels costing \$24,000.

Using backflush costing, calculate the ending balance in the Work in Process Inventory and Finished Goods Inventory accounts.

**LO 4 Backflush Costing**

**E13A.** Morning Enterprises produces clocks. It has a JIT assembly process and uses backflush costing to record production costs. Overhead is assigned at a rate of \$17 per assembly labor hour. There were no beginning inventories in March. During March, the following operating data were generated:

Cost of direct materials purchased and used	\$53,200
Direct labor costs incurred	\$27,300
Overhead costs assigned	?
Assembly hours worked	3,840 hours
Ending work in process inventory	\$1,050
Ending finished goods inventory	\$960

Using T accounts, show the flow of costs through the backflush costing system. What is the total cost of goods sold in March?

**LO 5 Comparison of ABM and Lean Operations**

**E14A.** Identify each of the following as a characteristic of ABM or lean operations:

- a. Backflush costing
- b. ABC used to assign overhead costs to the product cost
- c. ABC integrated with job order or process costing systems
- d. Complexity reduced by using work cells, minimizing inventories, and reducing or eliminating non-value-adding activities
- e. Activities reorganized so that they are performed within work cells

LO 5 **Comparison of ABM and Lean Operations**

**E15A. BUSINESS APPLICATION** ► Excerpts from a conversation between two managers about their companies' management systems follow. Identify the manager who works for a company that emphasizes ABM and the one who works for a company that emphasizes a lean operating system.

- **Manager 1:** We try to manage our resources effectively by monitoring operating activities. We analyze all major operating activities, and we focus on reducing or eliminating the ones that don't add value to our products.
- **Manager 2:** We're very concerned with eliminating waste. We've designed our operations to reduce the time it takes to move, store, queue, and inspect materials. We've also reduced our inventories by buying and using materials only when we need them.

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS**LO 1 **The Value Chain**

- ✓ 1: Total current cost per unit: \$27.60
- ✓ 1: Total projected cost per unit: \$22.25

**P1.** Reigle Electronics is a manufacturer of cell phones, a highly competitive business. Reigle's phones carry a price of \$99, but competition forces the company to offer significant discounts and rebates. As a result, the average price of Reigle's cell phones has dropped to around \$50, and the company is losing money. Management is applying value chain analysis to the company's operations in an effort to reduce costs and improve product quality. A study by the company's management accountant has determined the following per unit costs for primary processes:

Primary Process	Cost per Unit
Research and development	\$ 2.50
Design	3.50
Supply	4.50
Production	6.70
Marketing	8.00
Distribution	1.90
Customer service	0.50
Total cost	<u>\$27.60</u>

To generate a gross margin large enough for the company to cover its overhead costs and earn a profit, Reigle must lower its total cost per unit for primary processes to no more than \$20. After analyzing operations, management reached the following conclusions about primary processes:

- Research and development and design are critical functions because the market and competition require constant development of new features with "cool" designs at lower cost. Nevertheless, management feels that the cost per unit of these processes must be reduced by 10 percent.
- Six different suppliers currently provide the components for the cell phones. Ordering these components from just two suppliers and negotiating lower prices could result in a savings of 15 percent.
- The cell phones are currently manufactured in Mexico. By shifting production to China, the unit cost of production can be lowered by 20 percent.
- Most cell phones are sold through wireless communication companies that are trying to attract new customers with low-priced cell phones. Management believes that



these companies should bear more of the marketing costs and that it is feasible to renegotiate its marketing arrangements with them so that they will bear 35 percent of the current marketing costs.

- Distribution costs are already very low, but management will set a target of reducing the cost per unit by 10 percent.
- Customer service is a weakness of the company and has resulted in lost sales. Management therefore proposes increasing the cost per unit of customer service by 50 percent.

#### REQUIRED

1. Prepare a table showing the current cost per unit of primary processes and the projected cost per unit based on management's proposals for cost reduction. (Round to the nearest cent.)
2. **ACCOUNTING CONNECTION** ► Will management's proposals for cost reduction achieve the targeted total cost per unit? What further steps should management take to reduce costs? Which steps that management is proposing do you believe will be the most difficult to accomplish?
3. **ACCOUNTING CONNECTION** ► What are the company's support services? What role should these services play in the value chain analysis?

#### LO 2

### Activity-Based Costing

#### SPREADSHEET

- ✓ 1: Product unit cost: \$90.00
- ✓ 4: Activity cost per unit: \$21.47
- ✓ 4: Product unit cost: \$93.49

**P2.** Printware Products Inc. produces printers for wholesale distributors. It has just completed packaging an order from Hawes Company for 450 printers. Before the order is shipped, the controller wants to compare the unit costs computed under the company's new activity-based costing system with the unit costs computed under its traditional costing system. Printware's traditional costing system assigned overhead costs at a rate of 240 percent of direct labor cost.

Data for the Hawes order are as follows: direct materials, \$17,552; purchased parts, \$14,856; direct labor hours, 140; and average direct labor pay rate per hour, \$17.

Data for activity-based costing related to processing direct materials and purchased parts for the Hawes order follow.

Activity	Cost Driver	Activity Cost Rate	Activity Usage
Engineering systems design	Engineering hours	\$28 per engineering hour	18 engineering hours
Setup	Number of setups	\$36 per setup	12 setups
Parts production	Machine hours	\$37 per machine hour	82 machine hours
Product assembly	Assembly hours	\$42 per assembly hour	96 assembly hours
Packaging	Number of packages	\$5.60 per package	150 packages
Building occupancy	Machine hours	\$10 per machine hour	82 machine hours

#### REQUIRED

1. Use the traditional costing approach to compute the total cost and the product unit cost of the Hawes order.
2. Using the cost hierarchy, identify each activity as unit level, batch level, product level, or facility level.
3. Prepare a bill of activities for the activity costs.
4. Use ABC to compute the total cost and product unit cost of the Hawes order. (Round your answer to the nearest cent.)
5. **ACCOUNTING CONNECTION** ► What is the difference between the product unit cost you computed using the traditional approach and the one you computed using ABC? Does the use of ABC guarantee cost reduction for every order?

#### LO 2

### Activity Cost Rates

#### SPREADSHEET

- ✓ 3: Product unit cost: \$8.67

**P3.** Tailgator Company produces four versions of its model J7-21 bicycle seat. The four versions have different shapes, but their processing operations and production costs are identical. During July, the following costs were incurred:

(Continued)

Direct materials:	
Leather	\$25,430
Metal frame	39,180
Bolts	3,010
Materials handling:	
Labor	8,232
Equipment depreciation	4,410
Electrical power	2,460
Maintenance	5,184
Assembly:	
Direct labor	13,230
Engineering design:	
Labor	4,116
Electrical power	1,176
Engineering overhead	7,644
Overhead:	
Equipment depreciation	7,056
Indirect labor	30,870
Supervision	17,640
Operating supplies	4,410
Electrical power	10,584
Repairs and maintenance	21,168
Building occupancy overhead	52,920

July's output totaled 29,400 units. Each unit requires three machine hours of effort. Materials handling costs are allocated to the products based on direct materials cost, engineering design costs are allocated based on units produced, and overhead is allocated based on machine hours. Assembly costs are allocated based on direct labor hours, which are estimated at 882 for July.

During July, Tailgator completed 520 bicycle seats for Job 14. The activity usage for Job 14 was as follows: direct materials, \$1,150; direct labor hours, 15.

#### REQUIRED

1. Compute the following activity cost rates: (a) materials handling cost rate, (b) assembly cost rate, (c) engineering design cost rate, and (d) overhead rate.
2. Prepare a bill of activities for Job 14.
3. Use activity-based costing to compute the job's total cost and product unit cost. (Round activity costs to the nearest dollar, and round unit costs to the nearest cent.)

#### LO 3 Direct and Indirect Costs in Lean and Traditional Manufacturing Environments

✓ 3: Direct cost per unit: \$12

**P4.** Zunz Company, a producer of wooden toys, is about to adopt a lean operating environment. In anticipation of the change, Zunz's controller prepared the following list of costs for December:

Wood	\$1,200	Insurance—plant	\$ 324
Bolts	32	President's salary	4,000
Small tools	54	Engineering labor	2,700
Depreciation—plant	450	Utilities	1,250
Depreciation—machinery	275	Building occupancy	1,740
Direct labor	2,675	Supervision	2,686
Indirect labor	890	Operating supplies	254
Purchased parts	58	Repairs and maintenance	198
Materials handling	74	Employee benefits	2,654

**REQUIRED**

1. Identify each cost as direct or indirect, assuming that it was incurred in a traditional manufacturing setting.
2. Identify each cost as direct or indirect, assuming that it was incurred in a lean operating environment.
3. Assume that the costs incurred in the lean operating environment are for a work cell that completed 1,250 toy cars in December. Compute the total direct cost and the direct cost per unit for the cars produced.

**LO 4**

✓ 3: Total cost of goods sold:  
\$564,400

**Backflush Costing**

**P5.** Auto Parts Company produces 12 parts for car bodies and sells them to four automobile assembly companies in Canada. The company implemented lean operating and costing procedures three years ago. Overhead is applied at a rate of \$26 per work cell hour used. All direct materials and purchased parts are used as they are received.

One of the company's work cells produces automotive fenders that are completely detailed and ready to install when received by the customer. The cell is operated by four employees and involves a flexible manufacturing system with 14 workstations. Operating details for February for this cell follow.

Beginning work in process inventory	—
Beginning finished goods inventory	\$420
Cost of direct materials purchased on account and used	\$213,400
Cost of parts purchased on account and used	\$111,250
Direct labor costs incurred	\$26,450
Overhead costs assigned	?
Work cell hours used	8,260
Costs of goods completed during February	\$564,650
Ending work in process inventory	\$1,210
Ending finished goods inventory	\$670

**REQUIRED**

1. Using T accounts, show the cost flows through a backflush costing system.
2. Using T accounts, show the cost flows through a traditional costing system.
3. What is the total cost of goods sold for the month?

**ALTERNATE PROBLEMS****LO 1**

Support Services:  
✓ 1: Total current cost per unit: \$8.00  
✓ 1: Total projected cost per unit: \$6.40

**The Value Chain**

**P6.** Comfy Spot is a manufacturer of futon mattresses. Comfy Spot's mattresses are priced at \$60, but competition forces the company to offer significant discounts and rebates. As a result, the average price of the futon mattress has dropped to around \$50, and the company is losing money. Management is applying value chain analysis to the company's operations in an effort to reduce costs and improve product quality. A study by the company's management accountant has determined the following per unit costs for primary processes and support services:

*(Continued)*

	<b>Cost per Unit</b>
Primary processes:	
Research and development	\$ 5.00
Design	3.00
Supply	4.00
Production	16.00
Marketing	6.00
Distribution	7.00
Customer service	1.00
Total cost per unit	<u>\$42.00</u>
Support services:	
Human resources	\$ 2.00
Information services	5.00
Management accounting	1.00
Total cost per unit	<u>\$ 8.00</u>

To generate a gross margin large enough for the company to cover its overhead costs and earn a profit, Comfy Spot must lower its total cost per unit for primary processes to no more than \$32.00 and its support services to no more than \$5.00. After analyzing operations, management reached the following conclusions about primary processes and support services:

- Research and development and design are critical functions because the market and competition require constant development of new features with “cool” designs at lower cost. Nevertheless, management feels that the cost per unit of these processes must be reduced by 20 percent.
- Ten different suppliers currently provide the components for the futons. Ordering these components from just two suppliers and negotiating lower prices could result in a savings of 15 percent.
- The futons are currently manufactured in Mali. By shifting production to China, the unit cost of production can be lowered by 40 percent.
- Management believes that by selling to large retailers like Wal-Mart, it is feasible to lower current marketing costs by 25 percent.
- Distribution costs are already very low, but management will set a target of reducing the cost per unit by 10 percent.
- Customer service and support to large customers are key to keeping their business. Management therefore proposes increasing the cost per unit of customer service by 20 percent.
- By outsourcing its support services, management projects a 20 percent drop in these costs.

#### REQUIRED

1. Prepare a table showing the current cost per unit of primary processes and support services and the projected cost per unit based on management’s proposals.
2. **ACCOUNTING CONNECTION** ► Will management’s proposals achieve the targeted total cost per unit? What further steps should management take to reduce costs?
3. **ACCOUNTING CONNECTION** ► What role should the company’s support services play in the value chain analysis?

#### LO 2

#### Activity-Based Costing

- ✓ 1: Product unit cost traditional: \$7.03
- ✓ 4: Activity cost per unit: \$1.11
- ✓ 4: Product unit cost: \$6.91

**P7.** Kall Company produces cellular phones. It has just completed an order for 10,000 phones placed by Connect, Ltd. Kall recently shifted to an activity-based costing system, and its controller is interested in the impact that the ABC system had on the Connect order. Data for that order are as follows: direct materials, \$36,950; purchased parts, \$21,100; direct labor hours, 220; and average direct labor pay rate per hour, \$15.

Under Kall's traditional costing system, overhead costs were assigned at a rate of 270 percent of direct labor cost.

Data for activity-based costing for the Connect order follow.

Activity	Cost Driver	Activity Cost Rate	Activity Usage
Electrical engineering design	Engineering hours	\$19 per engineering hour	32 engineering hours
Setup	Number of setups	\$29 per setup	11 setups
Parts production	Machine hours	\$26 per machine hour	134 machine hours
Product testing	Number of tests	\$32 per test	52 tests
Packaging	Number of packages	\$0.0374 per package	10,000 packages
Building occupancy	Machine hours	\$9.80 per machine hour	134 machine hours
Assembly	Direct labor hours	\$15 per direct labor hour	220 direct labor hours

### REQUIRED

1. Use the traditional costing approach to compute the total cost and the product unit cost of the Connect order. (Round unit costs to the nearest cent.)
2. Using the cost hierarchy, identify each activity as unit level, batch level, product level, or facility level.
3. Prepare a bill of activities for the activity costs.
4. Use ABC to compute the total cost and product unit cost of the Connect order. (Round activity costs to the nearest dollar, and round unit costs to the nearest cent.)
5. **ACCOUNTING CONNECTION** ► What is the difference between the product unit cost you computed using the traditional approach and the one you computed using ABC? Does the use of ABC guarantee cost reduction for every order?

### LO 2

#### SPREADSHEET

✓ 3: Product unit cost: \$10.43

### Activity Cost Rates

**P8.** Nifty Company produces three models of aluminum skateboards. The models have minor differences, but their processing operations and production costs are identical. During June, the following costs were incurred:

Direct materials:	
Aluminum frame	\$162,524
Bolts	3,876
Purchased parts:	
Wheels	74,934
Decals	5,066
Materials handling ( <i>assigned based on direct materials cost</i> ):	
Labor	17,068
Utilities	4,438
Maintenance	914
Depreciation	876
Assembly line ( <i>assigned based on labor hours</i> ):	
Labor	46,080
Setup ( <i>assigned based on number of setups</i> ):	
Labor	6,385
Supplies	762
Overhead	3,953
Product testing ( <i>assigned based on number of tests</i> ):	
Labor	2,765
Supplies	435
Building occupancy ( <i>assigned based on machine hours</i> ):	
Insurance	5,767
Depreciation	2,452
Repairs and maintenance	3,781

(Continued)

For June, output totaled 32,000 skateboards. Each board required 1.5 machine hours of effort. During June, Nifty's assembly line worked 2,304 hours, performed 370 setups and 64,000 product tests, and completed an order for 1,000 skateboards placed by Wow Toys Company. The job incurred costs of \$5,200 for direct materials and \$2,500 for purchased parts. It required 3 setups, 2,000 tests, and 72 assembly line hours.

**REQUIRED**

1. Compute the following activity cost rates: (a) materials handling cost rate, (b) assembly line cost rate, (c) setup cost rate, (d) product testing cost rate, and (e) building occupancy cost rate.
2. Prepare a bill of activities for the Wow Toys job.
3. Use activity-based costing to compute the job's total cost and product unit cost. (Round unit costs to the nearest cent.)

**LO 3**

✓ 3: Direct cost per unit: \$2.19

**Direct and Indirect Costs in JIT and Traditional Manufacturing Environments**

**P9.** Peralto Company, which processes coffee beans into ground coffee, is about to adopt a JIT operating environment. In anticipation of the change, Peralto's controller prepared the following list of costs for the month:

Coffee beans	\$5,000	Insurance—plant	\$ 300
Bags	100	President's salary	4,000
Small tools	80	Engineering labor	1,700
Depreciation—plant	400	Utilities	1,250
Depreciation—grinder	200	Building occupancy	1,940
Direct labor	1,000	Supervision	400
Indirect labor	300	Operating supplies	205
Labels	20	Repairs and maintenance	120
Materials handling	75	Employee benefits	500

**REQUIRED**

1. Identify each cost as direct or indirect, assuming that it was incurred in a traditional manufacturing setting.
2. Identify each cost as direct or indirect, assuming that it was incurred in a just-in-time (JIT) environment.
3. Assume that the costs incurred in the JIT environment are for a work cell that completed 5,000 1-pound bags of coffee during the month. Compute the total direct cost and the direct cost per unit for the bags produced. (Carry unit cost to two decimal places.)

**LO 4**

✓ 3: Total cost of goods sold: \$391,520

**Backflush Costing**

**P10.** Elly Corporation produces metal fasteners using six work cells, one for each of its product lines. It implemented JIT operations and costing methods two years ago. Overhead is assigned using a rate of \$14 per machine hour for the Snap Work Cell. There were no beginning inventories on April 1. All direct materials and purchased parts are used as they are received. Operating details for April for the Snap Work Cell follow.

Cost of direct materials purchased on account and used	\$104,500
Cost of parts purchased on account and used	\$78,900
Direct labor costs incurred	\$39,000
Overhead costs assigned	?
Machine hours used	12,220
Costs of goods completed during April	\$392,540
Ending work in process inventory	\$940
Ending finished goods inventory	\$1,020

**REQUIRED**

1. Using T accounts, show the flow of costs through a backflush costing system.
2. Using T accounts, show the flow of costs through a traditional costing system.
3. What is the total cost of goods sold for April using a traditional costing system?

**CASES****LO 2, 5 Group Activity: ABM and ABC in a Service Business**

**C1.** MUF, a Chartered Accounting firm, has provided audit and tax services to businesses in the London area for over 50 years. Recently, the firm decided to use ABM and activity-based costing to assign its overhead costs to those service functions. Ginny Fior is interested in seeing how the change from the traditional to the activity-based costing approach affects the average cost per audit job. The following information has been provided to assist in the comparison:

Total direct labor costs	£400,000
Other direct costs	<u>120,000</u>
Total direct costs	<u>£520,000</u>

The traditional costing approach assigned overhead costs at a rate of 120 percent of direct labor costs.

Data for activity-based costing of the audit function follow.

Activity	Cost Driver	Activity Cost Rate	Activity Usage
Professional development	Number of employees	£2,000 per employee	50 employees
Administration	Number of jobs	£1,000 per job	50 jobs
Client development	Number of new clients	£5,000 per new client	29 new clients

Your instructor will divide the class into groups to work through the case. One student from each group should present the group's findings to the class.

1. Using traditional costing and direct labor cost as the cost driver, calculate the total costs for the audit function. What is the average cost per job?
2. Using activity-based costing to assign overhead, calculate the total costs for the audit function. What is the average cost per job?
3. Calculate the difference in total costs between the two approaches. Why would activity-based costing be the better approach for assigning overhead to the audit function?

**LO 2, 5 Interpreting Management Reports: ABC and Selling and Administrative Expenses**

**C2.** Star Kleymeyer, owner of Star Bakery, wants to know the profitability of each of her bakery's customer groups. She is especially interested in the State Institutions customer group, which is one of the company's largest. Currently, the bakery is selling doughnuts and snack foods to ten state institutions in three states. The controller has prepared the following income statement for the State Institutions customer group:

**Star Bakery**  
**Income Statement for State Institutions Customer Group**  
**For the Year Ended December 31**

Sales (\$5 per case × 50,000 cases)	\$250,000
Cost of goods sold (\$3.50 per case × 50,000 cases)	<u>175,000</u>
Gross margin	\$ 75,000
Less: Selling and administrative activity costs (see schedule below)	<u>94,750</u>
Operating income (loss) contributed by State Institutions customer group	<u>\$ (19,750)</u>

*(Continued)*



## Schedule of Selling and Administrative Activity Costs

Activity	Activity Cost Rate	Actual Cost Driver Level	Activity Cost
Make sales calls	\$60 per sales call	60 sales calls	\$ 3,600
Prepare sales orders	\$10 per sales order	900 sales orders	9,000
Handle inquiries	\$5 per minute	1,000 minutes	5,000
Ship products	\$1 per case sold	50,000 cases	50,000
Process invoices	\$20 per invoice	950 invoices	19,000
Process credits	\$20 per notice	40 notices	800
Process billings and collections	\$7 per billing	1,050 billings	7,350
Total selling and administrative activity costs			<u>\$94,750</u>

The controller has also provided budget information about selling and administrative activities for the State Institutions customer group. For this year, the planned activity cost rates and the annual cost driver levels for each selling and administrative activity are as follows:

Activity	Planned Activity Cost Rate	Planned Annual Cost Driver Level
Make sales calls	\$60 per sales call	59 sales calls
Prepare sales orders	\$10 per sales order	850 sales orders
Handle inquiries	\$5.10 per minute	1,000 minutes
Ship products	\$0.60 per case sold	50,000 cases
Process invoices	\$1 per invoice	500 invoices
Process credits	\$10 per notice	5 notices
Process billings and collections	\$4 per billing	600 billings

You have been called in as a consultant on the State Institutions customer group.

1. Calculate the planned activity cost for each activity.
2. Calculate the differences between the planned activity cost and the State Institutions customer group's activity costs for this year.
3. From your evaluation of the differences calculated in 2 and your review of the income statement, identify the non-value-adding activities and state which selling and administrative activities should be examined.
4. What actions might the company take to reduce the costs of non-value-adding selling and administrative activities?

LO 2, 5

SPREADSHEET

### Decision Analysis: ABC in Planning and Control

**C3.** Refer to the income statement in C2 for the State Institutions customer group for the year ended December 31, this year. Star Kleymeyer, owner of Star Bakery, is in the process of budgeting income for next year. She has asked the controller to prepare a budgeted income statement for the State Institutions customer group. She estimates that the selling price per case, the number of cases sold, the cost of goods sold per case, and the activity costs for making sales calls, preparing sales orders, and handling inquiries will remain the same for next year. She has contracted with a new freight company to ship the 50,000 cases at \$0.60 per case sold. She has also analyzed the procedures for invoicing, processing credits, billing, and collecting and has decided that it would be less expensive for a customer service agency to do the work. The agency will charge the bakery 1.5 percent of the total sales revenue.

1. Prepare a budgeted income statement for the State Institutions customer group for next year; the year ends December 31.

2. Refer to the information in **C2**. Assuming that the planned activity cost rate and planned annual cost driver level for each selling and administrative activity remain the same next year, calculate the planned activity cost for each activity.
3. Calculate the differences between the planned activity costs (determined in **2**) and the State Institutions customer group's budgeted activity costs for next year (determined in **1**).
4. Evaluate the results of changing freight companies and outsourcing the customer service activities.

**LO 3, 5 Conceptual Understanding: Lean Operations in a Service Business**

**C4.** At an initiation banquet for new members of your business club, you are talking with two college students who are majoring in marketing. In discussing the accounting course they are taking, they mention that they are having difficulty understanding lean operations. They have read that the elements of a company's operating system support the concepts of simplicity, continuous improvement, waste reduction, timeliness, and efficiency. They realize that to understand lean thinking in a complex manufacturing environment, they must first understand lean operations in a simpler service context. They ask you to explain the lean operating philosophy and provide an example.

Briefly explain lean operations. Apply the elements of a JIT operating system to the restaurant where the banquet is being held. Do you believe a lean operating philosophy applies in all restaurant operations? Explain your answer.

**LO 3, 5 Conceptual Understanding: Activities, Cost Drivers, and JIT**

**C5.** Fifteen years ago, Bryce Stabele, together with several financial supporters, founded SA Corporation. Located in Atlanta, the company originally manufactured roller skates, but 12 years ago, on the advice of its marketing department, it switched to making skateboards. More than 4 million skateboards later, SA Corporation finds itself an industry leader in both volume and quality. To retain market share, it has decided to automate its manufacturing process. It has ordered flexible manufacturing systems for wheel assembly and board shaping. Manual operations will be retained for board decorating because some hand painting is involved. All operations will be converted to a JIT environment.

Bryce wants to know how the JIT approach will affect the company's product costing practices and has called you in as a consultant.

1. Summarize the elements of a JIT environment.
2. How will the automated systems change product costing?
3. What are some cost drivers that the company should employ? In what situations should it employ them?

**Continuing Case: Cookie Company**

**C6.** As we continue with this case, assume that your company has been using a continuous manufacturing process to make chocolate chip cookies. Demand has been so great that the company has built a special plant that makes only custom-ordered cookies. The cookies are shaped by machines but vary according to the customer's specific instructions. Ten basic sizes of cookies are produced and then customized. Slight variations in machine setup produce the different sizes.

In the past six months, several problems have developed. Even though a computer-controlled machine is used in the manufacturing process, the company's backlog is growing rapidly, and customers are complaining that delivery is too slow. Quality is declining because cookies are being pushed through production without proper inspection. Working capital is tied up in excessive amounts of inventory and storage space. Workers are complaining about the pressure to produce the backlogged orders. Machine breakdowns are increasing. Production control reports are not useful because they are not timely and contain irrelevant information. The company's profitability and cash flow are suffering.

*(Continued)*

Assume that you have been appointed CEO and that the company has asked you to analyze its problems. The board of directors asks that you complete your preliminary analysis quickly so that you can present it to the board at its midyear meeting.

1. In memo form, prepare a preliminary report recommending specific changes in the manufacturing processes.
2. In preparing the report, answer the following questions:
  - a. Why are you preparing the report? What is its purpose?
  - b. Who is the audience for this report?
  - c. What kinds of information do you need to prepare the report, and where will you find it (i.e., what sources will you use)?
  - d. When do you need to obtain the information?

# CHAPTER 21

## Cost-Volume-Profit Analysis

### BUSINESS INSIGHT

#### My Media Place

My Media Place designs and sets up websites for small businesses and individuals. It also sells related networking products. Although relatively new, the company is now thinking about expanding the range of products and services that it offers. In deciding whether to expand the company's offerings, My Media Place's managers have to evaluate the mix of products and services that would appeal to customers and that would allow the company to optimize its resources, cash, and profits. In this chapter, we describe how managers in any company make such an evaluation.

- 1. CONCEPT** ▶ *Why is cost-volume-profit analysis useful for the purposes of comparability and understandability?*
- 2. ACCOUNTING APPLICATION** ▶ *How will My Media Place's managers decide which products and services to offer?*
- 3. BUSINESS APPLICATION** ▶ *How can managers use cost behavior analysis to improve business performance?*

### LEARNING OBJECTIVES

- LO 1** Define *cost behavior*, and identify variable, fixed, and mixed costs.
- LO 2** Separate mixed costs into their variable and fixed components, and prepare a contribution margin income statement.
- LO 3** Perform cost-volume-profit (CVP) analysis.
- LO 4** Define *breakeven point*, and use contribution margin to determine a company's breakeven point for multiple products.
- LO 5** Discuss how managers use CVP analysis in the management process and how they can project the profitability of products and services.

## SECTION 1

## CONCEPTS

## CONCEPTS

- Comparability
- Understandability

RELEVANT  
LEARNING OBJECTIVE

- LO 1** Define *cost behavior*, and identify variable, fixed, and mixed costs.

**LO 1** Concepts Underlying Cost Behavior

**Cost behavior**—the way costs respond to changes in volume or activity—is a factor in almost every decision managers make. Two underlying accounting concepts support the usefulness of cost-volume-profit analysis in decision making: *understandability* and *comparability*. Knowing how costs will behave improves manager comprehension of the meaning of the information they receive, enhancing their *understanding* of it. Knowledge of cost behavior patterns enables managers to identify cost similarities and differences so *comparisons* of alternatives are possible. Thus, when evaluating operations, managers compare how changes in cost and sales affect the profitability of product lines, sales territories, customers, departments, and other segments. Service businesses like **Flickr**, **Facebook**, and **Google** find that understanding cost behavior is useful when planning the optimal mix of services to offer. For example, Google's managers analyze cost behavior of new features for products like Gmail in their online Google Labs and gather user data and feedback before officially deciding to add a new feature.

During the year, managers collect cost behavior data and use it in decision making. Managers must understand and anticipate cost behavior to determine the impact of their actions on operating income and resource optimization. For example, Google's managers must compare the changes in income that can result from buying new, more productive servers or launching an online advertising product like AdWords or AdSense.

Although our focus in this chapter is on cost behavior as it relates to products and services, it is also important to understand the cost behaviors of selling, administrative, and general activities, such as how increasing the number of shipments affects shipping costs, how the number of units sold or total sales revenue affects the cost of sales commissions, and how the number of customers billed affects total billing costs. If managers can predict how costs behave, and whether they are product- or service-related or are for selling, administrative, or general activities, then costs become manageable.

**Cost Behavior**

Some costs vary with volume or operating activity (variable costs). Others remain fixed as volume changes (fixed costs). Between those two extremes are costs that exhibit characteristics of each type (mixed costs). Exhibit 1 shows examples of each type of cost for different industries.

**Variable Costs** Total costs that change in direct proportion to changes in productive output (or any other measure of volume) are called **variable costs**. They are referred to as unit-level activities, since the cost is incurred each time a unit is produced or a service is delivered. For example, direct materials, direct labor, operating supplies, and gasoline are variable costs.

Total variable costs go up or down as volume increases or decreases, but the cost per unit remains unchanged. For example, as shown in Exhibit 2, for My Media Place, there is a linear relationship between direct labor (webpage designers) and units produced (completed webpages). Each webpage, or unit of output, requires \$2.50 of labor cost. Total labor costs grow in direct proportion to the increase in units of output. For two units, total labor costs are \$5.00; for six units, the organization incurs \$15.00 in labor costs.

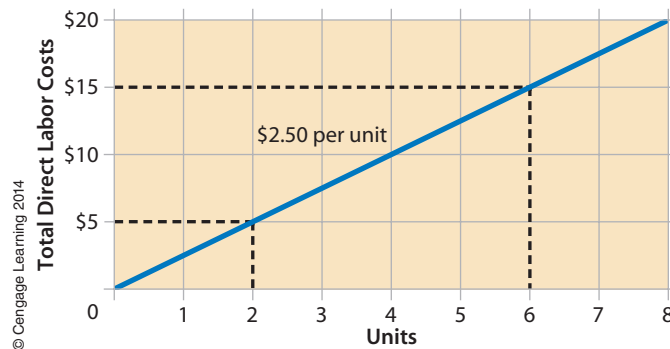


**Exhibit 1**  
Examples of Variable, Fixed, and Mixed Costs

Costs	Manufacturing Company— Tire Manufacturer	Merchandising Company— Department Store	Service Company— Bank
Variable	<ul style="list-style-type: none"> <li>• Direct materials</li> <li>• Direct labor (hourly)</li> <li>• Indirect labor (hourly)</li> <li>• Operating supplies</li> <li>• Small tools</li> </ul>	<ul style="list-style-type: none"> <li>• Merchandise to sell</li> <li>• Sales commissions</li> <li>• Shelf stockers (hourly)</li> </ul>	<ul style="list-style-type: none"> <li>• Computer equipment leasing (Based on usage)</li> <li>• Computer operators (hourly)</li> <li>• Operating supplies</li> <li>• Data storage disks</li> </ul>
Fixed	<ul style="list-style-type: none"> <li>• Depreciation, machinery and building (straight-line)</li> <li>• Insurance premiums</li> <li>• Labor (salaried)</li> <li>• Supervisory salaries</li> <li>• Property taxes (on machinery and building)</li> </ul>	<ul style="list-style-type: none"> <li>• Depreciation, equipment and building (straight-line)</li> <li>• Insurance premiums</li> <li>• Buyers (salaried)</li> <li>• Supervisory salaries</li> <li>• Property taxes (on equipment and building)</li> </ul>	<ul style="list-style-type: none"> <li>• Depreciation, furniture and fixtures (straight-line)</li> <li>• Insurance premiums</li> <li>• Salaries:                             <ul style="list-style-type: none"> <li>• Programmers</li> <li>• Systems designers</li> <li>• Bank administrators</li> </ul> </li> <li>• Rent, buildings</li> </ul>
Mixed	<ul style="list-style-type: none"> <li>• Electrical power</li> <li>• Telephone</li> <li>• Heat</li> </ul>	<ul style="list-style-type: none"> <li>• Electrical power</li> <li>• Telephone</li> <li>• Heat</li> </ul>	<ul style="list-style-type: none"> <li>• Electrical power</li> <li>• Telephone</li> <li>• Heat</li> </ul>

© Cengage Learning 2014

**Exhibit 2**  
A Common Variable Cost Behavior Pattern: A Linear Relationship



© Cengage Learning 2014

Variable cost can be computed using the following **variable cost formula**:

$$\text{Total Variable Cost} = \text{Variable Rate} \times \text{Units Produced}$$

The cost formula for direct labor for My Media Place is computed as follows.

$$\text{Total Direct Labor Costs} = \$2.50 \times \text{Units Produced}$$

**STUDY NOTE:** Variable costs change in direct proportion to changes in activity; that is, they increase in total with an increase in volume and decrease in total with a decrease in volume, but they remain the same on a per unit basis.

Because variable costs increase or decrease in direct proportion to volume or output, it is important to know an organization's operating capacity. **Operating capacity** is the upper limit of an organization's productive output capability, given its existing resources. It describes what an organization can accomplish in a given period. In our discussions, we assume that operating capacity is constant and that all activity occurs within the limits of current operating capacity.

There are three common measures, or types, of operating capacity:

- **Theoretical capacity** (or *ideal capacity*) is the maximum productive output for a given period in which all machinery and equipment are operating at optimum speed, without interruption. No company ever actually operates at such an ideal level.
- **Practical capacity** (or *engineering capacity*) is theoretical capacity reduced by normal and expected work stoppages, such as machine breakdowns; downtime for retooling, repairs, and maintenance; and employee breaks. Practical capacity is used primarily as a planning goal of what could be produced if all went well; but no company ever actually operates at such a level.
- **Normal capacity** is the average annual level of operating capacity needed to meet expected sales demand. Normal capacity is the realistic measure of what an organization is *likely* to produce, not what it *can* produce. Thus, each variable cost should be related to an appropriate measure of normal capacity. For example, operating costs can be related to machine hours used or total units produced, and sales commissions usually vary in direct proportion to total sales dollars.

The basis for measuring the activity of variable costs should be carefully selected for two reasons:

- An appropriate activity base simplifies cost planning and control.
- Managers must combine (aggregate) many variable costs with the same activity base so that the costs can be analyzed in a reasonable way. Such aggregation also provides information that allows managers to predict future costs.

An **activity base** (or *denominator activity* or *cost driver*) is the activity for which relationships are established. The basic relationships should not change greatly if activity fluctuates around the level of denominator activity. The general guide for selecting an activity base is to relate costs to their most logical or causal factor. For example, direct material and direct labor costs should be considered variable in relation to the number of units produced.

**Fixed Costs** **Fixed costs**, referred to as facility-level activities, are total costs that remain constant within a relevant range of volume or activity. **Relevant range** is the span of activity in which a company expects to operate. Within the relevant range, it is assumed that both total fixed costs and per unit variable costs are constant.

According to economic theory, all costs tend to be variable in the long run; thus, as the examples in Exhibit 1 suggest, a cost is fixed only within a limited period. A change in plant capacity, labor needs, or other production factors causes fixed costs to increase or decrease. Management usually considers a one-year period when planning and controlling costs; thus fixed costs are expected to be constant within that period.

Fixed cost behavior is expressed mathematically in the **fixed cost formula** as follows.

$$\text{Total Fixed Cost} = \text{Fixed Cost in Relevant Range}$$

Of course, fixed costs change when activity exceeds the relevant range. These costs are called *step costs* or *step-variable*, *step-fixed*, or *semifixed costs*. A **step cost** remains constant in a relevant range of activity and increases or decreases in a step-like manner when activity is outside the relevant range.

For example, assume that one Customer Support Team at My Media Place has the capacity to handle up to 500,000 customer incidents per 8-hour shift. The relevant range, then, is from 0 to 500,000 units. Unfortunately, volume has increased to more than 500,000 incidents per 8-hour shift, taxing current equipment capacity and the quality of customer care. My Media Place must add another Customer Support Team to handle the additional volume. Exhibit 3 shows this behavior pattern. The fixed costs for the first 500,000 units of production are \$4,000. Thus, the fixed cost formula for up to 500,000 units is:

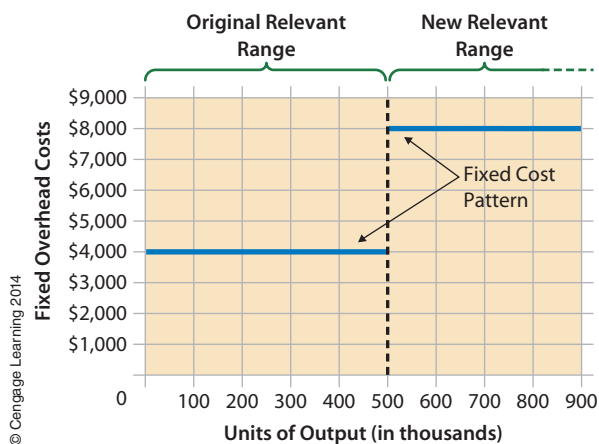
$$\text{Total Fixed Cost} = \$4,000$$

But if output goes above 500,000 units, another team must be added, pushing this fixed cost to \$8,000.

**STUDY NOTE:** Because fixed costs are expected to hold relatively constant over the entire relevant range of activity, they can be described as the costs of providing capacity.



**Exhibit 3**  
A Common Step-Like Fixed Cost Behavior Pattern



On a per unit basis, fixed costs go down as volume goes up, as long as a firm is operating within the relevant range of activity. Look at how the Customer Support Team cost per unit falls as the volume of activity increases within the relevant range:

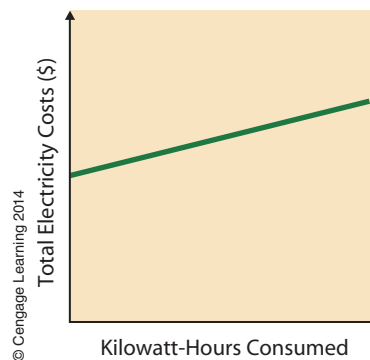
<b>Volume of Activity</b>	<b>Support Team Cost per Unit</b>
100,000 units	$\$4,000 \div 100,000 = \$0.0400$
300,000 units	$\$4,000 \div 300,000 = \$0.0133^*$
500,000 units	$\$4,000 \div 500,000 = \$0.0080$
600,000 units	$\$8,000 \div 600,000 = \$0.0133^*$

\*Rounded

At 600,000 units, the activity level is above the relevant range, which means another team must be added. Thus, the per unit cost changes to \$0.0133.

**Mixed Costs** Mixed costs have both variable and fixed cost components. Part of a mixed cost changes with volume or usage, and part is fixed over a particular period. Electric, telephone, and heating costs are examples of mixed costs. Exhibit 4 depicts My Media Place’s total electricity costs. Electric costs include charges per kilowatt-hour used plus a basic monthly service charge. The kilowatt-hour charges are variable because they depend on the amount of use; the monthly service charge is a fixed cost. Notice that the cost line does not start at \$0 (compare to Exhibit 2). The cost line starts at the Y axis at the amount of fixed cost, and the variable cost rate determines the slope of the line from that point as kilowatt-hours are consumed.

**Exhibit 4**  
Behavior Patterns of Mixed Costs



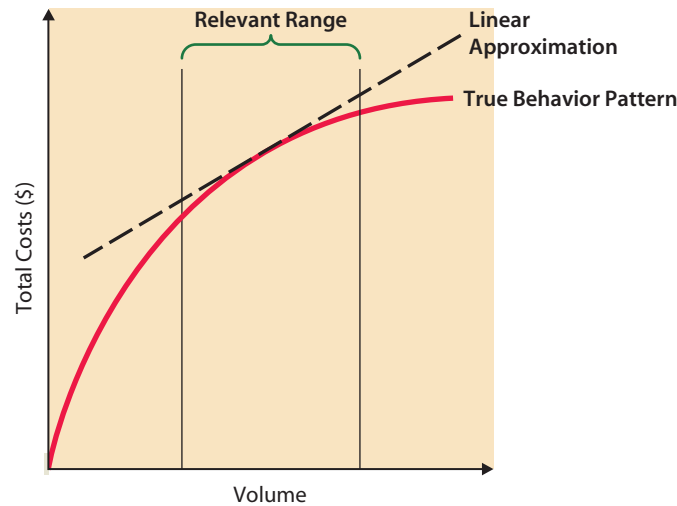
Mixed cost behavior is expressed mathematically in the **mixed cost formula** as follows.

$$\text{Total Mixed Cost} = (\text{Variable Rate} \times \text{Units Produced}) + \text{Fixed Cost}$$

**STUDY NOTE:** Nonlinear costs can be roughly estimated by treating them as if they were linear (variable) costs within set limits of volume.

Many mixed costs vary with operating activity in a nonlinear fashion. To simplify cost analysis procedures and make mixed costs easier to use, managers and accountants use *linear approximation* to convert nonlinear costs into linear ones. This method relies on the concept of relevant range. For example, My Media Place can examine the linearity of its monthly electricity costs with machine hours worked (in thousands) by plotting its monthly electric bills for the past year as illustrated in Exhibit 5. Since the data appears linear in the relevant range of the past 12 months then a cost formula can be derived for monthly electricity costs using one of the methods explained in Section 2 of this chapter. Those estimated costs can then be treated as part of the other variable and fixed costs.

**Exhibit 5**  
Relevant Range and  
Linear Approximation



© Cengage Learning 2014

A linear approximation of a nonlinear cost is not a precise measure, but it allows the inclusion of nonlinear costs in cost behavior analysis, and the loss of accuracy is usually not significant. The goal is to help management estimate and control costs and to prepare budgets.

## APPLY IT!

Indicate whether each of the following costs is usually variable (V) or fixed (F):

1. Operating supplies
2. Real estate taxes
3. Gasoline for a delivery truck
4. Property insurance
5. Depreciation expense of computers (calculated with the straight-line method)
6. Depreciation expense of machinery (calculated with the units-of-production method)

### SOLUTION

1. V; 2. F; 3. V; 4. F; 5. F; 6. V

**TRY IT! SE1, SE2, E1A, E2A, E1B, E2B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Separate mixed costs into their variable and fixed components using the high-low method
- Separate mixed costs into their variable and fixed components using the scatter diagram method
- Prepare a contribution margin income statement
- Compute the breakeven point in sales units and sales dollars
- Compute the breakeven point for multiple products

## RELEVANT LEARNING OBJECTIVES

**LO 2** Separate mixed costs into their variable and fixed components, and prepare a contribution margin income statement.

**LO 3** Perform cost-volume-profit (CVP) analysis.

**LO 4** Define *breakeven point*, and use contribution margin to determine a company's breakeven point for multiple products.

## LO 2 Mixed Costs and the Contribution Margin Income Statement

For cost planning and control purposes, mixed costs must be divided into their variable and fixed components. The separate components can then be grouped with other variable and fixed costs for analysis. Four methods are commonly used to separate mixed cost components. Because the results yielded by each of these methods often differ, managers usually use multiple approaches to find the best possible estimate for a mixed cost.

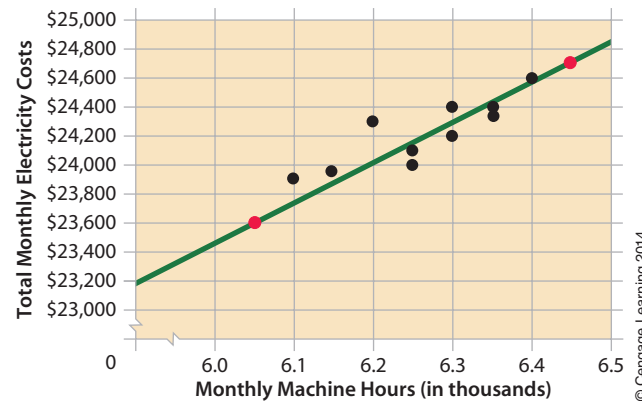
### The Scatter Diagram Method

When there is doubt about the behavior pattern of a particular cost, especially a mixed cost, it helps to plot past costs and related measures of volume in a scatter diagram. A **scatter diagram** is a chart of plotted points that helps determine whether a linear relationship exists between a cost item and its related activity measure. It is a form of linear approximation. If the diagram suggests a linear relationship, a cost line can be imposed on the data by either visual means or statistical analysis. For example, suppose that My Media Place incurred the following machine hours and electricity costs last year:

Month	Machine Hours	Electricity Costs
January	6,250	\$ 24,000
February	6,300	24,200
March	6,350	24,350
April	6,400	24,600
May	6,300	24,400
June	6,200	24,300
July	6,100	23,900
August	6,050	23,600
September	6,150	23,950
October	6,250	24,100
November	6,350	24,400
December	6,450	24,700
Totals	<u>75,150</u>	<u>\$290,500</u>

Exhibit 6 shows a scatter diagram of these data. The diagram suggests a linear relationship between machine hours and the cost of electricity. If we were to add a line to the diagram to represent the linear relationship, the estimated fixed electricity cost would occur at the point at which the line intersects the vertical axis, or \$23,200 of fixed monthly electric costs. The variable cost per machine hour can be estimated by determining the slope of the line, much as is done in Step 1 of the high-low method.

**Exhibit 6**  
Scatter Diagram of Machine Hours and Electricity Costs



© Cengage Learning 2014

**STUDY NOTE:** A scatter diagram shows how closely volume and costs are correlated. A tight, closely associated group of data is better suited to linear approximation than a random or circular pattern.

## The High-Low Method

The **high-low method** is another approach to determining the variable and fixed components of a mixed cost, which is based on the premise that only two data points are necessary to define a linear cost-volume relationship. The disadvantage of this method is that if the high or low data points are not representative of the remaining data set, the estimate of variable and fixed costs may not be accurate. Its advantage is that it can be used when only limited data are available. The example that follows illustrates how to use the high-low method for My Media Place.

**Step 1. Find the variable rate.** To determine the variable rate,

- Select the periods of highest and lowest activity within the accounting period. For My Media Place, the highest-volume machine-hour month was in December (6,450 hours) and the lowest was in August (6,050 hours).
- Find the difference between the highest and lowest amounts for both the machine hours and their related electricity costs.

$$6,450 \text{ hours} - 6,050 \text{ hours} = 400 \text{ hours}$$

$$\$24,700 - \$23,600 = \$1,100$$

- Compute the variable cost per machine hour by dividing the difference in cost by the difference in machine hours.

$$\begin{aligned} \text{Variable Cost per Machine Hour} &= \$1,100 \div 400 \text{ Machine Hours} \\ &= \$2.75 \text{ per Machine Hour} \end{aligned}$$

**Step 2. Find the total fixed costs.** Compute total fixed costs for a month by putting the known variable rate and the information from the month with the highest volume into the cost formula and solve for the total fixed costs.

$$\text{Total Fixed Costs} = \text{Total Costs} - \text{Total Variable Costs}$$

$$\text{Total Fixed Costs for December} = \$24,700.00 - (6,450 \text{ Hours} \times \$2.75) = \$6,962.50$$

You can check your answer by recalculating total fixed costs using the month with the lowest activity.

$$\text{Total Fixed Costs for August} = \$23,600.00 - (6,050 \text{ Hours} \times \$2.75) = \$6,962.50$$

**Step 3. Express the cost formula to estimate the total costs within the relevant range.** For My Media Place, this is computed as follows.

$$\text{Total Mixed Cost} = (\text{Variable Rate} \times \text{Volume Level}) + \text{Fixed Costs}$$

$$\text{Total Electricity Costs per Month} = (\$2.75 \times \text{Machine Hours}) + \$6,962.50$$

Remember that the cost formula will work only within the relevant range. In this example, the formula would work for activity between 6,050 machine hours and 6,450 machine hours. To estimate the electricity costs for machine hours outside the relevant range (in this case, below 6,050 machine hours or above 6,450 machine hours), a new cost formula must be calculated.

## Statistical Methods

Statistical methods, such as **regression analysis**, mathematically describe the relationship between costs and activities and are used to separate mixed costs into variable and fixed components. Because all data observations are used, the resulting linear equation is more representative of cost behavior than either the high-low or scatter diagram methods. Regression analysis can be performed using one or more activities to predict costs. For example, overhead costs can be predicted using only machine hours (a simple regression analysis), or they can be predicted using both machine hours and labor hours (a multiple regression analysis) because both activities affect overhead. We leave further description of regression analysis to statistics courses, which provide detailed coverage of this method.

## The Engineering Method

The **engineering method** separates costs by performing a step-by-step analysis (sometimes called a *time and motion study*) of the tasks, costs, and processes involved. The engineering method is expensive because it is so detailed, and it is generally used to estimate the cost of activities or new products. For example, the U.S. Postal Service conducts periodic audits of how many letters a postal worker should be able to deliver on a particular mail route within a certain period.

## Contribution Margin Income Statements

Once an organization's costs are classified as being either variable or fixed, the traditional income statement can be reorganized into a more useful format for internal operations and decision making. Exhibit 7 compares the structure of a traditional and a **contribution margin income statement** (or *variable costing income statement*). A contribution margin income statement emphasizes cost behavior rather than organizational functions. **Contribution margin (CM)** is the amount that remains after all variable costs are subtracted from sales. All variable costs related to production, selling, administration, and general expenses are subtracted from sales to determine the total contribution margin. All fixed costs related to production, selling, administration, and general expenses are subtracted from the total contribution margin to determine operating income.

Like most businesses, the U.S. Postal Service is concerned about delivery time. To determine how many deliveries a postal worker should be able to make within a certain period, it conducts periodic audits using the engineering method.



### Exhibit 7 Comparison of Income Statements

#### Traditional Income Statement

Sales revenue
– Cost of goods sold, variable
– Cost of goods sold, fixed
= Gross margin
– Operating expenses, variable
– Operating expenses, fixed
= Operating income

#### Contribution Margin Income Statement

Sales revenue
– Cost of goods sold, variable
– Operating expenses, variable
= Contribution margin
– Cost of goods sold, fixed
– Operating expenses, fixed
= Operating income

© Cengage Learning 2014

**STUDY NOTE:** Although both statements arrive at the same operating income, the traditional approach divides costs into product and period costs, whereas the contribution margin approach divides costs into variable and fixed costs.

The contribution margin income statement enables managers to view revenue and cost relationships on a per unit basis or as a percentage of sales. If managers understand these relationships, they can determine:

- How many units they must sell to avoid losing money
- What the sales price per unit must be to cover costs
- What their profits will be for a certain dollar amount of sales revenue

Exhibit 8 shows the two ways a contribution margin income statement can be presented.

### Exhibit 8 Contribution Margin Income Statement

	Per Unit Relationships	As a Percentage of Sales
Sales revenue	(Sales price per unit × Units sold)	(Sales revenue ÷ Sales revenue)
Less variable costs	(Variable rate per unit × Units sold)	(Variable costs ÷ Sales revenue)
Contribution margin	(Contribution margin per unit × Units sold)	Contribution margin ÷ Sales revenue
Less fixed costs	(Fixed costs)	(Fixed costs ÷ Sales revenue)
Operating income	(Operating income)	(Operating income ÷ Sales revenue)

© Cengage Learning 2014

## APPLY IT!

Using the high-low method and the information that follows, compute the monthly variable cost per kilowatt-hour and the monthly fixed electricity cost for a local business. Finally, express the monthly electricity cost formula and its relevant range.

Month	Kilowatt-Hours Used	Electricity Costs
April	90	\$450
May	80	430
June	70	420

### SOLUTION

Volume	Month	Activity Level	Cost
High	April	90 hours	\$450
Low	June	70 hours	420
Difference		20 hours	\$ 30

$$\text{Variable cost per kilowatt-hour} = \$30 \div 20 \text{ hours} = \$1.50 \text{ per hour}$$

$$\text{Fixed costs for April: } \$450 - (90 \times \$1.50) = \$315$$

$$\text{Fixed costs for June: } \$420 - (70 \times \$1.50) = \$315$$

$$\text{Monthly electricity costs} = (\$1.50 \times \text{Hours}) + \$315$$

The cost formula can be used for hourly activity between 70 and 90 hours per month.

**TRY IT! SE3, SE4, SE9, E3A, E4A, E5A, E3B, E4B, E5B**



### LO 3 Cost-Volume-Profit Analysis

**Cost-volume-profit (CVP) analysis** is an examination of the relationships among cost, volume of output, and profit. CVP analysis usually applies to a single product, product line, or division of a company. For that reason, *profit* is the term used in the CVP equation. In the context of CVP analysis, however, profit and operating income mean the same thing. The CVP equation is expressed as:

$$\text{Sales Revenue} - \text{Variable Costs} - \text{Fixed Costs} = \text{Profit}$$

or as:

$$(\text{Sales Price} \times \text{Units Sold}) - (\text{Variable Rate} \times \text{Units Sold}) - \text{Fixed Costs} = \text{Profit}$$

For example, suppose My Media Place wants to make a profit of \$50,000 on one of its services. Each service sells for \$95.50 and has variable costs of \$80. If 4,000 services are sold during the period, what are the fixed costs?

$$(\$95.50 \times 4,000) - (\$80 \times 4,000) - \text{Fixed Costs} = \$50,000$$

$$\$382,000 - \$320,000 - \text{Fixed Costs} = \$50,000$$

$$\text{Fixed Costs} = \underline{\underline{\$12,000}}$$

## APPLY IT!

A local business wants to make a profit of \$10,000 each month. It has variable costs of \$5 per unit and fixed costs of \$20,000 per month. How much must it charge per unit if 6,000 units are sold?

### SOLUTION

$$(\text{Sales Price} \times \text{Units Sold}) - (\text{Variable Rate} \times \text{Units Sold}) - \text{Fixed Costs} = \text{Profit}$$

$$(\text{Sales Price} \times 6,000) - (\$5 \times 6,000) - \$20,000 = \$10,000$$

$$\text{Sales Price} = \frac{(\$5 \times 6,000) + \$20,000 + \$10,000}{6,000 \text{ units}} = \frac{\$60,000}{6,000} = \$10 \text{ per unit}$$

**TRY IT! SE4, SE10, E6A, E12A, E13A, E14A, E6B, E12B, E13B, E14B**

### LO 4 Breakeven Analysis

The **breakeven point** is the point at which total revenues equal total costs. It is thus the point at which an organization can begin to earn a profit. When a new venture or product line is being planned, the likelihood of the project's success can be quickly measured by finding its breakeven point. If, for instance, the breakeven point is 24,000 units and the total market is only 25,000 units, the margin of safety would be very low, and the idea should be considered carefully. The **margin of safety** is the number of sales units or amount of sales dollars by which actual sales can fall below planned sales without resulting in a loss—in this example, 1,000 units.

The general equation for finding the breakeven point is expressed as:

$$\text{Breakeven Point} = \text{Sales} - \text{Variable Costs} - \text{Fixed Costs}$$

or as:

$$(\text{Sales Price} \times \text{Units Sold}) - (\text{Variable Rate} \times \text{Units Sold}) - \text{Fixed Costs} = \text{Profit}$$

Suppose, for example, that one of the services My Media Place sells is website setups. Variable costs are \$50 per unit, and fixed costs average \$20,000 per year. A unit is a basic website setup, which sells for \$90.



**Breakeven in Sales Units** The breakeven point for website setup services in sales units is:

$$\begin{aligned} \text{Sales Price} - \text{Variable Cost} - \text{Fixed Cost} &= \$0 \\ (\$90 \times \text{Sales Units}) - (\$50 \times \text{Sales Units}) - \$20,000 &= \$0 \\ (\$40 \times \text{Sales Units}) &= \$20,000 \\ \text{Sales Units} &= \$20,000 \div \$40 \\ \text{Sales Units} &= \underline{\underline{500}} \end{aligned}$$

**Breakeven in Sales Dollars** The breakeven point in sales dollars is:

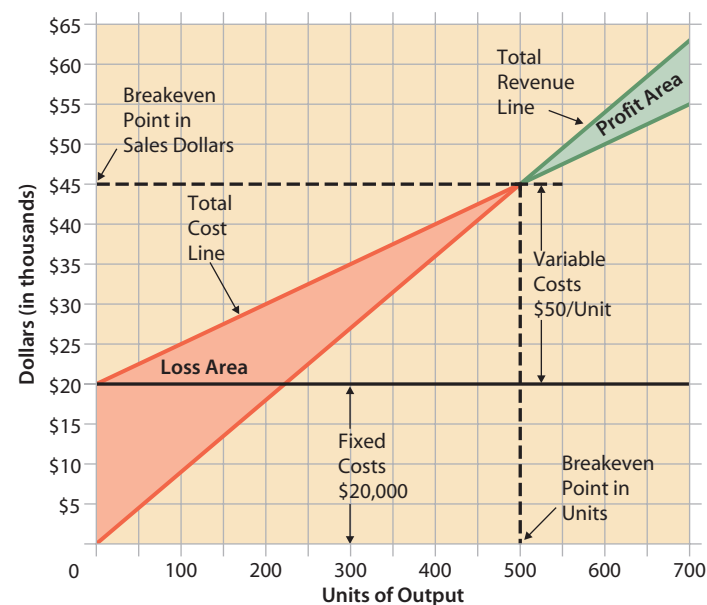
$$\$90 \times 500 \text{ units} = \underline{\underline{\$45,000}}$$

**Breakeven by Scatter Diagram** We can make a rough estimate of the breakeven point using a scatter diagram. Exhibit 9 shows My Media Place's breakeven graph, which has five parts:

- A horizontal axis for units of output
- A vertical axis for dollars
- A line running horizontally from the vertical axis at the level of fixed costs
- A total cost line that begins at the point where the fixed cost line crosses the vertical axis and slopes upward to the right (The slope of the line depends on the variable cost per unit.)
- A total revenue line that begins at the origin of the vertical and horizontal axes and slopes upward to the right (The slope depends on the selling price per unit.)

At the point at which the total revenue line crosses the total cost line, revenues equal total costs. The breakeven point, stated in either sales units or dollars of sales, is found by extending broken lines from this point to the axes. As Exhibit 9 shows, My Media Place will break even when it has sold 500 website setups for \$45,000.

**Exhibit 9**  
Graphic Breakeven  
Analysis



## Using an Equation to Determine the Breakeven Point

A simpler method of determining the breakeven point uses contribution margin in an equation. You will recall from the contribution margin income statement that the contribution margin is the amount that remains after all variable costs are subtracted from sales:

$$\text{Sales} - \text{Variable Costs} = \text{Contribution Margin}$$

**STUDY NOTE:** The maximum contribution a unit of product or service can make is its selling price. After paying for itself (variable costs), a product or service provides a contribution margin to help pay total fixed costs and then earn a profit.

A product line's contribution margin represents its net contribution to paying off fixed costs and earning a profit. Profit is what remains after fixed costs are paid and subtracted from the contribution margin:

$$\text{Contribution Margin} - \text{Fixed Costs} = \text{Profit}$$

The example that follows uses the contribution margin income statement approach to determine the profitability of one of My Media Place's products.

Symbols		Units Produced and Sold		
		250	500	750
S	Sales revenue (\$90 per unit)	\$ 22,500	\$45,000	\$67,500
VC	Less variable costs (\$50 per unit)	12,500	25,000	37,500
CM	Contribution margin (\$40 per unit)	\$ 10,000	\$20,000	\$30,000
FC	Less fixed costs	20,000	20,000	20,000
P	Profit (loss)	<u>\$(10,000)</u>	<u>\$ 0</u>	<u>\$10,000</u>

The breakeven point (BE) can be expressed as the point at which contribution margin minus total fixed costs equals zero (or the point at which contribution margin equals total fixed costs).

**Breakeven in Sales Units** In terms of units of product, the equation for the breakeven point looks like this:

$$(\text{Contribution Margin per Unit} \times \text{Breakeven Point Units}) - \text{Fixed Costs} = \$0$$

It can also be expressed like this:

$$\text{Breakeven (BE) Point Units} = \frac{\text{Fixed Costs (FC)}}{\text{Contribution Margin (CM) per Unit}}$$

For My Media Place, the breakeven point would be computed as follows.

$$\text{Breakeven Point Units} = \frac{\text{Fixed Costs}}{\text{Contribution Margin per Unit}} = \frac{\$20,000}{\$90 - \$50} = \frac{\$20,000}{\$40} = 500 \text{ units}$$

**Breakeven in Sales Dollars** The breakeven point in total sales dollars may be determined as follows.

$$\begin{aligned} \text{Breakeven (BE) Point Dollars} &= \text{Selling Price (SP)} \times \text{Breakeven (BE) Point Units} \\ &= \$90 \times 500 \text{ units} \\ &= \underline{\underline{\$45,000}} \end{aligned}$$

**RATIO**

An alternative way of determining the breakeven point in total sales dollars is to divide the fixed costs by the contribution margin ratio. The contribution margin ratio is the contribution margin divided by the selling price:

$$\text{Contribution Margin Ratio} = \frac{\text{Contribution Margin}}{\text{Selling Price}} = \frac{\$40}{\$90} = 0.444^*, \text{ or } 4/9$$

$$\text{Breakeven Point Dollars} = \frac{\text{Fixed Costs}}{\text{Contribution Margin Ratio}} = \frac{\$20,000}{0.444} = \underline{\underline{\$45,045^*}}$$

\*Rounded

## The Breakeven Point for Multiple Products

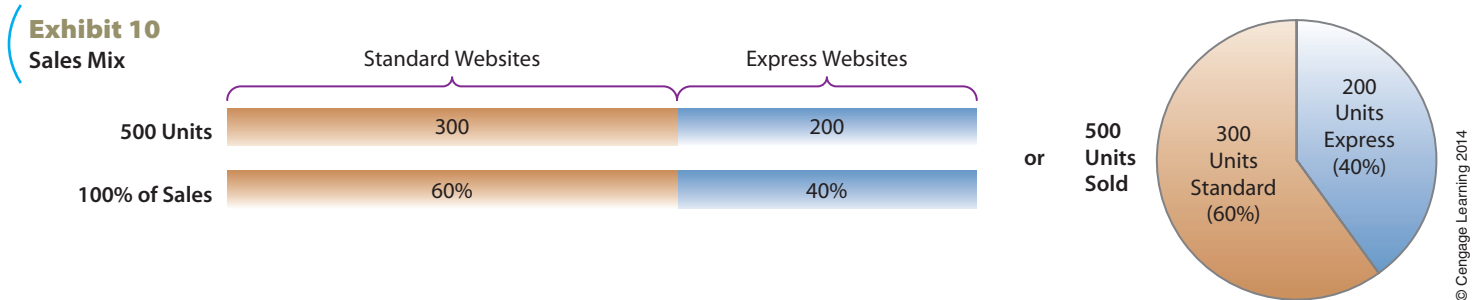
To satisfy the needs of different customers, most companies sell a variety of products or services that often have different variable and fixed costs and different selling prices.

**STUDY NOTE:** Remember that the breakeven point provides a rough estimate of the number of units that must be sold to cover the total costs.

**STUDY NOTE:** A company's sales mix can be very dynamic. If the mix is constantly changing, an assumption of stability may undermine the CVP analysis.

To calculate the breakeven point for each product, its unit contribution margin must be weighted by the sales mix. The **sales mix** is the proportion of each product's unit sales relative to the company's total unit sales.

Assume that My Media Place sells two types of websites: standard and express. If the company sells 500 units, of which 300 units are standard and 200 are express, the sales mix would be 3:2. The sales mix can also be stated in percentages. Of the 500 units sold, 60 percent ( $300 \div 500$ ) are standard sales, and 40 percent ( $200 \div 500$ ) are express sales (see Exhibit 10).



The example that follows illustrates how to compute the breakeven point for multiple products using My Media Place's sales mix of 60 percent standard websites to 40 percent express websites and total fixed costs of \$32,000.

**Step 1. Compute the weighted-average contribution margin.** Multiply the contribution margin for each product by its percentage of the sales mix, as follows.

	Selling Price	Variable Costs	Contribution Margin (CM)	Percentage of Sales Mix	Weighted-Average CM
Standard	\$90	– \$50	= \$40	× 60%	= \$24
Express	\$40	– \$20	= \$20	× 40%	= 8
Weighted-average contribution margin					<u>\$32</u>

**Step 2. Calculate the weighted-average breakeven point.** Divide total fixed costs by the weighted-average contribution margin:

$$\begin{aligned} \text{Weighted-Average Breakeven Point Units} &= \text{Total Fixed Costs} \div \text{Weighted Average Contribution Margin} \\ &= \$32,000 \div \$32 \\ &= \underline{\underline{1,000 \text{ units}}} \end{aligned}$$

**Step 3. Calculate the breakeven point for each product.** Multiply the weighted-average breakeven point by each product's percentage of the sales mix:

	Weighted-Average Breakeven Point	Sales Mix	Breakeven Point
Standard	1,000 units	× 60%	= 600 units
Express	1,000 units	× 40%	= 400 units

**Step 4. Verify results.** To verify, determine the contribution margin of each product and subtract the total fixed costs:

Contribution margin:		
Standard	600 × \$40	\$24,000
Express	400 × \$20	8,000
Total contribution margin		<u>\$32,000</u>
Less fixed costs		32,000
Profit		<u>\$ 0</u>

## APPLY IT!

Using the contribution margin approach, find the breakeven point in units for a local business's two products. Product M's selling price per unit is \$20, and its variable cost per unit is \$11. Product N's selling price per unit is \$12, and its variable cost per unit is \$6. Fixed costs are \$24,000, and the sales mix of Product M to Product N is 2:1.

### SOLUTION

#### Step 1.

	Selling Price	Variable Costs	Contribution Margin (CM)	Percentage of Sales Mix	Weighted-Average CM*
M	\$20	– \$11	= \$9	× 66.67%	= \$6
N	\$12	– \$ 6	= \$6	× 33.33%	= 2
Weighted-average contribution margin					<u>\$8</u>

\*Rounded

#### Step 2.

Weighted-average breakeven point =  $\$24,000 \div \$8.00 = \underline{3,000}$  units

#### Step 3. Breakeven point for each product line:

	Weighted-Average Breakeven Point	Sales Mix	Breakeven Point
M	= 3,000 units	× 0.6667	= <u>2,000 units</u>
N	= 3,000 units	× 0.3333	= <u>1,000 units</u>

#### Step 4. Check:

Contribution margin:				
Product M	=	2,000	×	\$9 = \$18,000
Product N	=	1,000	×	\$6 = <u>6,000</u>
Total contribution margin				<u>\$24,000</u>
Less fixed costs				24,000
Profit				<u>\$ 0</u>

**TRY IT! SE5, SE6, SE7, SE8, E5A, E6A, E7A, E8A, E9A, E10A, E11A, E15A, E5B, E6B, E7B, E8B, E9B, E10B, E11B, E15B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

**LO 5** Discuss how managers use CVP analysis in the management process and how they can project the profitability of products and services.

## **LO 5** Using CVP Analysis to Plan Future Sales, Costs, and Profits

CVP analysis is a general model of financial activity. CVP analysis allows managers to adjust different variables and to evaluate how these changes affect profit. For planning, managers can use CVP analysis to calculate net income when sales volume is known, or they can determine the level of sales needed to reach a targeted amount of net income. CVP analysis is used extensively in budgeting as well, and is also a way of measuring how well an organization's departments are performing. At the end of a period, sales volume and related actual costs are analyzed to find actual net income. A department's performance is measured by comparing actual costs with expected costs, which have been computed by applying CVP analysis to actual sales volume. The result is a performance report on which managers can base the control of operations.

Managers use CVP analysis to measure the effects of alternative courses of action, such as changing variable or fixed costs, expanding or contracting sales volume, and increasing or decreasing selling prices. CVP analysis is useful in making decisions about:

- product pricing
- product mix (when an organization makes more than one product or offers more than one service)
- adding or dropping a product line
- accepting special orders.

### **Assumptions Underlying CVP Analysis**

CVP analysis is useful only under certain conditions and only when the following assumptions hold true:

- The behavior of variable and fixed costs can be measured accurately.
- Costs and revenues have a close linear approximation throughout the relevant range. For example, if costs rise, revenues rise proportionately.
- Efficiency and productivity hold steady within the relevant range of activity.
- Cost and price variables also hold steady during the period being planned.
- The sales mix does not change during the period being planned.
- Production and sales volume are roughly equal.

If one or more of these conditions and assumptions are absent, the CVP analysis may be misleading.

### **Applying CVP to Target Profits**

The primary goal of a business venture is not to break even, but to generate profits. CVP analysis adjusted for targeted profit can be used to estimate the profitability of a venture. This approach is excellent for “what-if” analysis, in which managers select several scenarios and compute the profit that may be anticipated from each. For instance, what if sales increase by 17,000 units? What effect will the increase have on profit? What if sales increase by only 6,000 units? What if fixed costs are reduced by \$14,500? What if the variable unit cost increases by \$1.40?

We will continue the My Media Place example to illustrate two ways a business can apply CVP analysis to target profits. Assuming that the company wants to make \$4,000 in profit this year, how many website services must it sell to reach the targeted profit?

**Contribution Margin Approach** Using the contribution margin approach, the number of websites My Media Place must sell to obtain \$4,000 in profit would be computed as follows.

$$\begin{aligned}\text{Sales Revenue} &= \text{Variable Costs} + \text{Fixed Costs} + \text{Profit} \\ (\$90 \times \text{Targeted Sales Units}) &= (\$50 \times \text{Targeted Sales Units}) + \$20,000 + \$4,000 \\ (\$40 \times \text{Targeted Sales Units}) &= \$24,000 \\ \text{Targeted Sales Units} &= \underline{\underline{600 \text{ units}}}\end{aligned}$$

**Equation Approach** Using the equation approach, add the targeted profit to the numerator of the contribution margin breakeven equation and solve for targeted sales in units:

$$\text{Targeted Sales Units} = \frac{\text{Fixed Costs} + \text{Profit}}{\text{Contribution Margin per Unit}}$$

The number of sales units My Media Place needs to generate \$4,000 in profit is computed as follows.

$$\begin{aligned}\text{Targeted Sales Units} &= \frac{\$20,000 + \$4,000}{\$40} \\ &= \frac{\$24,000}{\$40} \\ &= \underline{\underline{600 \text{ units}}}\end{aligned}$$

**Contribution Margin Income Statement** To summarize My Media Place's plans for the coming year, a contribution income statement can be used, as shown below. The focus of such a statement is on cost behavior, *not* cost function.

<b>My Media Place Contribution Income Statement For the Year Ended December 31</b>		
	Per Unit	Total for 600 Units
Sales revenue	\$90	\$54,000
Less variable costs	50	30,000
Contribution margin	<u>\$40</u>	<u>\$24,000</u>
Less fixed costs		20,000
Operating income		<u>\$ 4,000</u>

**Comparing Alternative Options Using CVP** My Media Place's planning team wants to consider three alternatives to the original plan shown in the statement.

**Alternative 1: Decrease Variable Costs, Increase Sales Volume** What if website design labor were outsourced? Based on the planning team's research, the direct labor cost of a website would decrease by \$3 to \$47 and sales volume would increase by 10 percent to 660 units. How does this alternative affect operating income?

<b>Alternative 1</b>	Per Unit	Total for 660 Units
Sales revenue	\$90	\$59,400
Less variable costs	47	31,020
Contribution margin	<u>\$43</u>	<u>\$28,380</u>
Less fixed costs		20,000
Operating income		<u>\$ 8,380</u>
Increase in operating income (\$8,380 – \$4,000)		<u>\$ 4,380</u>





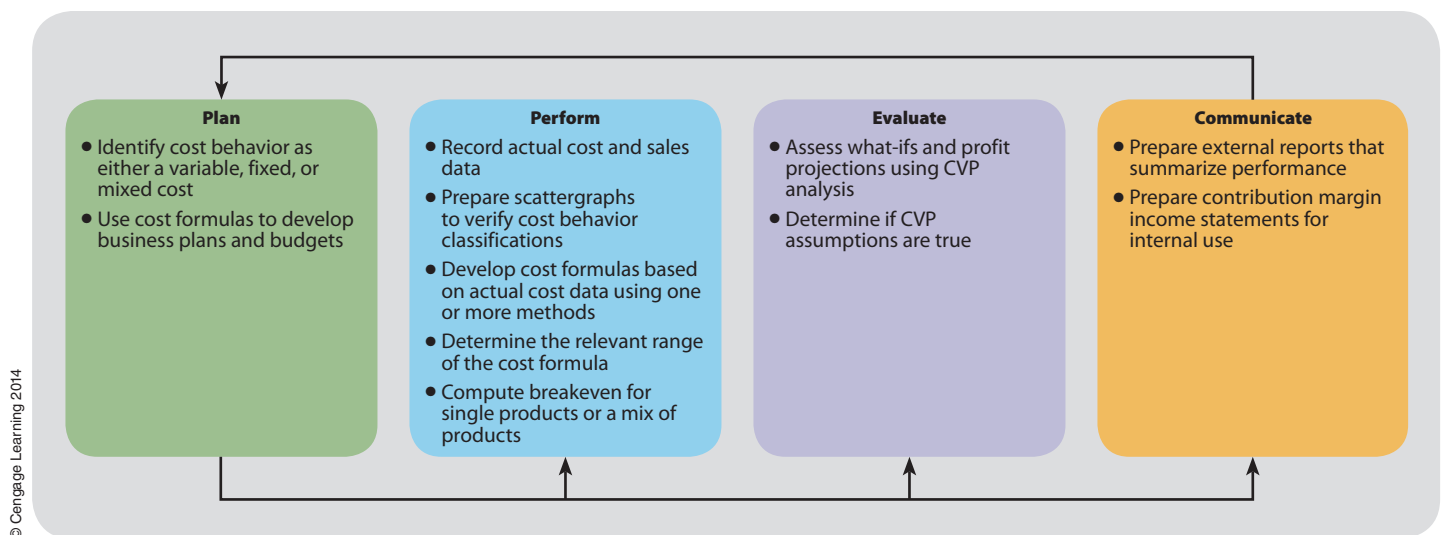
The three alternatives differ as follows.

- The decrease in variable costs (direct materials) proposed in Alternative 1 increases the contribution margin per unit (from \$40 to \$43), which reduces the breakeven point. Because fewer sales dollars are required to cover variable costs, the breakeven point is reached sooner than in the original plan—at a sales volume of 466 units rather than at 500 units.
- In Alternative 2, the increase in fixed costs has no effect on the contribution margin per unit, but it does require the total contribution margin to cover more fixed costs before reaching the breakeven point. Thus, the breakeven point is higher than in the original plan—513 units, as opposed to 500.
- The increase in selling price in Alternative 3 increases the contribution margin per unit, which reduces the breakeven point. Because more sales dollars are available to cover fixed costs, the breakeven point of 400 units is lower than the breakeven point in the original plan.

From a strategic standpoint, which plan should the planning team choose? If they want the highest operating income, they will choose Alternative 1. If, however, they want the company to begin generating operating income more quickly, they will choose the plan with the lowest breakeven point, Alternative 3. Additional quantitative and qualitative information may help the planning team make a better decision. While quantitative information is essential for planning, managers must also be sensitive to qualitative factors, such as product quality, reliability and quality of suppliers, and availability of human and technical resources.

Besides using cost-volume-profit analysis for planning and evaluating purposes, it can be a useful tool in the performing stage of the management process for determining cost behavior and in the communicating stage for providing relevant information for internal decision makers and for summarizing performance in external reports. Exhibit 12 summarizes how CVP analysis relates to the management process.

### Exhibit 12 CVP and the Management Process



© Cengage Learning 2014

## APPLY IT!

A local real estate appraisal business is planning its home appraisal activities for the coming year. The manager estimates that her variable costs per appraisal will be \$220, monthly fixed costs are \$16,200, and service fee revenue will be \$400 per appraisal. How many appraisals will the business have to perform each month to achieve a targeted profit of \$18,000 per month?

### SOLUTION

$$\begin{aligned}
 \text{Sales Revenue} - \text{Variable Costs} - \text{Fixed Costs} &= \text{Profit} \\
 (\$400 \times \text{Targeted Sales Units}) - & \\
 (\$220 \times \text{Targeted Sales Units}) - \$16,200 &= \$18,000 \\
 \$180 \times \text{Targeted Sales Units} &= \$34,200 \\
 \text{Targeted Sales Units} &= \underline{190} \text{ appraisals per month}
 \end{aligned}$$

**TRY IT! SE9, SE10, E12A, E13A, E14A, E15A, E12B, E13B, E14B, E15B**

## TriLevel Problem



PhotoAlto/Alix-Minder/PhotoAlto Agency/Jupiter Images

### My Media Place

The beginning of this chapter focused on My Media Place, a company that is considering expanding the range of products and services that it offers. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

#### Section 1: Concepts

*Why is cost-volume-profit analysis useful for the purposes of comparability and understandability?*

#### Section 2: Accounting Applications

*How will My Media Place's managers decide which products and services to offer? Suppose My Media Place is considering entering the online digital lockbox business by renting server space to customers to store their movies, music, photos, and other computer files. Its managers believe this service has a large potential market as more individuals and small businesses are starting to move their backup files to secure online servers that can be accessed around the clock. Here is a summary of data projections for this potential service offering:*

Selling price per year per customer account	<u>\$95</u>
Variable costs per account:	
Direct supplies	\$23
Direct labor	8
Overhead	6
Selling expense	<u>5</u>
Total variable costs per account	<u>\$42</u>
Annual fixed costs:	
Overhead	\$195,000
Advertising	55,000
Administrative expense	<u>68,000</u>
Total annual fixed costs	<u>\$318,000</u>

1. Compute the annual breakeven point in customer accounts.
2. My Media Place projects sales to 6,500 customer accounts next year. If that projection is accurate, how much profit will it realize?
3. To improve profitability, management is considering the following four alternative courses of action. (In performing the required steps, use the figures from items **1** and **2**, and treat each alternative independently.)
  - a. Calculate the number of accounts My Media Place must sell to generate a targeted profit of \$95,400. Assume that costs and selling price remain constant.
  - b. Calculate the operating income if the company increases the number of accounts sold by 20 percent and cuts the selling price by \$5 per account.
  - c. Determine the number of accounts that must be sold to break even if advertising costs (fixed costs) increase by \$47,700.
  - d. Find the number of accounts that must be sold to generate a target profit of \$120,000 if variable costs decrease by 10 percent.



$$\begin{aligned}
 3. \text{ a. Targeted Sales Units} &= \frac{\text{Fixed Costs} + \text{Profit}}{\text{Contribution Margin per Unit}} \\
 &= \frac{\$318,000 + \$95,400}{\$53} = \frac{\$413,400}{\$53} \\
 &= \underline{\underline{7,800}} \text{ accounts}
 \end{aligned}$$

b. Sales revenue [7,800 (6,500 × 1.20) accounts at \$90 per account]	\$702,000
Less variable costs (7,800 units × \$42)	<u>327,600</u>
Contribution margin	\$374,400
Less fixed costs	<u>318,000</u>
Operating income	<u>\$ 56,400</u>

$$\begin{aligned}
 \text{c. Breakeven Point Units} &= \frac{\text{Fixed Costs}}{\text{Contribution Margin per Unit}} \\
 &= \frac{\$318,000 + \$47,700}{\$53} = \frac{\$365,700}{\$53} \\
 &= \underline{\underline{6,900}} \text{ accounts}
 \end{aligned}$$

$$\begin{aligned}
 \text{d. Targeted Sales Units} &= \frac{\text{Fixed Costs} + \text{Profit}}{\text{Contribution Margin per Unit}} \\
 &= \frac{\$318,000 + \$120,000}{\$95 - (\$42 \times 0.9)} = \frac{\$438,000}{\$57.20} \\
 &= \underline{\underline{7,658}} \text{ accounts}^*
 \end{aligned}$$

\*Rounded

### Section 3: Business Applications

- |      |       |
|------|-------|
| 1. b | 7. b  |
| 2. a | 8. d  |
| 3. c | 9. b  |
| 4. a | 10. d |
| 5. b | 11. c |
| 6. b |       |

## Chapter Review

Define *cost behavior*, and identify *variable, fixed, and mixed costs*. **LO 1**

Cost behavior is the way costs respond to changes in volume or activity. Some costs vary in relation to volume or operating activity; other costs remain fixed as volume changes. Total costs that change in direct proportion to changes in productive output (or any other volume measure) are called variable costs. They include hourly wages, the cost of operating supplies, direct materials costs, and the cost of merchandise. Total fixed costs remain constant within a relevant range of volume or activity. They change only when volume or activity exceeds the relevant range—for example, when new equipment or new buildings must be purchased, higher insurance premiums and property taxes must be paid, or additional supervisory personnel must be hired to accommodate increased activity. A mixed cost, such as the cost of electricity, has both variable and fixed cost components.

**Separate mixed costs into their variable and fixed components, and prepare a contribution margin income statement.** **Lo 2**

Mixed costs must be separated into their variable and fixed components, using a variety of methods, including the engineering, scatter diagram, high-low, and statistical methods. When preparing a contribution margin income statement, all variable costs related to production, selling, and administration are subtracted from sales to determine the total contribution margin. Then, all fixed costs are subtracted from the total contribution margin to determine operating income.

**Perform cost-volume-profit (CVP) analysis.** **Lo 3**

Cost-volume-profit analysis is an examination of the cost behavior patterns that underlie the relationships among cost, volume of output, and profit. It is a tool for both planning and control.

**Define breakeven point, and use contribution margin to determine a company's breakeven point for multiple products.** **Lo 4**

The breakeven point is the point at which total revenues equal total costs—the point at which net sales equal variable costs plus fixed costs. Once the number of units needed to break even is known, the number can be multiplied by the product's selling price to determine the breakeven point in sales dollars. Contribution margin is the amount that remains after all variable costs have been subtracted from sales. A product's contribution margin represents its net contribution to paying off fixed costs and earning a profit. The breakeven point in units can be computed by using the following formula:

$$\text{Breakeven Point Units} = \frac{\text{Fixed Costs}}{\text{Contribution Margin per Unit}}$$

Sales mix is used to calculate the breakeven point for each product when a company sells more than one product.

**Discuss how managers use CVP analysis in the management process and how they can project the profitability of products and services.** **Lo 5**

CVP relationships provide a general model of financial activity that management can use for short-range planning and for evaluating performance and analyzing alternatives. The addition of targeted profit to the breakeven equation makes it possible to plan levels of operation that yield the desired profit. The formula in terms of contribution margin is:

$$\text{Targeted Sales Units} = \frac{\text{Fixed Costs} - \text{Profit}}{\text{Contribution Margin per Unit}}$$

CVP analysis enables managers to select several “what-if” scenarios and evaluate the outcome of each to determine which will generate the desired results.

## Key Terms

**activity base** 924 (LO1)  
**breakeven point** 931 (LO4)  
**contribution margin (CM)** 929 (LO2)  
**contribution margin income statement** 929 (LO2)  
**cost behavior** 922 (LO1)  
**cost-volume-profit (CVP) analysis** 931 (LO3)  
**engineering method** 929 (LO2)

**fixed cost formula** 924 (LO1)  
**fixed costs** 924 (LO1)  
**high-low method** 928 (LO2)  
**margin of safety** 931 (LO4)  
**mixed cost formula** 925 (LO1)  
**mixed costs** 925 (LO1)  
**normal capacity** 924 (LO1)  
**operating capacity** 923 (LO1)  
**practical capacity** 924 (LO1)

**regression analysis** 929 (LO2)  
**relevant range** 924 (LO1)  
**sales mix** 934 (LO4)  
**scatter diagram** 927 (LO2)  
**step cost** 924 (LO1)  
**theoretical capacity** 924 (LO1)  
**variable cost formula** 923 (LO1)  
**variable costs** 922 (LO1)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ▶ Describe how the identification of variable, fixed, and mixed costs increases cost comparability and understanding within the relevant range of volume or activity.
- LO 2 **DQ2. CONCEPT** ▶ What methods separate mixed costs into their fixed and variable components to better understand cost behavior?
- LO 2 **DQ3. CONCEPT** ▶ How does the preparation of a contribution margin income statement enhance cost behavior understanding and comparisons?
- LO 3, 4 **DQ4. CONCEPT** ▶ How does cost-volume-profit (CVP) analysis improve understanding and comparisons when using the contribution margin to determine a company's breakeven point for a single product or multiple products?
- LO 5 **DQ5. CONCEPT** ▶ **BUSINESS APPLICATION** ▶ Why does CVP analysis in the management process reinforce the concepts of comparability and understandability to better business profitability?

### SHORT EXERCISES

#### LO 1 Accounting Concepts

**SE1. CONCEPT** ▶ Match the accounting concepts with why they support the decision usefulness of CVP analysis.

- |                      |   |
|----------------------|---|
| a. Understandability | 1. A quality that enables users to identify similarities and differences between alternatives |
| b. Comparability     | 2. A quality that enables users to comprehend the meaning of the information they receive     |

#### LO 1 Identification of Variable, Fixed, and Mixed Costs

**SE2.** Identify the following as (a) fixed costs, (b) variable costs, or (c) mixed costs:

- |                          |                       |
|--------------------------|-----------------------|
| 1. Direct materials      | 4. Manager's salary   |
| 2. Electricity           | 5. Operating supplies |
| 3. Factory building rent |                       |

#### LO 2 Mixed Costs: High-Low Method

**SE3.** Using the high-low method, compute Soho Corporation's monthly variable cost per telephone hour and total fixed costs.

Month	Telephone Hours Used	Telephone Costs
April	95	\$4,350
May	90	4,230
June	100	4,680

#### LO 2, 3 Contribution Margin Income Statement

**SE4.** Prepare a contribution margin income statement if Greenwich, Inc., wants to make a profit of \$50,000. It has variable costs of \$10 per unit and fixed costs of \$20,000. How much must it charge per unit if 5,000 units are sold?

#### LO 4 Breakeven Analysis in Units and Dollars

**SE5.** How many units must Queens Company sell to break even if the selling price per unit is \$9, variable costs are \$5 per unit, and fixed costs are \$6,000? What is the breakeven point in total dollars of sales?



**LO 4 Contribution Margin in Units**

**SE6.** Using the contribution margin approach, find the breakeven point in units for Staten Products if the selling price per unit is \$11, the variable cost per unit is \$4, and the fixed costs are \$7,700.

**LO 4 Contribution Margin Ratio****RATIO**

**SE7.** Compute the contribution margin ratio and the breakeven point in total sales dollars for Wall Street Products if the selling price per unit is \$16, the variable cost per unit is \$8, and the fixed costs are \$6,250.

**LO 4 Breakeven Analysis for Multiple Products**

**SE8.** Using the contribution margin approach, find the breakeven point in units for Suffolk Company's two products. Product A's selling price per unit is \$10, and its variable cost per unit is \$4. Product B's selling price per unit is \$8, and its variable cost per unit is \$5. Fixed costs are \$14,175, and the sales mix of Product A to Product B is 3:1.

**LO 2, 5 Monthly Costs and the High-Low Method**

**SE9.** Pup Noir, a private investigation firm, investigated 90 cases in December and had the following costs: direct labor, \$190 per case; and service overhead of \$20,840. Service overhead for October was \$21,150; for November, it was \$21,350. The number of cases investigated during October and November was 92 and 95, respectively. Compute the variable and fixed cost components of service overhead using the high-low method. Then determine the variable and fixed costs per case for December. (Round final answers to the nearest dollar where necessary.)

**LO 3, 5 CVP Analysis and Projected Profit**

**SE10.** If Bronx Watches sells 300 watches at \$38 per watch and has variable costs of \$18 per watch and fixed costs of \$4,000, what is the projected profit?

**EXERCISES: SET A****LO 1 Identification of Variable and Fixed Costs**

**E1A.** Indicate whether each of the following costs of productive output is usually (a) variable or (b) fixed:

- |                                |  |
|--------------------------------|--|
| 1. License fee for company car | 6. Machine depreciation based on machine hours used          |
| 2. Wiring used in radios       | 7. Machine operator's hourly wages                           |
| 3. Machine helper's wages      | 8. Cost of required outside inspection of each unit produced |
| 4. Wood used in bookcases      |  |
| 5. City operating license      |  |

**LO 1 Variable Cost Analysis**

**E2A.** Zero Time Oil Change has been in business for six months. The company pays \$0.75 per quart for the oil it uses in servicing cars. Each job requires an average of 4 quarts of oil. The company estimates that in the next three months, it will service 250, 280, and 360 cars.

1. Compute the cost of oil for each of the three months and the total cost for all three months.
2. Complete the following sentences by choosing the words that best describe the cost behavior at Zero Time:
  - a. Cost per unit (increased, decreased, remained constant).
  - b. Total variable cost per month (increased, decreased) as the quantity of oil used (increased, decreased).



**LO 2 Mixed Costs: High-Low Method**

**E3A.** Madison Company manufactures major appliances. Because of growing interest in its products, it has just had its most successful year. In preparing the budget for next year, its controller compiled the following information:

Month	Volume in Machine Hours	Electricity Cost
July	6,000	\$ 60,000
August	5,000	53,000
September	4,500	49,500
October	4,000	46,000
November	3,500	42,500
December	3,000	36,000
Six-month total	<u>26,000</u>	<u>\$287,000</u>

Using the high-low method, determine the variable electricity cost per machine hour and the monthly fixed electricity cost. Estimate the total variable electricity costs and fixed electricity costs if 4,800 machine hours are projected to be used next month.

**LO 2 Mixed Costs: High-Low Method**

**E4A.** When Jerome Company's monthly costs were \$80,000, sales were \$90,000. When its monthly costs were \$60,000, sales were \$50,000. Use the high-low method to develop a monthly cost formula for Jerome's coming year.

**LO 2, 4 Contribution Margin Income Statement and Ratio**
**RATIO**

**E5A.** Bowery Company manufactures a single product that sells for \$100 per unit. The company projects sales of 400 units per month. Projected costs follow.

Type of Cost	Manufacturing	Nonmanufacturing
Variable	\$10,000	\$6,000
Nonvariable	13,000	5,000

1. Prepare a contribution margin income statement for the month.
2. What is the contribution margin ratio?
3. What volume, in terms of units, must the company sell to break even?

**LO 3, 4 Contribution Margin Income Statement and Breakeven Analysis**

**E6A.** Using the data in the contribution margin income statement for Broadway, Inc., that follows, calculate (a) selling price per unit, (b) variable costs per unit, and (c) break-even point in units and in sales dollars.

**Broadway, Inc.**  
**Contribution Margin Income Statement**  
**For the Year Ended December 31**

Sales (20,000 units)		\$16,000,000
Less variable costs:		
Cost of goods sold	\$8,000,000	
Selling, administrative, and general	<u>4,000,000</u>	
Total variable costs		<u>12,000,000</u>
Contribution margin		\$ 4,000,000
Less fixed costs:		
Overhead	\$1,200,000	
Selling, administrative, and general	<u>800,000</u>	
Total fixed costs		<u>2,000,000</u>
Operating income		<u>\$ 2,000,000</u>

LO 4 **Breakeven Analysis**

**E7A.** Meadowlands Design produces head covers for golf clubs. The company expects to generate a profit next year. It anticipates fixed manufacturing costs of \$200,500 and fixed general and administrative expenses of \$80,000 for the year. Variable manufacturing and selling costs per set of head covers will be \$8 and \$12, respectively. Each set will sell for \$30.

1. Compute the breakeven point in sales units.
2. Compute the breakeven point in sales dollars.
3. If the selling price is increased to \$34 per unit and fixed general and administrative expenses are cut to \$37,500, what will the new breakeven point be in units?
4. Prepare a graph to illustrate the breakeven point computed in 3.

LO 4 **Breakeven Point for Multiple Products**

**E8A.** Eastside Aquarium, Inc., manufactures and sells aquariums, water pumps, and air filters. The sales mix is 1:2:2 (i.e., for every one aquarium sold, two water pumps and two air filters are sold). Using the contribution margin approach, find the breakeven point in units for each product. The company's fixed costs are \$52,000. Other information follows.

	Selling Price per Unit	Variable Costs per Unit
Aquariums	\$60	\$25
Water pumps	20	12
Air filters	10	3

LO 4 **Breakeven Point for Multiple Products**

**E9A.** Hamburgers and More, Inc., sells hamburgers, drinks, and fries. The sales mix is 1:3:2 (i.e., for every one hamburger sold, three drinks and two fries are sold). Using the contribution margin approach, find the breakeven point in units for each product. The company's fixed costs are \$1,020. Other information follows.

	Selling Price per Unit	Variable Costs per Unit
Hamburgers	\$0.99	\$0.27
Drinks	0.99	0.09
Fries	0.99	0.15

LO 4 **Sales Mix Analysis**

**E10A.** Marj Plimpton is the owner of a hairdressing salon in New York City. Her salon provides three basic services: shampoo and set, permanent, and cut and blow dry. Its operating results from the past quarter follow.

Type of Service	Number of Customers	Total Sales	Contribution Margin in Dollars
Shampoo and set	1,200	\$24,000	\$14,700
Permanent	420	21,000	15,120
Cut and blow dry	1,000	15,000	10,000
	<u>2,620</u>	<u>\$60,000</u>	<u>\$39,820</u>
Total fixed costs			40,000
Profit (loss)			<u>\$ (180)</u>

Compute the breakeven point in units based on the weighted-average contribution margin for the sales mix.

**LO 2, 5 Cost Behavior in a Service Business**

**E11A. BUSINESS APPLICATION** ► Jim Lucky, CPA, is the owner of a firm that provides payroll support services. The firm charges \$40 per payroll return for the direct professional labor involved in preparing the payroll and submitting the required tax forms. In January, the firm prepared 50 such returns; in February, 100; and in March, 70. Service overhead (telephone and utilities, depreciation on equipment and building, tax forms, office supplies, and wages of clerical personnel) for January was \$2,000; for February, \$3,500; and for March, \$2,700.

1. Using the high-low method, determine the variable and fixed cost components of the firm's Service Overhead account.
2. What would the estimated total cost per tax return be if the firm prepares 80 payroll forms in April?

**LO 4, 5 CVP Analysis and Profit Planning**

**E12A. BUSINESS APPLICATION** ► Cos Cob Systems, Inc., makes heat-seeking missiles. It has recently been offered a government contract from which it may realize a profit. The contract purchase price is \$130,000 per missile, but the number of units to be purchased has not yet been decided. The company's fixed costs are budgeted at \$4,035,000, and variable costs are \$68,500 per unit.

1. Compute the number of units the company should agree to make at the stated contract price to earn a profit of \$1,500,000.
2. Using a lighter material, the variable unit cost can be reduced by \$1,730, but total fixed overhead will increase by \$29,240. How many units must be produced to make \$1,500,000 in profit?
3. Given the figures in 2, how many additional units must be produced to increase profit by \$1,264,600?

**LO 4, 5 Planning Future Sales**

**E13A. BUSINESS APPLICATION** ► Short-term automobile rentals are Snap Rentals, Inc.'s specialty. Average variable operating costs have been \$20 per day per automobile. The company owns 50 automobiles. Fixed operating costs for the next year are expected to be \$150,000. Average daily rental revenue per automobile is expected to be \$40. Management would like to earn a profit of \$50,000 during the year.

1. Calculate the total number of daily rentals the company must have during the year to earn the targeted profit.
2. On the basis of your answer to 1, determine the average number of days each automobile must be rented.
3. Determine the total revenue needed to achieve the targeted profit of \$50,000.
4. What would the total rental revenue be if fixed operating costs could be lowered by \$5,000 and the targeted profit increased to \$70,000?

**LO 4, 5 CVP Analysis in a Service Business**

**E14A. BUSINESS APPLICATION** ► Westport Inspection Service specializes in inspecting cars that have been returned to automobile leasing companies at the end of their leases. Westport's charge for each inspection is \$60; its average cost per inspection is \$15. The owner wants to expand his business by hiring another employee and purchasing an automobile. The fixed costs of the new employee and automobile would be \$3,000 per month. How many inspections per month would the new employee have to perform to earn a profit of \$1,500?

**LO 3, 4, 5 CVP and Breakeven Analysis and Pricing**

**E15A.** Americas Company has a plant capacity of 100,000 units per year, but its budget for this year indicates that only 60,000 units will be produced and sold. The entire budget for this year follows.

Sales (60,000 units at \$3.75)		\$225,000
Less cost of goods produced (based on production of 60,000 units):		
Direct materials (variable)	\$60,000	
Direct labor (variable)	30,000	
Variable overhead costs	45,000	
Fixed overhead costs	<u>75,000</u>	
Total cost of goods produced		<u>210,000</u>
Gross margin		\$ 15,000
Less selling and administrative expenses:		
Selling (fixed)	\$24,000	
Administrative (fixed)	<u>36,000</u>	
Total selling and administrative expenses		<u>60,000</u>
Operating income (loss)		<u>\$(45,000)</u>

- Given the budgeted selling price and cost data, how many units would Americas have to sell to break even? (*Hint*: Be sure to consider selling and administrative expenses.)
- BUSINESS APPLICATION** ▶ Market research indicates that if Americas were to drop its selling price to \$3.70 per unit, it could sell 100,000 units. Would you recommend the drop in price? What would the new operating income or loss be?

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

LO 1, 2, 5

- ✓ 2: Fixed cost component of mixed cost: \$1,145
- ✓ 3: Average cost per job: \$907.76

### Cost Behavior and Projection for a Service Business

**P1.** Wabash Company specializes in refurbishing exterior painted surfaces that have been hard hit by humidity and insect debris. It uses a special technique, called pressure cleaning, before priming and painting the surface. The refurbishing process involves the following steps:

- Unskilled laborers trim all trees and bushes within two feet of the structure.
- Skilled laborers clean the building with a high-pressure cleaning machine, using about 6 gallons of chlorine per job.
- Unskilled laborers apply a coat of primer.
- Skilled laborers apply oil-based exterior paint to the entire surface.

On average, skilled laborers work 12 hours per job, and unskilled laborers work 8 hours. The refurbishing process generated the following operating results during the year on 500 jobs:

Skilled labor	\$20	per hour
Unskilled labor	\$8	per hour
Gallons of chlorine used	3,000	gallons at \$5.50 per gallon
Paint primer	7,536	gallons at \$15.50 per gallon
Paint	6,280	gallons at \$16.00 per gallon
Depreciation of paint-spraying equipment	\$600	per month depreciation
Lease of two vans	\$800	per month total
Rent on storage building	\$421	per month

(Continued)

Data on utilities for the year follow:

Month	Number of Jobs	Cost	Hours Worked
January	42	\$ 3,950	840
February	37	3,550	740
March	44	4,090	880
April	49	4,410	980
May	54	4,720	1,080
June	62	5,240	1,240
July	71	5,820	1,420
August	73	5,890	1,460
September	63	5,370	1,260
October	48	4,340	960
November	45	4,210	900
December	40	3,830	800
Totals	<u>628</u>	<u>\$55,420</u>	<u>12,560</u>

### REQUIRED

1. Classify the costs as variable, fixed, or mixed.
2. Using the high-low method, separate mixed costs into their variable and fixed components. Use total hours worked as the basis.
3. Compute the average cost per job for the year. (*Hint:* Divide the total of all costs for the year by the number of jobs completed.) Use estimated hours to determine utilities costs. (Round to two decimal places.)
4. **BUSINESS APPLICATION** ▶ Project the average cost per job for next year if variable costs per job increase 20 percent. (Round to two decimal places.)
5. **ACCOUNTING CONNECTION** ▶ Why can actual utilities costs vary from the amount computed using the utilities cost formula?

### LO 4, 5

✓ 1: Breakeven hours: 7,500 hours

### Breakeven Analysis

**P2.** Park & Morgan, a law firm, is considering opening a legal clinic for middle- and low-income clients. The clinic would bill at a rate of \$18 per hour. It would employ law students as paraprofessional help and pay them \$9 per hour. Other variable costs are anticipated to be \$5.40 per hour, and annual fixed costs are expected to total \$27,000.

### REQUIRED

1. Compute the breakeven point in billable hours.
2. Compute the breakeven point in total billings.
3. **BUSINESS APPLICATION** ▶ Find the new breakeven point in total billings if fixed costs should go up by \$2,340.
4. **BUSINESS APPLICATION** ▶ Using the original figures, compute the breakeven point in total billings if the billing rate decreases by \$1 per hour, other variable costs decrease by \$0.40 per hour, and fixed costs go down by \$3,600.

### LO 3, 4, 5

#### SPREADSHEET

✓ 1a: Breakeven units: 3,500 units  
✓ 3: Selling price: \$51

### Planning Future Sales: Contribution Margin Approach

**P3. BUSINESS APPLICATION** ▶ All Honors Industries is considering a new product for its Trophy Division. The product, which would feature an alligator, is expected to have global market appeal and to become the mascot for many high school and university athletic teams. Expected variable unit costs are as follows: direct materials, \$18.50; direct labor, \$4.25; production supplies, \$1.10; selling costs, \$2.80; and other, \$1.95. Annual fixed costs are depreciation, building, and equipment, \$36,000; advertising, \$45,000; and other, \$11,400. Plans are to sell the product for \$55.

**REQUIRED**

- Using the contribution margin approach, compute the number of units the company must sell to (a) break even and (b) earn a profit of \$70,224.
- Using the same data, compute the number of units that must be sold to earn a profit of \$139,520 if advertising costs rise by \$40,000.
- Using the original information and sales of 10,000 units, compute the selling price the company must use to make a profit of \$131,600. (*Hint:* Calculate contribution margin per unit first.)
- According to the vice president of marketing, Flora Albert, the most optimistic annual sales estimate for the product would be 15,000 units, and the highest competitive selling price the company can charge is \$52 per unit. How much more can be spent on fixed advertising costs if the selling price is \$52, the variable costs cannot be reduced, and the targeted profit for 15,000 unit sales is \$251,000?

LO 4, 5

SPREADSHEET

- ✓ 1a: Breakeven units: 150,000 units
- ✓ 2: 190,000 units

**Breakeven Analysis and Planning Future Sales**

**P4.** Marina Company has a maximum capacity of 200,000 units per year. Variable manufacturing costs are \$12 per unit. Fixed overhead is \$600,000 per year. Variable selling and administrative costs are \$5 per unit, and fixed selling and administrative costs are \$300,000 per year. The current sales price is \$23 per unit.

**REQUIRED**

- What is the breakeven point in (a) sales units and (b) sales dollars?
- BUSINESS APPLICATION** ► How many units must Marina Company sell to earn a profit of \$240,000 per year?
- BUSINESS APPLICATION** ► A strike at one of the company's major suppliers has caused a shortage of materials, so the current year's production and sales are limited to 160,000 units. To partially offset the effect of the reduced sales on profit, management is planning to reduce fixed costs to \$841,000. Variable costs per unit are the same as last year. The company has already sold 30,000 units at the regular selling price of \$23 per unit.
  - What amount of fixed costs was covered by the total contribution margin of the first 30,000 units sold?
  - What contribution margin per unit will be needed on the remaining 130,000 units to cover the remaining fixed costs and to earn a profit of \$210,000 this year?

LO 3, 4, 5

- ✓ 1a: 262 loans
- ✓ 3: Loan application fee: \$255

**Planning Future Sales for a Service Business**

**P5. BUSINESS APPLICATION** ► State Street Lending processes loan applications. The manager of the loan department has established a policy of charging a \$250 fee for every loan application processed. Variable costs have been projected as follows: loan consultant's wages, \$15.50 per hour (a loan application takes 5 hours to process); supplies, \$2.40 per application; and other variable costs, \$5.60 per application. Annual fixed costs include depreciation of equipment, \$8,500; building rental, \$14,000; promotional costs, \$12,500; and other fixed costs, \$8,099.

**REQUIRED**

- Using the contribution margin approach, compute the number of loan applications the company must process to (a) break even and (b) earn a profit of \$14,476.
- Using the same approach and assuming promotional costs increase by \$5,662, compute the number of applications the company must process to earn a profit of \$20,000.
- Assuming the original information and the processing of 500 applications, compute the loan application fee the company must charge if the targeted profit is \$41,651.
- The maximum number of loan applications that the department can process is 750. How much more can be spent on promotional costs if the highest fee tolerable to the customer is \$280, if variable costs cannot be reduced, and if the targeted profit is \$50,000?



## ALTERNATE PROBLEMS

LO 1, 2, 5

- ✓ 1: Total fixed cost: \$2,250
- ✓ 3: Total repairs and maintenance cost: \$99,824

### Mixed Costs

**P6.** Officials of the Oakbrook Hills Golf and Tennis Club are in the process of preparing a budget for the year ending December 31. Because the club treasurer has had difficulty with two expense items, the process has been delayed. The two items are mixed costs—expenses for electricity and for repairs and maintenance—and the treasurer has been having trouble breaking them down into their variable and fixed components.

An accountant friend has suggested that he use the high-low method to divide the costs into their variable and fixed parts. The spending patterns and activity measures related to each cost during the past year are as follows:

Month	Electricity Expense		Repairs and Maintenance	
	Amount	Kilowatt-Hours	Amount	Labor Hours
January	\$ 7,500	210,000	\$ 7,578	220
February	8,255	240,200	7,852	230
March	8,165	236,600	7,304	210
April	8,960	268,400	7,030	200
May	7,520	210,800	7,852	230
June	7,025	191,000	8,126	240
July	6,970	188,800	8,400	250
August	6,990	189,600	8,674	260
September	7,055	192,200	8,948	270
October	7,135	195,400	8,674	260
November	8,560	252,400	8,126	240
December	8,415	246,600	7,852	230
Totals	<u>\$92,550</u>	<u>2,622,000</u>	<u>\$96,416</u>	<u>2,840</u>

### REQUIRED

- Using the high-low method, compute the variable cost rates used last year for each expense. What was the monthly fixed cost for electricity and for repairs and maintenance? (Round variable cost rate answers to three decimal places.)
- Compute the total variable cost and total fixed cost for each expense category for last year.
- BUSINESS APPLICATION** ▶ The treasurer believes that in the coming year, the electricity rate will increase by \$0.005 and the repairs rate, by \$1.20. Usage of all items and their fixed cost amounts will remain constant. Compute the projected total cost for each category. How will the cost increases affect the club's profits and cash flow?

LO 4, 5

- ✓ 1: Breakeven units: 740 systems
- ✓ 4: Breakeven units: 790 systems

### Breakeven Analysis

**P7.** At the beginning of each year, LED Lighting, Ltd.'s Accounting Department must find the point at which projected sales revenue will equal total budgeted variable and fixed costs. The company produces low-voltage outdoor lighting systems. Each system sells for an average of \$435. Variable costs per unit are \$210. Total fixed costs for the year are estimated to be \$166,500.

### REQUIRED

- Compute the breakeven point in sales units.
- Compute the breakeven point in sales dollars.
- BUSINESS APPLICATION** ▶ Find the new breakeven point in sales units if the fixed costs go up by \$10,125.
- BUSINESS APPLICATION** ▶ Using the original figures, compute the breakeven point in sales units if the selling price decreases to \$425 per unit, fixed costs go up by \$15,200, and variable costs decrease by \$15 per unit.



LO 3, 4, 5

SPREADSHEET

- ✓ 1a: Breakeven units: 7,900 statues
- ✓ 2: Target sales units: 16,900 statues

### Planning Future Sales: Contribution Margin Approach

**P8. BUSINESS APPLICATION** ▶ Lipsius Marbles manufactures birdbaths, statues, and other decorative items, which it sells to florists and retail home and garden centers. Its design department has proposed a new product, a frog statue, that it believes will be popular with home gardeners. Expected variable unit costs are direct materials, \$9.25; direct labor, \$4.00; production supplies, \$0.55; selling costs, \$2.40; and other, \$3.05. The following are fixed costs: depreciation, \$33,000; advertising, \$40,000; and other, \$6,000. Management plans to sell the product for \$29.25.

#### REQUIRED

- Using the contribution margin approach, compute the number of statues the company must sell to (a) break even and (b) earn a profit of \$50,000.
- Using the same data, compute the number of statues that must be sold to earn a profit of \$70,000 if advertising costs rise by \$20,000.
- Using the original data and sales of 15,000 units, compute the selling price the company must charge to make a profit of \$101,000.
- According to the vice president of marketing, if the price of the statues is reduced and advertising is increased, the most optimistic annual sales estimate is 25,000 units. How much more can be spent on fixed advertising costs if the selling price is reduced to \$28.00 per statue, the variable costs cannot be reduced, and the targeted profit for sales of 25,000 statues is \$120,000?

LO 4, 5

SPREADSHEET

- ✓ 1a: Breakeven units: 200,000 units
- ✓ 2: Sales units: 300,000 units

### Breakeven Analysis and Planning Future Sales

**P9.** Bar Company has a maximum capacity of 500,000 units per year. Variable manufacturing costs are \$25 per unit. Fixed overhead is \$900,000 per year. Variable selling and administrative costs are \$5 per unit, and fixed selling and administrative costs are \$300,000 per year. The current sales price is \$36 per unit.

#### REQUIRED

- What is the breakeven point in (a) sales units and (b) sales dollars?
- BUSINESS APPLICATION** ▶ How many units must Bar Company sell to earn a profit of \$600,000 per year?
- BUSINESS APPLICATION** ▶ A strike at one of the company's major suppliers has caused a shortage of materials, so the current year's production and sales are limited to 400,000 units. To partially offset the effect of the reduced sales on profit, management is planning to reduce fixed costs to \$1,000,000. Variable cost per unit is the same as last year. The company has already sold 30,000 units at the regular selling price of \$36 per unit.
  - What amount of fixed costs was covered by the total contribution margin of the first 30,000 units sold?
  - What contribution margin per unit will be needed on the remaining 370,000 units to cover the remaining fixed costs and to earn a profit of \$290,000 this year?

LO 3, 4, 5

- ✓ 1a: Breakeven units: 270 loans
- ✓ 3: Loan application fee: \$403

### Planning Future Sales for a Service Business

**P10. BUSINESS APPLICATION** ▶ Last Mortgage Inc.'s primary business is processing mortgage loan applications. Last year, the manager of the mortgage application department established a policy of charging a \$500 fee for every loan application processed. Next year's variable costs have been projected as follows: mortgage processor wages, \$30 per hour (a mortgage application takes 3 hours to process); supplies, \$10 per application; and other variable costs, \$15 per application. Annual fixed costs include depreciation of equipment, \$4,950; building rental, \$34,000; promotional costs, \$45,000; and other fixed costs, \$20,000.

*(Continued)*

**REQUIRED**

1. Using the contribution margin approach, compute the number of loan applications the company must process to (a) break even and (b) earn a profit of \$50,050.
2. Using the same approach and assuming promotional costs increase by \$5,450, compute the number of applications the company must process to earn a profit of \$60,000.
3. Assuming the original information and the processing of 500 applications, compute the loan application fee the company must charge if the targeted profit is \$40,050.
4. The mortgage department can handle a maximum of 750 loan applications. How much more can be spent on promotional costs if the highest fee tolerable to the customer is \$400, if variable costs cannot be reduced, and if the targeted profit for the loan applications is \$50,000?

**CASES****LO 4 Ethical Dilemma: Breaking Even and Ethics**

**C1.** Les Pulaski is the supervisor of a new division of Innovation Corporation. Her annual bonus is based on the success of new products and is computed on the number of sales that exceed each new product's projected breakeven point. In reviewing the computations supporting her most recent bonus, Pulaski found that although an order for 7,500 units of a new product called R56 had been refused by a customer and returned to the company, the order had been included in the bonus calculations. She later discovered that the company's accountant had labeled the return an overhead expense and had charged the entire cost of the returned order to the plantwide Overhead account. The result was that product R56 appeared to exceed breakeven by more than 5,000 units and Pulaski's bonus from this product amounted to over \$1,000. What actions should Pulaski take? Be prepared to discuss your response in class.

**LO 1, 4 Group Activity: Cost Behavior and Contribution Margin**

**C2.** Visit a local fast-food restaurant. Observe all aspects of the operation and take notes on the entire process. Describe the procedures used to take, process, and fill an order and deliver the order to the customer. Based on your observations, make a list of the costs incurred by the operation. Identify at least three variable costs and three fixed costs. Can you identify any potential mixed costs? Why is the restaurant willing to sell a large drink for only a few cents more than a medium drink? How is the restaurant able to offer a "value meal" (e.g., sandwich, drink, and fries) for considerably less than those items would cost if they were bought separately? Bring your notes to class and be prepared to discuss your findings.

Your instructor will divide the class into groups to discuss the case. Summarize your group's discussion, and ask one member of the group to present the summary to the rest of the class.

**LO 3, 4 Conceptual Understanding: CVP Analysis**

**C3.** Based in Italy, Datura, Ltd., is an international importer-exporter of pottery with distribution centers in the United States, Europe, and Australia. The company was very successful in its early years, but its profitability has since declined. As a member of a management team selected to gather information for Datura's next strategic planning meeting, you have been asked to review its most recent contribution margin income statement for the year ended December 31, 2014, which follows.

**Datura, Ltd.**  
**Contribution Margin Income Statement**  
**For the Year Ended December 31, 2014**

Sales revenue		€13,500,000
Less variable costs:		
Purchases	€6,000,000	
Distribution	2,115,000	
Sales commissions	1,410,000	
Total variable costs		9,525,000
Contribution margin		€ 3,975,000
Less fixed costs:		
Distribution	€ 985,000	
Selling	1,184,000	
General and administrative	871,875	
Total fixed costs		3,040,875
Operating income		€ 934,125

In 2014, Datura sold 15,000 sets of pottery.

1. For each set of pottery sold in 2014, calculate the (a) selling price, (b) variable purchases cost, (c) variable distribution cost, (d) variable sales commission, and (e) contribution margin.
2. Calculate the breakeven point in units and in sales euros.
3. Historically, Datura's variable costs have been about 60 percent of sales. What was the ratio of variable costs to sales in 2014? (Round to two decimal places.) List three actions Datura could take to correct the difference.
4. How would fixed costs have been affected if Datura had sold only 14,000 sets of pottery in 2014?

**LO 5 Business Communications: CVP Analysis Applied**

**C4.** Refer to the information in **C3**. In January 2015, the president of Datura, Ltd., conducted a strategic planning meeting. During the meeting, the vice president of distribution noted that because of a new contract with an international shipping line, the company's fixed distribution costs for 2015 would be reduced by 10 percent and its variable distribution costs by 4 percent. The vice president of sales offered the following information:

*We plan to sell 15,000 sets of pottery again in 2015, but based on review of the competition, we are going to lower the selling price to €890 per set. To encourage increased sales, we will raise sales commissions to 12 percent of the selling price.*

The president is concerned that the changes described by the vice presidents may not improve operating income sufficiently in 2015. If operating income does not increase by at least 10 percent, she will want to find other ways to reduce the company's costs. She asks you to evaluate the situation in a written report. Because it is already January 2015 and changes need to be made quickly, she requests your report within five days.

1. Prepare a budgeted contribution margin income statement for 2015. Your report should show the budgeted (estimated) operating income based on the information provided above and in **C3**. Will the changes improve operating income sufficiently? Explain.
2. In preparation for writing your report, answer the following questions:
  - a. Why are you preparing the report?
  - b. Who needs the report?
  - c. What sources of information will you use?
  - d. When is the report due?

## LO 5

**Decision Analysis: Planning Future Sales**

## SPREADSHEET

**C5.** As noted in **C3** and **C4**, Datura, Ltd., sold 15,000 sets of pottery in 2014. For the next year, 2015, Datura's strategic planning team targeted sales of 15,000 sets of pottery, reduced the selling price to €890 per set, increased sales commissions to 12 percent of the selling price, and decreased fixed distribution costs by 10 percent and variable distribution costs by 4 percent. It was assumed that all other costs would stay the same.

Based on an analysis of these changes, Datura's president is concerned that the proposed strategic plan will not meet her goal of increasing Datura's operating income by 10 percent over last year's income and that the operating income will be less than last year's income. She has come to you for spreadsheet analysis of the proposed strategic plan and for analysis of a special order she just received from an Australian distributor for 4,500 sets of pottery. The order's selling price, variable purchases cost per unit, sales commission, and total fixed costs will be the same as for the rest of the business, but the variable distribution costs will be €160 per unit.

Using a spreadsheet, complete the following tasks:

1. Calculate the targeted operating income for 2015 using just the proposed strategic plan. (Round to the nearest whole number.)
2. Prepare a budgeted contribution margin income statement for 2015 based on just the strategic plan. Do you agree with Datura's president that the company's projected operating income for 2015 will be less than the operating income for 2014? Explain your answer.
3. Calculate the total contribution margin from the Australian sales.
4. Prepare a revised budgeted contribution margin income statement for 2015 that includes the Australian order. (*Hint:* Combine the information from **2** and **3** above.)
5. Does Datura need the Australian sales to achieve its targeted operating income for 2015?

## RATIO

**Continuing Case: Cookie Company**

**C6.** In this segment of our continuing cookie company case, you will classify the costs of the business as variable, fixed, or mixed; use the high-low method to evaluate utility costs; and prepare a contribution margin income statement.

1. Review your cookie recipe and the overhead costs you identified in previous chapters, and classify the costs as variable, fixed, or mixed costs.
2. Obtain your electric bills for three months, and use the high-low method's cost formula to determine the monthly cost of electricity—that is, monthly electric cost = variable rate per kilowatt-hour + monthly fixed cost. If you do not receive an electric bill, use the following information:

Month	Kilowatt-Hours Used	Electric Costs
August	1,439	\$202
September	1,866	230
October	1,146	158

3. a. Prepare a daily contribution margin income statement based on the following assumptions:

My Cookie Company makes only one kind of cookie and sells it for \$1.00 per unit. The company projects sales of 500 units per day. Projected daily costs are as follows:

Type of Cost	Manufacturing	Nonmanufacturing
Variable	\$100	\$50
Nonvariable	120	60

- b. What is the contribution margin ratio?
- c. What volume, in terms of units, must the company sell to break even each day? (Round to the nearest dollar.)



# CHAPTER 22

## The Budgeting Process

### BUSINESS INSIGHT

#### Framecraft Company

Framecraft Company makes high-quality plastic picture frames. Because the company believes its work force is its most valuable asset, one of its priorities is to help employees attain their personal goals. To achieve congruence between its goals and its employees' personal aspirations, Framecraft has adopted a participatory budgeting process that involves personnel at all levels of the company. This ongoing dialogue provides both managers and lower-level employees with insight into the company's current activities and future direction and motivates them to improve their performance, which, in turn, improves the company's performance.

- 1. CONCEPT** ► *What concepts underlie the usefulness of the budgeting process?*
- 2. ACCOUNTING APPLICATION** ► *How does the budgeting process translate long-term goals into operating objectives?*
- 3. BUSINESS APPLICATION** ► *Why are budgets an essential part of planning, controlling, evaluating, and reporting on business?*

### LEARNING OBJECTIVES

- LO 1** Define *budgeting* and describe how it relates to the concepts of comparability and understandability.
- LO 2** Identify the elements of a master budget in different types of organizations and the guidelines for preparing budgets.
- LO 3** Prepare the operating budgets that support the financial budgets.
- LO 4** Prepare a budgeted income statement, a cash budget, and a budgeted balance sheet.
- LO 5** Explain why budgeting is essential to the management process.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Comparability
- Understandability

RELEVANT  
LEARNING OBJECTIVE

**LO 1** Define *budgeting* and describe how it relates to the concepts of comparability and understandability.

## LO 1 Concepts Underlying the Budgeting Process

**Budgeting** is the process of identifying, gathering, summarizing, and communicating financial and nonfinancial information about an organization's future activities. The budgeting process provides managers of all types of organizations the opportunity to match their organizational goals with the resources necessary to accomplish those goals. Budgeting empowers all in the organization to understand organizational goals in terms of their responsibilities and be held accountable for budget plans and results since they can be compared. Budgeting is synonymous with managing an organization. **Budgets** are plans of action based on forecasted transactions, activities, and events.

The concepts of *understandability* and *comparability* underlie the power of budgeting. Budgeting enhances *understandability*, since managers and employees will understand their organizational roles and responsibilities based on how the budget links the organization's strategic plans to its annual plans. Because the budget expresses these plans and objectives in concrete monetary terms, managers and employees are able to understand and act in ways that will achieve them. Budgeting enhances *comparability*, since budget-to-actual comparisons give managers and employees a means of monitoring the results of their actions. As you will see in this chapter, budgeting is not only an essential part of planning; it also helps managers command, control, evaluate, and report on operations.

### The Master Budget

A **master budget** consists of a set of operating budgets and a set of financial budgets that detail an organization's financial plans for a specific period, generally a year. When a master budget covers an entire year, some of the operating and financial budgets may show planned results by month or by quarter. As the term implies, **operating budgets** are plans used in daily operations.

Operating budgets include:

- sales budget
- production budget
- direct materials purchases budget
- direct labor budget
- overhead budget
- selling and administrative expenses budget
- cost of goods manufactured budget

The sales budget is prepared first because it is used to estimate sales volume and revenues. Once managers know the quantity of products or services to be sold and how many sales dollars to expect, they can develop other budgets that will enable them to manage their resources so that they generate profits on those sales.

Operating budgets are also the basis for preparing the **financial budgets**, which are projections of financial results for the period.

Financial budgets include:

- a budgeted income statement
- a capital expenditures budget
- a cash budget
- a budgeted balance sheet

**STUDY NOTE:** Budgeted financial statements are often referred to as forecasted financial statements, pro forma financial statements, or forward-looking financial statements.

The budgeted income statement and budgeted balance sheet are also called **pro forma financial statements**, meaning that they show projections rather than actual results. Pro forma financial statements are often used to communicate business plans to external parties. For example, if you apply for a bank loan to start a new business, you would have to present a pro forma income statement and balance sheet showing that you could repay the loan with cash generated by profitable operations.

## APPLY IT!

A master budget is a compilation of forecasts for the coming year or operating cycle made by various departments or functions within an organization. What is the most important forecast made in a master budget? List the reasons for your answer.

- a. Direct materials purchases in units
- b. Sales in units
- c. Cash outflows
- d. Selling expenses

### SOLUTION

b. The amount of estimated sales in units is the most important forecast. It is the key to an accurate master budget. The entire master budget is based on the unit sales forecast.

### TRY IT! SE1



## SECTION 2

## ACCOUNTING APPLICATIONS

### ACCOUNTING APPLICATIONS

- Prepare operating budgets
  - Sales budget
  - Production budget
  - Direct materials purchases budget
  - Direct labor budget
  - Overhead budget
  - Selling and administrative expenses budget
  - Cost of goods manufactured budget
- Prepare financial budgets
  - Budgeted income statement
  - Cash budget
  - Budgeted balance sheet

### RELEVANT LEARNING OBJECTIVES

**LO 2** Identify the elements of a master budget in different types of organizations and the guidelines for preparing budgets.

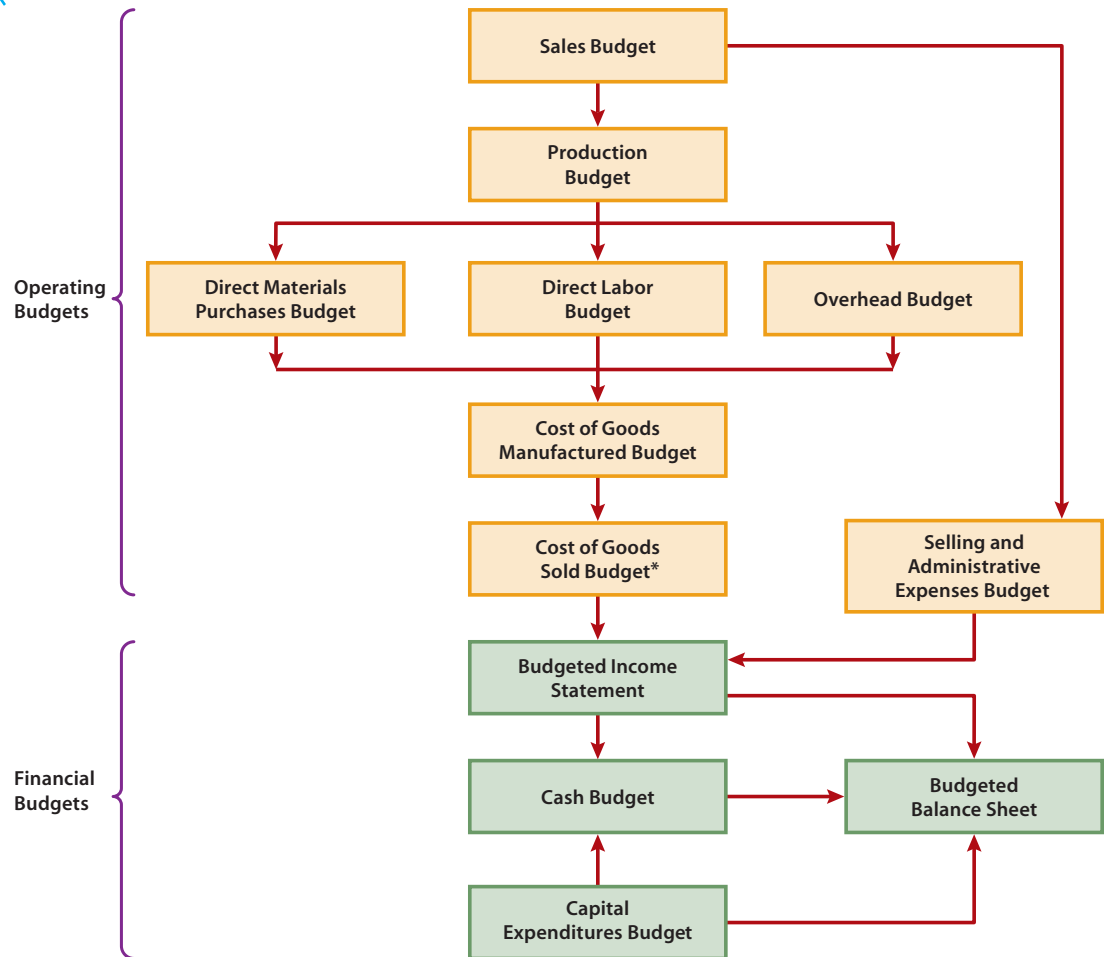
**LO 3** Prepare the operating budgets that support the financial budgets.

**LO 4** Prepare a budgeted income statement, a cash budget, and a budgeted balance sheet.

## LO 2 Preparation of a Master Budget

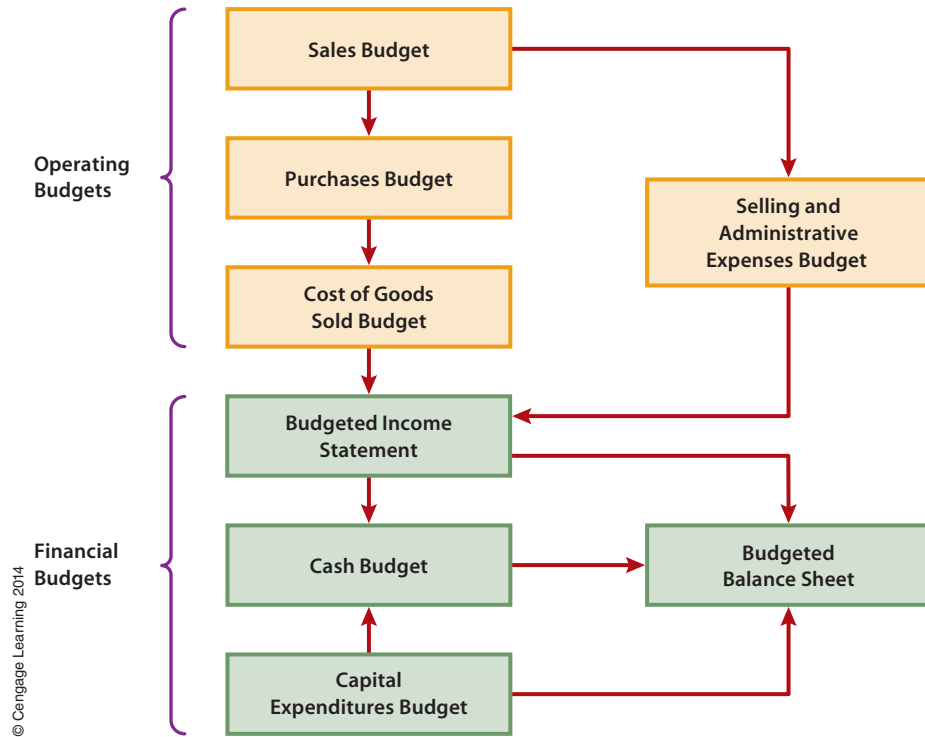
Exhibits 1, 2, and 3 display the elements of a master budget for a manufacturing organization, a retail organization, and a service organization, respectively. As these illustrations indicate, the process of preparing a master budget is similar in all three types of organizations in that each prepares a set of operating budgets that serve as the basis for preparing the financial budgets. The sales budget (or, in service organizations, the service revenue budget) is prepared first because it is used to estimate sales volume and revenues. Once managers know the quantity of products or services to be sold and how many sales dollars to expect, they can develop other budgets that will enable them to manage their resources so that they generate profits on those sales.

**Exhibit 1**  
Preparation of a Master Budget for a Manufacturing Organization

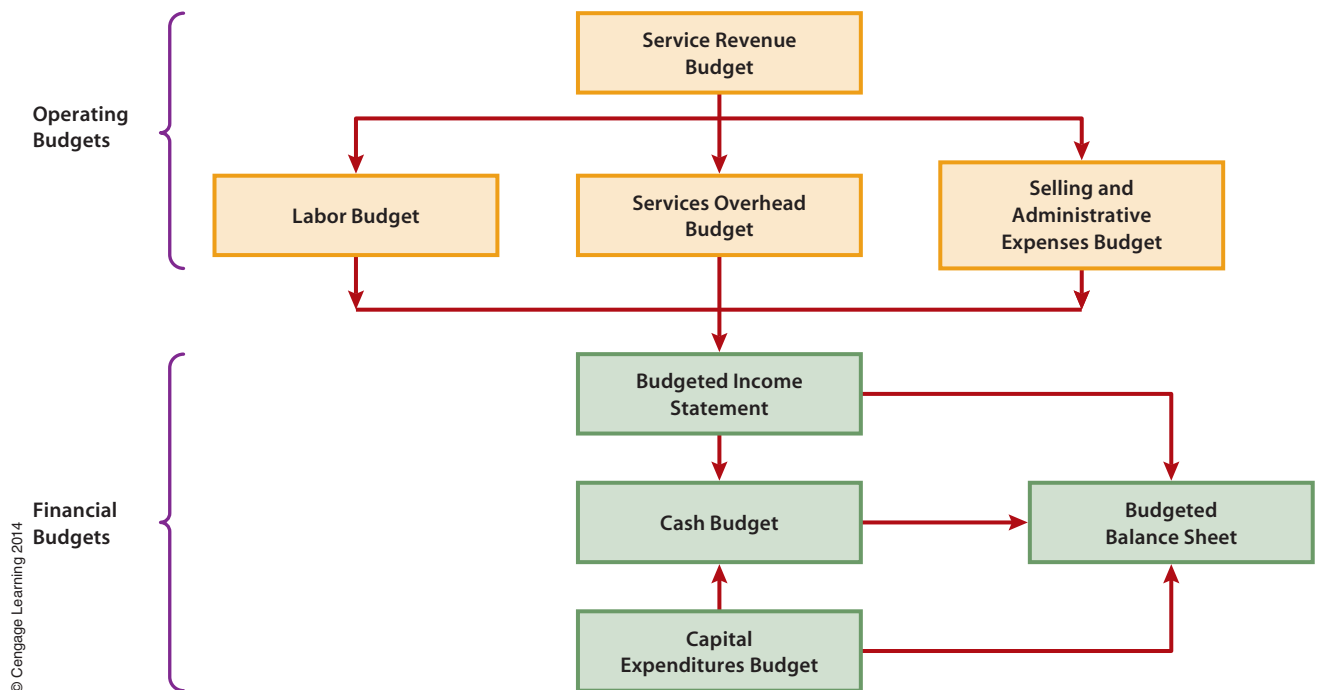


\*Some organizations choose to include the cost of goods sold budget in the budgeted income statement.

**Exhibit 2**  
Preparation of a Master Budget  
for a Retail Organization



**Exhibit 3**  
Preparation of a Master Budget for a Service Organization



The process differs mainly in the kinds of operating budgets that each type of organization prepares.

- The operating budgets of manufacturing organizations, such as Framcraft, **GM**, and **Harley-Davidson**, include budgets for sales, production, direct materials, direct labor, overhead, selling and administrative expenses, and cost of goods manufactured.

- Retail organizations, such as **Michaels**, **Old Navy**, and **Lowe's**, prepare a sales budget, a purchases budget, a selling and administrative expenses budget, and a cost of goods sold budget.
- The operating budgets of service organizations, such as **Enterprise Rent-A-Car**, **UPS**, and **Amtrak**, include budgets for service revenue (sales), labor, services overhead, and selling and administrative expenses.

## Budget Procedures

Because procedures for preparing budgets vary from organization to organization, there is no standard format for budget preparation. The only universal requirement is that budgets communicate the appropriate information to the reader in a clear and understandable manner. Using the following guidelines, managers can improve the quality of budgets in any type of organization:

- Know the purpose of the budget, and clearly identify who is responsible for carrying out the activities in the budget.
- Identify the user group and its information needs.
- Identify sources of accurate, meaningful budget information. Such information may be gathered from documents or from interviews with employees, suppliers, or managers who work in the related areas.
- Establish a clear format for the budget. A budget should begin with a clearly stated heading that includes the organization's name, the type of budget, and the accounting period under consideration. The budget's components should be clearly labeled, and the unit and financial data should be listed in an orderly manner.
- Use appropriate formulas and calculations in deriving the quantitative information.
- Revise the budget until it includes all planning decisions. Several revisions may be required before the final version is ready for distribution.

## APPLY IT!

Identify the order in which the following budgets are prepared:

- overhead budget
- production budget
- direct labor budget
- direct materials purchases budget
- sales budget
- budgeted balance sheet
- cash budget
- budgeted income statement

### SOLUTION

1. sales budget
2. production budget
3. direct materials purchases budget, direct labor budget, and overhead budget
4. budgeted income statement
5. cash budget
6. budgeted balance sheet

**TRY IT! SE1, E1A, E1B**

## LO 3 Operating Budgets

We use Framcraft Company to illustrate how a manufacturing organization prepares its operating budgets. Because Framcraft makes only one product—a plastic picture frame—it prepares only one of each type of operating budget as it plans for daily operations in the coming year. Organizations that manufacture a variety of products or provide many types of services may prepare either separate operating budgets or one comprehensive budget for each product or service.

### The Sales Budget

The first step in preparing a master budget is to prepare a sales budget. A **sales budget** shows expected sales during a period, expressed in both units and dollars. Sales managers use this information to plan sales- and marketing-related activities and to determine

**STUDY NOTE:** The sales budget is the only budget based on an estimate of customer demand. Other budgets for the period are based on the sales numbers.

their human, physical, and technical resource needs. Accountants use the information to determine estimated cash receipts for the cash budget.

The following equation is used to determine the total budgeted sales:

$$\text{Total Budgeted Sales} = \text{Estimated Selling Price per Unit} \times \text{Estimated Sales in Units}$$

Although the calculation is easy, selecting the best estimates for the selling price per unit and the sales demand in units can be difficult. An estimated selling price below the current selling price may be needed if competitors are currently selling the same product or service at lower prices or if the organization wants to increase its share of the market. On the other hand, if the organization has improved the quality of its product or service by using more expensive materials or processes, the estimated selling price may have to be higher than the current price.

The estimated sales volume is very important because it will affect the level of operating activities and the amount of resources needed for operations. To help estimate sales volume, managers often use a **sales forecast**, which is a projection of the estimated sales in units, based on an analysis of external and internal factors.

External factors include:

- the state of the local and national economies
- the state of the industry’s economy
- the nature of the competition and its sales volume and selling price

Internal factors include:

- the number of units sold in prior periods
- the organization’s credit policies
- the organization’s collection policies
- the organization’s pricing policies
- any new products that the organization plans to introduce to the market
- the capacity of the organization’s manufacturing facilities

Exhibit 4 shows Framecraft’s sales budget for the year. The budget shows the estimated number of unit sales and dollar revenue amounts for each quarter and for the entire year. Because the sales forecast indicated a highly competitive marketplace, Framecraft’s managers have estimated a selling price of \$5 per unit. The sales forecast also indicated highly seasonal sales activity. The estimated sales volume therefore varies from 10,000 to 40,000 per quarter.

**Exhibit 4**  
Sales Budget

<b>Framecraft Company Sales Budget For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Sales in units	10,000	30,000	10,000	40,000	90,000
Selling price per unit	× \$5	× \$5	× \$5	× \$5	× \$5
Total sales	<u>\$50,000</u>	<u>\$150,000</u>	<u>\$50,000</u>	<u>\$200,000</u>	<u>\$450,000</u>

© Cengage Learning 2014

## The Production Budget

A **production budget** shows the number of units that a company must produce to meet budgeted sales and inventory needs. Production managers use this information to plan for the materials and human resources that production-related activities will require. To prepare a production budget, managers must know the budgeted number of unit sales

(which is specified in the sales budget) and the desired level of ending finished goods inventory for each period in the budget year. That level is often stated as a percentage of the next period's budgeted unit sales.

For example, Framecraft's desired level of ending finished goods inventory is 10 percent of the next quarter's budgeted unit sales. (Its desired level of beginning finished goods inventory is 10 percent of the current quarter's budgeted unit sales.)

The following formula identifies the production needs for each period:

$$\begin{array}{r} \text{Total Production} \\ \text{Units} \end{array} = \begin{array}{r} \text{Budgeted Sales in} \\ \text{Units} \end{array} + \begin{array}{r} \text{Desired Units of} \\ \text{Ending Finished} \\ \text{Goods Inventory} \end{array} - \begin{array}{r} \text{Desired Units of} \\ \text{Beginning Finished} \\ \text{Goods Inventory} \end{array}$$

Exhibit 5 shows Framecraft's production budget for the year. Notice that each quarter's desired total units of ending finished goods inventory become the next quarter's desired total units of beginning finished goods inventory.

### Exhibit 5 Production Budget

<b>Framecraft Company</b>					
<b>Production Budget (Units)</b>					
<b>For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Sales in units	10,000	30,000	10,000	40,000	90,000
Plus desired units of ending finished goods inventory	<u>3,000</u>	<u>1,000</u>	<u>4,000</u>	<u>1,500</u>	<u>1,500</u>
Desired total units	13,000	31,000	14,000	41,500	91,500
Less desired units of beginning finished goods inventory	<u>1,000</u>	<u>3,000</u>	<u>1,000</u>	<u>4,000</u>	<u>1,000</u>
Total production units	<u>12,000</u>	<u>28,000</u>	<u>13,000</u>	<u>37,500</u>	<u>90,500</u>

© Cengage Learning 2014

Because unit sales of 15,000 are budgeted for the first quarter of next year, the ending finished goods inventory for the fourth quarter of the year is 1,500 units ( $0.10 \times 15,000$  units), which is the same as the desired number of units of ending finished goods inventory for the entire year.

## The Direct Materials Purchases Budget

A **direct materials purchases budget** identifies the quantity of purchases required to meet budgeted production and inventory needs and the costs associated with those purchases. A purchasing department uses this information to plan purchases of direct materials. Accountants use the same information to estimate cash payments to suppliers.

To prepare a direct materials purchases budget, managers must know what production needs will be in each period. This information is provided by the production budget. They must also know the desired level of the direct materials inventory for each period and the per-unit cost of direct materials. The desired level of ending direct materials inventory is usually stated as a percentage of the next period's production needs.

For example, Framecraft's desired level of ending direct materials inventory is 20 percent of the next quarter's budgeted production needs. (Its desired level of beginning direct materials inventory is 20 percent of the current quarter's budgeted production needs.)

The following steps are involved in preparing a direct materials purchases budget:

- **Step 1.** Calculate each period’s total production needs in units of direct materials using the following formula:

$$\begin{array}{r} \text{Total Production Needs} \\ \text{in Units of Direct} \\ \text{Materials} \end{array} = \begin{array}{r} \text{Total Production} \\ \text{Units} \end{array} \times \begin{array}{r} \text{Required Amount of} \\ \text{Direct Materials per} \\ \text{Unit} \end{array}$$

Plastic is the only direct material used in Framecraft’s picture frames. Framecraft’s managers calculate units of production needs in ounces by multiplying the number of frames budgeted for production by the 10 ounces of plastic that each frame requires.

- **Step 2.** Determine the quantity of direct materials to be purchased during each accounting period in the budget using the following formula:

$$\begin{array}{r} \text{Total Units} \\ \text{of Direct} \\ \text{Materials to} \\ \text{Be Purchased} \end{array} = \begin{array}{r} \text{Total Production} \\ \text{Needs in} \\ \text{Units of Direct} \\ \text{Materials} \end{array} + \begin{array}{r} \text{Desired Units} \\ \text{of Ending} \\ \text{Direct Materials} \\ \text{Inventory} \end{array} - \begin{array}{r} \text{Desired Units} \\ \text{of Beginning} \\ \text{Direct Materials} \\ \text{Inventory} \end{array}$$

As shown in Exhibit 6, Framecraft’s total ounces of direct materials to be purchased in the first quarter are 152,000 ounces and for the year are 911,000 ounces.

- **Step 3.** Calculate the cost of the direct materials purchases using the following formula:

$$\begin{array}{r} \text{Cost of Direct} \\ \text{Materials Purchased} \end{array} = \begin{array}{r} \text{Total Units to} \\ \text{Be Purchased} \end{array} \times \begin{array}{r} \text{Direct Materials Cost} \\ \text{per Unit} \end{array}$$

Framecraft’s Purchasing Department has estimated the cost of the plastic used in the picture frames at \$0.05 per ounce.

Exhibit 6 shows Framecraft’s direct materials purchases budget for the year. Notice that each quarter’s desired units of ending direct materials inventory become the next quarter’s desired units of beginning direct materials inventory.

**Exhibit 6**  
Direct Materials  
Purchases Budget

<b>Framecraft Company</b>					
<b>Direct Materials Purchases Budget</b>					
<b>For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Total production units	12,000	28,000	13,000	37,500	90,500
Ounces per unit	× 10	× 10	× 10	× 10	× 10
Total production needs in ounces	120,000	280,000	130,000	375,000	905,000
Plus desired ounces of ending direct materials inventory	56,000	26,000	75,000	30,000	30,000
	176,000	306,000	205,000	405,000	935,000
Less desired ounces of beginning direct materials inventory	24,000	56,000	26,000	75,000	24,000
Total ounces of direct materials to be purchased	152,000	250,000	179,000	330,000	911,000
Cost per ounce	× \$0.05	× \$0.05	× \$0.05	× \$0.05	× \$0.05
Total cost of direct materials purchases	\$ 7,600	\$ 12,500	\$ 8,950	\$ 16,500	\$ 45,550

© Cengage Learning 2014

Framecraft's budgeted number of units for the first quarter of the following year is 150,000 ounces; its ending direct materials inventory for the fourth quarter of this year is therefore 30,000 ounces ( $0.20 \times 150,000$  ounces), which is the same as the number of desired units of ending direct materials inventory for the entire year.

## The Direct Labor Budget

A **direct labor budget** shows the direct labor hours needed during a period and the associated costs. Production managers use estimated direct labor hours to plan how many employees will be required during the period and the hours that each will work. Accountants use estimated direct labor costs to plan for cash payments to the workers. Managers of human resources use the direct labor budget in deciding whether to hire new employees or reduce the existing work force. The direct labor budget also serves as a guide in assessing employee training needs and preparing schedules of employee benefits.

The following two steps are used to prepare a direct labor budget:

- **Step 1.** Estimate the total direct labor hours using the following formula:

$$\text{Total Direct Labor Hours} = \text{Estimated Direct Labor Hours per Unit} \times \text{Total Production Units}$$

Framecraft's Production Department needs an estimated one-tenth (0.10) of a direct labor hour to complete one unit.

- **Step 2.** Calculate the total budgeted direct labor cost using the following formula:

$$\text{Total Budgeted Direct Labor Costs} = \text{Total Direct Labor Hours} \times \text{Estimated Direct Labor Cost per Hour}$$

A company's human resources department provides an estimate of the hourly labor wage. Framecraft's Human Resources Department estimates a direct labor cost of \$6 per hour.

Exhibit 7 shows how Framecraft uses these data and formulas to estimate the total direct labor cost.

### Exhibit 7 Direct Labor Budget

<b>Framecraft Company</b>					
<b>Direct Labor Budget</b>					
<b>For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Total production units	12,000	28,000	13,000	37,500	90,500
Direct labor hours per unit	$\times 0.10$	$\times 0.10$	$\times 0.10$	$\times 0.10$	$\times 0.10$
Total direct labor hours	1,200	2,800	1,300	3,750	9,050
Direct labor cost per hour	$\times \$6$	$\times \$6$	$\times \$6$	$\times \$6$	$\times \$6$
Total direct labor cost	<u>\$7,200</u>	<u>\$16,800</u>	<u>\$7,800</u>	<u>\$22,500</u>	<u>\$54,300</u>

© Cengage Learning 2014

## The Overhead Budget

An **overhead budget** shows the anticipated manufacturing costs, other than direct materials and direct labor costs, that must be incurred to meet budgeted production needs. It has two purposes:

- To integrate the overhead cost budgets developed by the managers of production and production-related departments.
- To group information for the calculation of overhead rates for the next accounting period.



The format for presenting information in an overhead budget is flexible. Grouping information by activities is useful for organizations that use activity-based costing. This approach makes it easier for accountants to determine the application rates for each cost pool.

### Exhibit 8 Overhead Budget

<b>Framecraft Company Overhead Budget For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
<b>Total production units</b>	<b>12,000</b>	<b>28,000</b>	<b>13,000</b>	<b>37,500</b>	<b>90,500</b>
Variable overhead costs:*					
Factory supplies (\$0.18)	\$ 2,160	\$ 5,040	\$ 2,340	\$ 6,750	\$ 16,290
Employee benefits (\$0.24)	2,880	6,720	3,120	9,000	21,720
Inspection (\$0.09)	1,080	2,520	1,170	3,375	8,145
Maintenance and repairs (\$0.16)	1,920	4,480	2,080	6,000	14,480
Utilities (\$0.30)	3,600	8,400	3,900	11,250	27,150
Total variable overhead costs	<u>\$11,640</u>	<u>\$27,160</u>	<u>\$12,610</u>	<u>\$36,375</u>	<u>\$ 87,785</u>
Fixed overhead costs:					
Depreciation—machinery	\$ 2,810	\$ 2,810	\$ 2,810	\$ 2,810	\$ 11,240
Depreciation—building	3,225	3,225	3,225	3,225	12,900
Supervision	9,000	9,000	9,000	9,000	36,000
Maintenance and repairs	2,150	2,150	2,150	2,150	8,600
Other overhead expenses	3,630	3,630	3,630	3,630	14,520
Total fixed overhead costs	<u>\$20,815</u>	<u>\$20,815</u>	<u>\$20,815</u>	<u>\$20,815</u>	<u>\$ 83,260</u>
Total overhead costs	<u>\$32,455</u>	<u>\$47,975</u>	<u>\$33,425</u>	<u>\$57,190</u>	<u>\$171,045</u>

\*Amounts in parentheses are unit variable costs.

© Cengage Learning 2014

As Exhibit 8 shows, Framecraft prefers to group overhead information into variable and fixed costs to facilitate CVP analysis. The single overhead rate is computed using the following formula:

$$\text{Single Overhead Rate} = \text{Estimated Total Overhead Costs} \div \text{Estimated Total Direct Labor Hours}$$

Framecraft's predetermined overhead rate is:

$$\$171,045 \div 9,050 \text{ direct labor hours} = \underline{\underline{\$18.90}} \text{ per direct labor hour}$$

or

$$\$18.90 \text{ per direct labor hour} \times 0.10 \text{ direct labor hour per unit} = \underline{\underline{\$1.89}} \text{ per unit produced}$$

## The Selling and Administrative Expenses Budget

A **selling and administrative expenses budget** shows the operating expenses, other than those related to production, that are needed to support sales and overall operations during a period. Accountants use this budget to estimate cash payments for products or services not used in production-related activities.

Framecraft's selling and administrative expenses budget appears in Exhibit 9. The company groups its selling and administrative expenses into variable and fixed

**STUDY NOTE:** Selling and administrative expenses are period costs, not product costs.

**Exhibit 9**  
Selling and Administrative  
Expenses Budget

<b>Framecraft Company</b>					
<b>Selling and Administrative Expenses Budget</b>					
<b>For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
<b>Total sales units</b>	<b>10,000</b>	<b>30,000</b>	<b>10,000</b>	<b>40,000</b>	<b>90,000</b>
Variable selling and administrative expenses:*					
Delivery expenses (\$0.08)	\$ 800	\$ 2,400	\$ 800	\$ 3,200	\$ 7,200
Sales commissions (\$0.10)	1,000	3,000	1,000	4,000	9,000
Accounting (\$0.07)	700	2,100	700	2,800	6,300
Other administrative Expenses (\$0.04)	400	1,200	400	1,600	3,600
<b>Total variable selling and administrative expenses</b>	<b>\$ 2,900</b>	<b>\$ 8,700</b>	<b>\$ 2,900</b>	<b>\$11,600</b>	<b>\$ 26,100</b>
Fixed selling and administrative expenses:					
Sales salaries	\$ 4,500	\$ 4,500	\$ 4,500	\$ 4,500	\$ 18,000
Executive salaries	12,750	12,750	12,750	12,750	51,000
Depreciation—office equipment	925	925	925	925	3,700
Taxes and insurance	1,700	1,700	1,700	1,700	6,800
<b>Total fixed selling and administrative expenses</b>	<b>\$19,875</b>	<b>\$19,875</b>	<b>\$19,875</b>	<b>\$19,875</b>	<b>\$ 79,500</b>
<b>Total selling and administrative expenses</b>	<b>\$22,775</b>	<b>\$28,575</b>	<b>\$22,775</b>	<b>\$31,475</b>	<b>\$105,600</b>

\*Amounts in parentheses are unit variable costs.

© Cengage Learning 2014

components for purposes of cost behavior analysis, CVP analysis, and profit planning. The number of units sold, not produced, are used to compute this budget since selling and administrative costs are triggered by sales, not production.

## The Cost of Goods Manufactured Budget

A **cost of goods manufactured budget** summarizes the estimated costs of production during a period. The sources of information for total manufacturing costs are the direct materials, direct labor, and overhead budgets. Most manufacturing organizations anticipate some work in process at the beginning or end of a period. However, Framecraft has a policy of no work in process on December 31 of any year.

Exhibit 10 summarizes the company's estimated costs of production for the year. (The right-hand column of the exhibit shows the sources of key data.) The budgeted, or standard, product unit cost for one picture frame is computed as follows.

$$\begin{aligned}
 \text{Budgeted Product Unit Cost} &= \text{Cost of Goods Manufactured} \div \text{Units Produced} \\
 &= \$270,595 \div 90,500 \text{ units} \\
 &= \underline{\underline{\$2.99}}
 \end{aligned}$$

**Exhibit 10**  
**Cost of Goods**  
**Manufactured Budget**

Framecraft Company		Source of Data
Cost of Goods Manufactured Budget		
For the Year Ended December 31		
Direct materials used:		
Direct materials inventory, beginning	\$ 1,200*	Direct materials purchases budget
Purchases	<u>45,550</u>	Direct materials purchases budget
Cost of direct materials available for use	\$46,750	
Less direct materials inventory, ending	<u>1,500*</u>	Direct materials purchases budget
Cost of direct materials used	\$ 45,250	
Direct labor costs	54,300	Direct labor budget
Overhead costs	<u>171,045</u>	Overhead budget
Total manufacturing costs	\$270,595	
Work in process inventory, beginning	—**	
Less work in process inventory, ending	—**	
Cost of goods manufactured	<u>\$270,595</u>	

\* The desired direct materials inventory balance at the beginning of the year is \$1,200 (24,000 ounces × \$0.05 per ounce); at year end, it is \$1,500 (30,000 ounces × \$0.05 per ounce).  
 \*\* It is the company's policy to have no units in process at the beginning or end of the year.

© Cengage Learning 2014

**APPLY IT!**

Sample Company is preparing a production budget for the year. The company's policy is to maintain a finished goods inventory equal to one-half of the next month's sales. Sales of 4,000 units are budgeted for April. Complete the following monthly production budget for the first quarter to determine how many units should be produced in January, February, and March:

	January	February	March
Sales in units	3,000	2,400	6,000
Add desired units in ending finished goods inventory	<u>?</u>	<u>?</u>	<u>?</u>
Desired total units	?	?	?
Less desired units of beginning finished goods inventory	<u>?</u>	<u>?</u>	<u>?</u>
Total production units	<u>?</u>	<u>?</u>	<u>?</u>

**SOLUTION**

	January	February	March
Sales in units	3,000	2,400	6,000
Add desired units of ending finished goods inventory	<u>1,200</u>	<u>3,000</u>	<u>2,000</u>
Desired total units	4,200	5,400	8,000
Less desired units of beginning finished goods inventory	<u>1,500</u>	<u>1,200</u>	<u>3,000</u>
Total production units	<u>2,700</u>	<u>4,200</u>	<u>5,000</u>

**TRY IT! SE2, SE3, SE4, E2A, E3A, E4A, E5A, E6A, E7A, E2B, E3B, E4B, E5B, E6B, E7B**

## LO 4 Financial Budgets

With revenues and expenses itemized in the operating budgets, an organization is able to prepare the financial budgets, which are projections of financial results for the period. Financial budgets include a budgeted income statement, a capital expenditures budget, a cash budget, and a budgeted balance sheet.

### The Budgeted Income Statement

A **budgeted income statement** projects an organization's net income for a period based on the revenues and expenses estimated for that period. Exhibit 11 shows Framecraft's budgeted income statement for the year. The company's expenses include 8 percent interest paid on a \$70,000 note payable and income taxes paid at a rate of 30 percent. Information about projected sales and costs comes from several operating budgets. (The right-hand column of the exhibit shows the sources of key data.)

At this point, you can review the overall preparation of the operating budgets and the budgeted income statement by comparing the preparation flow in Exhibit 1 with the budgets in Exhibits 4 through 11. Framecraft has no separate budget for cost of goods sold since it is embedded in its budgeted income statement.

**Exhibit 11**  
Budgeted Income Statement

<b>Framecraft Company</b>		
<b>Budgeted Income Statement</b>		
<b>For the Year Ended December 31</b>		<b>Source of Data</b>
Sales	\$450,000	Sales budget
Cost of goods sold:		
Finished goods inventory, beginning	\$ 2,990*	Production budget
Cost of goods manufactured	<u>270,595</u>	Cost of goods manufactured budget
Cost of goods available for sale	\$273,585	
Less finished goods inventory, ending	<u>4,485**</u>	Production budget
Cost of goods sold	<u>269,100</u>	
Gross margin	\$180,900	
Selling and administrative expenses	<u>105,600</u>	Selling and admin. expenses budget
Income from operations	\$ 75,300	
Interest expense (8% × \$70,000)	<u>5,600</u>	
Income before income taxes	\$ 69,700	
Income taxes expense (30%)	<u>20,910</u>	
Net income	<u>\$ 48,790</u>	

Note: Finished goods inventory balances assume that product unit costs were the same in both years:

*Beginning	**Ending
1,000 units <sup>a</sup>	1,500 units <sup>a</sup>
× \$2.99 <sup>b</sup>	× \$2.99 <sup>b</sup>
<u>\$2,990</u>	<u>\$ 4,485</u>

<sup>a</sup>Production budget (Exhibit 5)

<sup>b</sup> $\$270,595 \div 90,500 \text{ units (Exhibits 10 and 5)} = \underline{\underline{\$2.99}}$

## The Capital Expenditures Budget

A **capital expenditures budget** outlines the anticipated amount and timing of capital outlays for long-term assets during a period. Managers rely on the information in a capital expenditures budget when making decisions about such matters as buying equipment, building a new plant, purchasing and installing a materials handling system, or acquiring another business. Framecraft’s capital expenditures budget for the year includes \$30,000 for the purchase of a new framemaking machine. The company plans to pay \$15,000 in the first quarter of the year, when the order is placed, and \$15,000 in the second quarter of the year, when it receives the machine. This information is necessary for preparing the company’s cash budget.\*



## The Cash Budget

A **cash budget** is a projection of the cash that an organization will receive and pay out during a period. It summarizes the cash flow prospects of all transactions considered in the master budget. Exhibit 12 shows how the elements of a cash budget relate to operating, investing, and financing activities.

A cash budget excludes planned noncash transactions, such as depreciation expense, amortization expense, issuance and receipt of stock dividends, uncollectible accounts expense, and gains and losses on sales of assets. Some organizations also exclude deferred taxes and accrued interest from the cash budget.

The following formula is useful in preparing a cash budget:

$$\text{Estimated Ending Cash Balance} = \text{Total Estimated Cash Receipts} - \text{Total Estimated Cash Payments} + \text{Estimated Beginning Cash Balance}$$

**Exhibit 12**  
Elements of a Cash Budget

Activities	Cash Receipts From	Cash Payments For
Operating	<ul style="list-style-type: none"> <li>Cash sales</li> <li>Cash collections on credit sales</li> <li>Interest income from investments</li> <li>Cash dividends from investments</li> </ul>	<ul style="list-style-type: none"> <li>Purchases of materials</li> <li>Direct labor</li> <li>Overhead expenses</li> <li>Selling and administrative expenses</li> <li>Interest expense</li> <li>Income taxes</li> </ul>
Investing	<ul style="list-style-type: none"> <li>Sale of investments</li> <li>Sale of long-term assets</li> </ul>	<ul style="list-style-type: none"> <li>Purchases of investments</li> <li>Purchases of long-term assets</li> </ul>
Financing	<ul style="list-style-type: none"> <li>Proceeds from loans</li> <li>Proceeds from issue of stock</li> <li>Proceeds from issue of bonds</li> </ul>	<ul style="list-style-type: none"> <li>Loan repayments</li> <li>Cash dividends to stockholders</li> <li>Retirement of bonds</li> <li>Purchases of treasury stock</li> </ul>

*Note:* Classifications of cash receipts and cash payments correspond to those in a statement of cash flows.

© Cengage Learning 2014

In estimating cash receipts and cash payments for the cash budget, many organizations prepare supporting schedules. For example, Framecraft’s controller converts credit sales to cash inflows and purchases made on credit to cash outflows and then discloses those conversions to support the cash budget.

\*We discuss capital expenditures in more detail in a later chapter.

**Cash Collections** The schedule in Exhibit 13 shows the cash that Framecraft expects to collect from customers during the year. Cash sales represent 20 percent of the company's expected sales; the other 80 percent are credit sales. Experience has shown that Framecraft collects payments for 60 percent of all credit sales in the quarter of sale, 30 percent in the quarter following sale, and 10 percent in the second quarter following sale.

**Exhibit 13**  
Schedule of Expected Cash  
Collections from Customers

<b>Framecraft Company</b>					
<b>Schedule of Expected Cash Collections from Customers</b>					
<b>For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Accounts receivable, beginning	\$38,000	\$ 10,000	\$ —	\$ —	\$ 48,000
Cash sales	10,000	30,000	10,000	40,000	90,000
Collections of credit sales:					
First quarter (\$40,000)	24,000	12,000	4,000	—	40,000
Second quarter (\$120,000)	—	72,000	36,000	12,000	120,000
Third quarter (\$40,000)	—	—	24,000	12,000	36,000
Fourth quarter (\$160,000)	—	—	—	96,000	96,000
Total cash to be collected from customers	<u>\$72,000</u>	<u>\$124,000</u>	<u>\$74,000</u>	<u>\$160,000</u>	<u>\$430,000</u>

© Cengage Learning 2014

As you can see in Exhibit 13, Framecraft's balance of accounts receivable was \$48,000 at the beginning of the budget year. The company expects to collect \$38,000 of that amount in the first quarter and the remaining \$10,000 in the second quarter. At the end of the budget year, the estimated ending balance of accounts receivable is \$68,000 comprised of \$ 4,000 from the third quarter's credit sales [ $(\$50,000 \times 0.80) \times 0.10$ ] and \$64,000 from the fourth quarter's sales [ $(\$200,000 \times 0.80) \times 0.40$ ].

The expected cash collections for each quarter and for the year appear in the total cash receipts section of the cash budget.

**Cash Payments** Exhibit 14 shows Framecraft's schedule of expected cash payments for direct materials during the year. This information is summarized in the first line of the cash payments section of the company's cash budget. Framecraft pays 50 percent of the invoices it receives in the quarter of purchase and the other 50 percent in the following quarter.

**Exhibit 14**  
Schedule of Expected Cash  
Payments for Direct Materials

<b>Framecraft Company</b>					
<b>Schedule of Expected Cash Payments for Direct Materials</b>					
<b>For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Accounts payable, beginning	\$4,200	\$ —	\$ —	\$ —	\$ 4,200
First quarter (\$7,600)	3,800	3,800	—	—	7,600
Second quarter (\$12,500)	—	6,250	6,250	—	12,500
Third quarter (\$8,950)	—	—	4,475	4,475	8,950
Fourth quarter (\$16,500)	—	—	—	8,250	8,250
Total cash payments for direct materials	<u>\$8,000</u>	<u>\$10,050</u>	<u>\$10,725</u>	<u>\$12,725</u>	<u>\$41,500</u>

© Cengage Learning 2014

The beginning balance of accounts payable for the first quarter is given at \$4,200. At the end of the budget year, the estimated ending balance of accounts payable is \$8,250 (50 percent of the \$16,500 of direct materials purchases in the fourth quarter).

**Exhibit 15**  
**Cash Budget**

**Cash Budget** Framecraft's cash budget for the year appears in Exhibit 15. (The right-hand column of the exhibit shows the sources of key data.) It shows the estimated cash

<b>Framecraft Company</b>						<b>Source of Data</b>
<b>Cash Budget</b>						
<b>For the Year Ended December 31</b>						
	<b>Quarter</b>				<b>Year</b>	
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>		
<b>Cash receipts:</b>						
Cash collections from customers	\$ 72,000	\$124,000	\$74,000	\$160,000	\$430,000	Schedule of expected cash collections from customers
Total cash receipts	\$ 72,000	\$124,000	\$74,000	\$160,000	\$430,000	
<b>Cash payments:</b>						
Direct materials	\$ 8,000	\$ 10,050	\$10,725	\$ 12,725	\$ 41,500	Schedule of expected cash payments for direct materials
Direct labor	7,200	16,800	7,800	22,500	54,300	Direct labor budget
Factory supplies	2,160	5,040	2,340	6,750	16,290	Overhead budget
Employee benefits	2,880	6,720	3,120	9,000	21,720	Overhead budget
Inspection	1,080	2,520	1,170	3,375	8,145	Overhead budget
Variable maintenance and repairs	1,920	4,480	2,080	6,000	14,480	Overhead budget
Utilities	3,600	8,400	3,900	11,250	27,150	Overhead budget
Supervision	9,000	9,000	9,000	9,000	36,000	Overhead budget
Fixed maintenance and repairs	2,150	2,150	2,150	2,150	8,600	Overhead budget
Other overhead expenses	3,630	3,630	3,630	3,630	14,520	Overhead budget
Delivery expenses	800	2,400	800	3,200	7,200	Selling and admin. expenses budget
Sales commissions	1,000	3,000	1,000	4,000	9,000	Selling and admin. expenses budget
Accounting	700	2,100	700	2,800	6,300	Selling and admin. expenses budget
Other administrative expenses	400	1,200	400	1,600	3,600	Selling and admin. expenses budget
Sales salaries	4,500	4,500	4,500	4,500	18,000	Selling and admin. expenses budget
Executive salaries	12,750	12,750	12,750	12,750	51,000	Selling and admin. expenses budget
Taxes and insurance	1,700	1,700	1,700	1,700	6,800	Selling and admin. expenses budget
Capital expenditures*	15,000	15,000			30,000	Budgeted income statement
Interest expense	1,400	1,400	1,400	1,400	5,600	Budgeted income statement
Income taxes	5,228	5,227	5,228	5,227	20,910	Budgeted income statement
Total cash payments	\$ 85,098	\$118,067	\$74,393	\$123,557	\$401,115	
Cash increase (decrease)	\$ (13,098)	\$ 5,933	\$ (393)	\$ 36,443	\$ 28,885	
Beginning cash balance	20,000	6,902	12,835	12,442	20,000	
Ending cash balance	\$ 6,902	\$ 12,835	\$12,442	\$ 48,885	\$ 48,885	

\*The company plans to purchase a machine costing \$30,000 and to pay for it in two installments of \$15,000 each in the first and second quarters of the year.



receipts and cash payments for the period, as well as the cash increase or decrease. The cash increase or decrease plus the period's beginning cash balance equals the ending cash balance anticipated for the period. As you can see in Exhibit 15, the beginning cash balance for the first quarter is \$20,000. Note that each quarter's budgeted ending cash balance becomes the next quarter's beginning cash balance. Also note that equal income tax payments are made quarterly.

**Minimum Cash Balance** Many organizations maintain a minimum cash balance to provide a margin of safety against uncertainty. If the ending cash balance on the cash budget falls below the minimum level required, short-term borrowing may be necessary to cover planned cash payments during the year. If the ending cash balance is significantly larger than the organization needs, it may invest the excess cash in short-term securities to generate additional income.

For example, if Framcraft wants a minimum of \$10,000 cash available at the end of each quarter, its balance of \$6,902 at the end of the first quarter indicates that there is a problem. Framcraft can borrow cash to cover the first quarter's cash needs, delay purchasing the new machine until the second quarter, or reduce some of the operating expenses. On the other hand, the balance at the end of the fourth quarter may be higher than the company wants, in which case management might invest a portion of the idle cash in short-term securities.

## The Budgeted Balance Sheet

A **budgeted balance sheet** projects an organization's financial position at the end of a period. It uses all estimated data compiled in preparing a master budget and is the final step in the budgeting process. Exhibit 16 presents Framcraft Company's budgeted balance sheet at the end of the year. (The right-hand column of the exhibit shows the sources of key data.) The beginning balances for Land, Notes Payable, Common Stock, and Retained Earnings were \$50,000, \$70,000, \$150,000, and \$52,107, respectively.

### APPLY IT!

Sample Corporation's budgeted balance sheet for the beginning of the coming year shows total assets of \$5,000,000 and total liabilities of \$2,000,000. Common stock and retained earnings make up the entire stockholders' equity section of the balance sheet. Common stock remains at its beginning balance of \$1,500,000. The projected net income for the year is \$350,000. The company plans to pay no cash dividends. What is the balance of retained earnings at the beginning and end of the year?

#### SOLUTION

Using the accounting equation  $A = L + OE$ , knowing that common stock + retained earnings make up the entire OE, and the information given:

Beginning retained earnings:

$$\$5,000,000 = \$2,000,000 + \$1,500,000 + \text{Beginning RE}$$

Thus, the beginning balance of retained earnings is \$1,500,000.

Ending retained earnings:

Beginning retained earnings	\$1,500,000
+ Net income	350,000
– Dividends	<u>0</u>
Ending retained earnings	<u>\$1,850,000</u>

**TRY IT! SE4, SE5, SE6, SE7, SE8, E8A, E9A, E10A, E11A, E12A, E8B, E9B, E10B, E11B, E12B**

**Exhibit 16**  
Budgeted  
Balance Sheet

Framecraft Company Budgeted Balance Sheet		December 31	Source of Data
<b>Assets</b>			
Current assets:			
Cash	\$	48,885	Cash budget
Accounts receivable		68,000 <sup>a</sup>	Schedule of expected cash collections from customers
Direct materials inventory		1,500	Cost of goods manufactured budget
Work in process inventory		—	Cost of goods manufactured budget (note)
Finished goods inventory		<u>4,485</u>	Budgeted income statement (note)
Total current assets		\$122,870	
Property, plant, and equipment:			
Land		\$ 50,000	
Plant and equipment <sup>b</sup>	\$200,000		
Less accumulated depreciation <sup>c</sup>	<u>45,000</u>	<u>155,000</u>	
Total property, plant, and equipment		<u>205,000</u>	
Total assets		<u>\$327,870</u>	
<b>Liabilities</b>			
Current liabilities:			
Accounts payable		\$ 8,250 <sup>d</sup>	Schedule of expected cash payments for direct materials
Long-term liabilities:			
Notes payable		<u>70,000</u>	
Total liabilities		<u>\$ 78,250</u>	
<b>Stockholders' Equity</b>			
Common stock		\$150,000	
Retained earnings <sup>e</sup>		<u>99,620</u>	
Total stockholders' equity		<u>249,620</u>	
Total liabilities and stockholders' equity		<u>\$327,870</u>	

<sup>a</sup>The accounts receivable balance at year end is \$68,000: \$4,000 from the third quarter's sales  $[(\$50,000 \times 0.80) \times 0.10]$  plus \$64,000 from the fourth quarter's sales  $[(\$200,000 \times 0.80) \times 0.40]$ .

<sup>b</sup>The plant and equipment balance includes the \$30,000 purchase of a machine.

<sup>c</sup>The accumulated depreciation balance includes depreciation expense of \$27,840 for machinery, building, and office equipment (\$11,240, \$12,900, and \$3,700, respectively).

<sup>d</sup>At year end, the estimated ending balance of accounts payable is \$8,250 (50 percent of the \$16,500 of direct materials purchases in the fourth quarter).

<sup>e</sup>The retained earnings balance at December 31 equals the beginning retained earnings balance plus the net income projected for the year (\$50,830 and \$48,790, respectively).

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

**LO 5** Explain why budgeting is essential to the management process.

## LO 5 Budgeting and the Management Process

Budgets are essential to accomplishing an organization's strategic plan. They are used to communicate understandable information, coordinate activities and resource usage, motivate employees, and provide comparative information to evaluate performance. For example, a board of directors may use budgets to determine managers' areas of responsibility and to measure managers' performance in those areas. Budgets are also used to manage and account for cash.

### Advantages of Budgeting

Budgeting is advantageous for organizations, because budgets:

- foster organizational communication
- ensure a focus both on future events and on resolving day-to-day issues
- assign resources and the responsibility to use them wisely to managers who are held accountable for their results
- can identify potential constraints before they become problems
- facilitate congruence between organizational and personal goals
- define organizational goals and objectives numerically, against which actual performance results can be evaluated

### Budgeting and Goals

Budgeting helps managers achieve both long-term and short-term goals.

**Long-Term Goals** **Strategic planning** is the process by which management establishes an organization's long-term goals. These goals define the direction that an organization will take and are the basis for making annual operating plans and preparing budgets. Long-term goals cannot be vague. They must set specific tactical targets and timetables and assign responsibility to specific personnel. For example, a long-term goal for a company that currently holds only 4 percent of its product's market share might specify that the vice president of marketing is to develop strategies to ensure that the company controls 10 percent of the market in five years and 15 percent by the end of ten years.



## Business Perspective

### What Can Cause the Planning Process to Fail?

When chief financial officers were asked what caused their planning process to fail, the six factors they most commonly cited were:<sup>1</sup>

- An inadequately defined strategy
- No clear link between strategy and the operational budget
- Lack of individual accountability for results
- Lack of meaningful performance measures
- Inadequate pay for performance
- Lack of appropriate data

© Allia / iStockphoto.com

**STUDY NOTE:** As plans are formulated for time periods closer to the current date, they become more specific and quantified. The annual budget is a very specific plan of action.

**Short-Term Goals** Annual operating plans involve every part of an enterprise and are much more detailed than long-term strategic plans. To formulate an annual operating plan, an organization must restate its long-term goals in terms of what it needs to accomplish during the next year. The process entails making decisions about sales and profit targets, human resource needs, and the introduction of new products or services. The short-term goals identified in an annual operating plan are the basis of an organization's operating budgets for the year.

## Budgeting Basics

Once long- and short-term goals have been decided, the organization's management plays a central role in coordinating the budgeting process. Managers set the basics of the budgeting process, including assigning budget authority, inviting employee participation, selecting the budget period, and implementing the budget.

**Assigning Budget Authority** Every budget and budget line item is associated with a specific role or job in an organization. For example, a department manager is responsible for the department's budget, and the marketing vice president is responsible for what is spent on advertising.

Since manager responsibilities and budget authority are linked, managers must explain or take corrective action for any deviations between budget and actual results. Responsibility accounting (which will be discussed in greater detail in the next chapter) authorizes managers to command and be held accountable for the revenues and expenses in their budgets. If managers do not have budget authority over what they need to accomplish their job responsibilities, they lack the control necessary to accomplish their duties and cannot be held accountable for results.

**Inviting Employee Participation** Because an organization's main activities—such as production, sales, and employee training—take place at its lower levels, the information necessary for establishing a budget flows from the employees and supervisors of those activities through middle managers to senior executives. Each person in this chain of communication thus plays a role in developing a budget, as well as in implementing it. If these individuals have a voice in setting the budget targets, they will be motivated to ensure that their departments attain those targets and stay within the budget. If they do not have a role in the budgeting process, motivation will suffer. The key to a successful budget is therefore **participative budgeting**, a process in which personnel at all levels of an organization actively engage in making decisions about the budget. Participative budgeting depends on joint decision making. Without it, the budgeting process will be authoritative rather than participative, and the budget targets may be unrealistic and impossible to attain.

**Selecting the Budget Period** Budgets, like the company's fiscal period, generally cover a one-year period of time. An annual operating budget may be divided further into monthly or quarterly periods, depending on the detail of information needed.

The organization's management will decide if they will use a static or continuous budgeting process. **Static budgets** are prepared once a year and do not change during



## Business Perspective

### Can Budgeting Lead to a Breakdown in Corporate Ethics?

When budgets are used to force performance results, as they were at **WorldCom**, breaches in corporate ethics can occur. One former WorldCom employee described the situation at that company as follows: "You would have a budget, and he [WorldCom CEO Bernard Ebbers] would mandate that you had to be 2% under budget. Nothing else was acceptable."<sup>2</sup> This type of restrictive budget policy appears to have been a factor in many corporate scandals.

the annual budget period. To ensure that its managers have continuously updated operating data against which to measure performance, an organization may select an ongoing budgeting process, called a continuous budget. A **continuous budget** is a 12-month forward-rolling budget that summarizes budgets for the next 12 months. Each month managers prepare a budget for that month, 12 months hence.

Traditional budgeting approaches require managers to justify only budget changes over the past year. An alternative to traditional budgeting is **zero-based budgeting**, which requires that every budget item be justified annually. So each year the budget is built from scratch.

**Implementing the Budget** The **budget committee**, which includes the controller and many of the organization's top management, has overall responsibility for budget implementation. The budget committee:

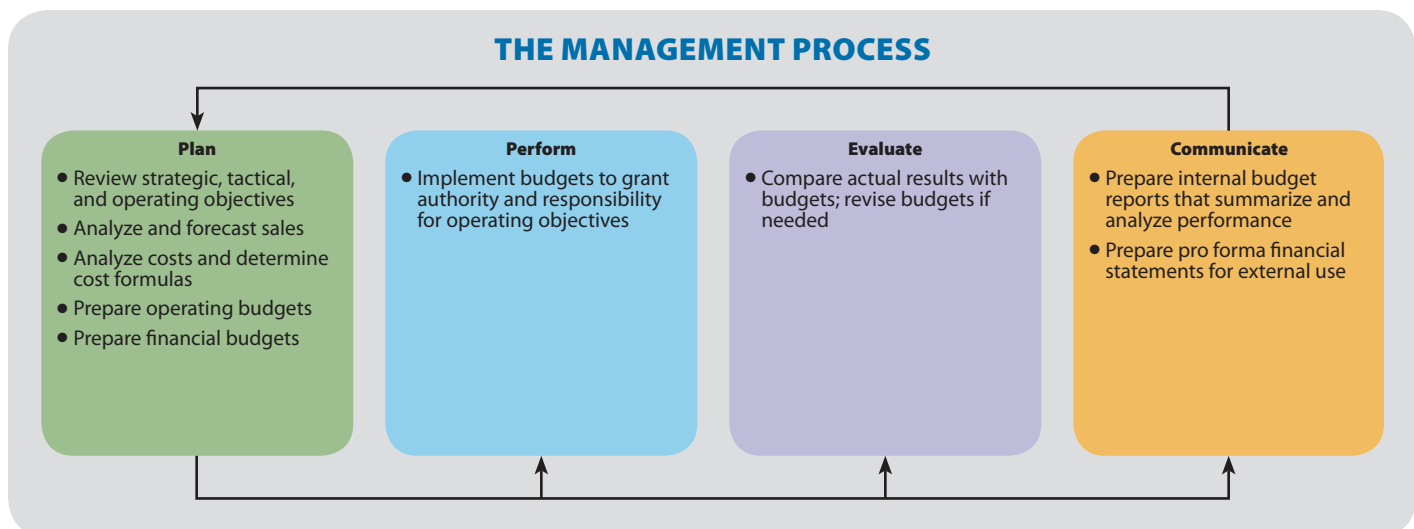
- Oversees each stage in the preparation of the organization's overall budget
- Mediates any departmental disputes that may arise in the process
- Gives final approval to the budget

A budget may go through many revisions before it includes all planning decisions and has the approval of the committee. Once approved, periodic reports from department managers allow the committee to monitor the company's progress in attaining budget targets.

Successful budget implementation depends on two factors—clear communication and the support of top management. To ensure their cooperation in implementing the budget, all key persons involved must know what roles they are expected to play and must have specific directions on how to achieve their performance goals. Thus, the budget committee must communicate clearly the performance expectations and budget targets. Equally important, top management must show support for the budget and encourage its implementation. The process will succeed only if middle- and lower-level managers are confident that top management is truly interested in the outcome and is willing to reward personnel for meeting the budget targets. Today, many organizations have employee incentive plans that tie the achievement of budget targets to bonuses or other types of compensation.

As you have seen in this chapter, budgeting is not only an essential part of planning; it also helps managers command, control, evaluate, and report on operations. Exhibit 17 summarizes how budgeting is an integral part of the management process.

### Exhibit 17 Budgeting and the Management Process



## APPLY IT!

Randi Quelle is the manager of the electronics department in a large discount store. During a recent meeting, Quelle and her supervisor agreed that Quelle's goal for the next year would be to increase the number of flat-screen televisions sold by 20 percent. The department sold 500 TV sets last year. Two salespersons currently work for Quelle. What types of budgets should Quelle use to help her achieve her sales goal? What kinds of information should those budgets provide?

### SOLUTION

Budgets and information that might be useful include:

- Breakdown by month of last year's sales to use as a guide to build this year's monthly targets. This would include seasonal sales information.
- Budgets by salesperson, which may indicate a need for a third salesperson.
- Inventory and purchasing information.
- Budgets of sales promotion and advertising.
- Information on customer flow and the best times to sell.

**TRY IT! SE9, SE10, E12A, E13A, E14A, E15A, E12B, E13B, E14B, E15B**

## TriLevel Problem



Jeremy Hoare/Photostock

**Framecraft Company**

The beginning of this chapter focused on Framecraft Company, which uses a participatory budgeting process as the basis for budgeting decisions. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*What concepts underlie the usefulness of the budgeting process?*

### Section 2: Accounting Applications

*How does the budgeting process translate long-term goals into operating objectives?*

Suppose Framecraft has an Information Processing Division that provides database management services for the professional photographers and artists who buy its frames. The division uses state-of-the-art equipment and employs five information specialists. Each specialist works an average of 160 hours a month. The division's controller has compiled the following information:

	Actual Data for Past Year		Forecasted Data for This Year		
	November	December	January	February	March
Client billings (sales)	\$25,000	\$35,000	\$25,000	\$20,000	\$40,000
Selling and administrative expenses	12,000	13,000	12,000	11,000	12,500
Operating supplies	2,500	3,500	2,500	2,500	4,000
Processing overhead	3,200	3,500	3,000	2,500	3,500

Of the client billings, 60 percent are cash sales collected during the month of sale, 30 percent are collected in the first month following the sale, and 10 percent are collected in the second month following the sale. Operating supplies are paid for in the month of purchase. Selling and administrative expenses and processing overhead are paid in the month following the cost's incurrence.

The division has a bank loan of \$12,000 with a 12 percent annual interest rate. Interest is paid monthly, and \$2,000 of the loan principal is due on February 28 of next year. Income taxes of \$4,550 for this calendar year are due and payable on March 15 of next year. The information specialists earn \$8.50 an hour, and all payroll-related employee benefit costs are included in processing overhead. The division anticipates no capital expenditures for









Identify the elements of a master budget in different types of organizations and the guidelines for preparing budgets. **Lo 2**

The operating budgets of a manufacturing organization include budgets for sales, production, direct materials purchases, direct labor, overhead, selling and administrative expenses, and cost of goods manufactured. The operating budgets of a retail organization include budgets for sales, purchases, selling and administrative expenses, and cost of goods sold. The operating budgets of a service organization include budgets for service revenue, labor, services overhead, and selling and administrative expenses.

The guidelines for preparing budgets include identifying the purpose of the budget, the user group and its information needs, and the sources of budget information; establishing a clear format for the budget; and using appropriate formulas and calculations to derive the quantitative information.

Prepare the operating budgets that support the financial budgets. **Lo 3**

The initial step in preparing a master budget in any type of organization is to prepare a sales budget. Once sales have been estimated, the manager of a manufacturing organization's production department is able to prepare a budget that shows how many units of products must be manufactured to meet the projected sales volume. With that information, other managers are able to prepare budgets for direct materials purchases, direct labor, overhead, selling and administrative expenses, and cost of goods manufactured. A cost of goods sold budget may be prepared separately, or it may be included in the cost of goods manufactured budget for a manufacturing organization. The operating budgets supply the information needed to prepare the financial budgets.

Prepare a budgeted income statement, a cash budget, and a budgeted balance sheet. **Lo 4**

With estimated revenues and expenses itemized in the operating budgets, a controller is able to prepare the financial budgets. A budgeted income statement projects an organization's net income for a specific accounting period. A capital expenditures budget estimates the amount and timing of the organization's capital outlays during the period. A cash budget projects its cash receipts and cash payments for the period. Information about cash receipts comes from several sources, including the sales budget, the budgeted income statement, and various financial records. Sources of information about cash payments include the operating budgets, the budgeted income statement, and the capital expenditures budget. The difference between the total estimated cash receipts and total estimated cash payments is the cash increase or decrease anticipated for the period. That total plus the period's beginning cash balance equals the ending cash balance. The final step in developing a master budget is to prepare a budgeted balance sheet, which projects the organization's financial position at the end of the period.

Explain why budgeting is an essential part of the management process. **Lo 5**

Budgeting helps managers plan, command, control, evaluate, and report on operations. When managers develop budgets, they match their organizational goals with the resources necessary to accomplish those goals. During the budgeting process, they evaluate operational, tactical, value chain, and capacity issues; assess how resources can be efficiently used; and develop contingency budgets as business conditions change. During the budget period, budgets authorize managers to use resources and provide guidelines to control costs. When managers assess performance, they can compare actual operating results to budget plans and evaluate the variances. In participative budgeting, personnel at all levels actively engage in making decisions about the budget.

Budgets can be static, meaning they do not change during the annual budget period, or continuous, meaning they are forward-moving for the next 12 months. An alternative to traditional budgeting is zero-based budgeting, which requires every budget item to be justified, not just the changes over the past year.

A budget committee made up of the company's controller and top managers has overall responsibility for budget implementation. The committee oversees each stage in the preparation of the master budget, mediates any departmental disputes that may arise during the process, and gives final approval to the budget. After the master budget is approved, periodic reports from department managers enable the committee to monitor the progress in attaining budget targets.

## Key Terms

**budget committee** 978 (LO5)  
**budgeted balance sheet** 974 (LO4)  
**budgeted income statement** 970 (LO4)  
**budgeting** 958 (LO1)  
**budgets** 958 (LO1)  
**capital expenditures budget** 971 (LO4)  
**cash budget** 971 (LO4)  
**continuous budget** 978 (LO5)

**cost of goods manufactured budget** 968 (LO3)  
**direct labor budget** 966 (LO3)  
**direct materials purchases budget** 964 (LO3)  
**financial budgets** 958 (LO1)  
**master budget** 958 (LO1)  
**operating budgets** 958 (LO1)  
**overhead budget** 966 (LO3)  
**participative budgeting** 977 (LO5)

**pro forma financial statements** 959 (LO1)  
**production budget** 963 (LO3)  
**sales budget** 962 (LO3)  
**sales forecast** 963 (LO3)  
**selling and administrative expenses budget** 967 (LO3)  
**static budgets** 977 (LO5)  
**strategic planning** 976 (LO5)  
**zero-based budgeting** 978 (LO5)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1, 2 **DQ1. CONCEPT** ► What is a master budget and what are the guidelines that enhance its understandability and comparability?
- LO 3, 4 **DQ2.** Why does the preparation of operating budgets before financial budgets increase the usefulness of the budget process?
- LO 5 **DQ3. BUSINESS APPLICATION** ► Why is the difference between a static budget and a continuous budget important in understanding budgets?
- LO 5 **DQ4. CONCEPT** ► **BUSINESS APPLICATION** ► How are understandability and comparability enhanced when knowing who is responsible for the budgeting process?
- LO 5 **DQ5. CONCEPT** ► **BUSINESS APPLICATION** ► Why does the use of budgets in the management process reinforce the concepts of comparability and understandability to better business performance?

### SHORT EXERCISES

- LO 1, 2 **Budget Usefulness**
- SE1. CONCEPT** ► Budgeting is not only an essential part of planning; but it also helps managers command, control, evaluate, and report on operations. Why are the concepts of understandability and comparability important in budgeting? List the reasons for your answer.
- LO 3 **Production Budget**
- SE2.** Windsor Lock Company's controller is preparing a production budget for the year. The company's policy is to maintain a finished goods inventory equal to one-half of the following month's sales. Sales of 5,000 locks are budgeted for April. Complete the monthly production budget for the first quarter:

	January	February	March
Sales in units	5,000	4,000	6,000
Add desired units of ending finished goods inventory	2,000	?	?
Desired total units	7,000	?	?
Less desired units of beginning finished goods inventory	?	?	?
Total production units	4,500	?	?

### LO 3 Preparing an Operating Budget

**SE3.** Hartford Company expects to sell 50,000 units of its product in the coming year. Each unit sells for \$50. Sales brochures and supplies for the year are expected to cost \$9,000. Two sales representatives cover the southeast region. Each representative's base salary is \$20,000, and each earns a sales commission of 5 percent of the selling price of the units he or she sells. The sales representatives supply their own transportation; they are reimbursed for travel at a rate of \$0.60 per mile. The company estimates that the sales representatives will drive a total of 70,000 miles next year. Calculate Hartford's budgeted selling expenses for the coming year.

### LO 3, 4 Budgeted Gross Margin

**SE4.** Eastport Company's operating budgets reveal the following information: net sales, \$400,000; beginning materials inventory, \$23,000; materials purchased, \$185,000; beginning work in process inventory, \$64,700; beginning finished goods inventory, \$21,600; direct labor costs, \$34,000; overhead applied, \$67,000; ending work in process inventory, \$61,200; ending materials inventory, \$20,000; and ending finished goods inventory, \$18,000. Compute Eastport's budgeted gross margin.

### LO 4 Estimating Cash Collections



**SE5.** Standard Insurance Company specializes in term life insurance contracts. Cash collection experience shows that 40 percent of billed premiums are collected in the month in which they are billed, 50 percent are paid in the first month after they are billed, and 6 percent are paid in the second month after they are billed. Four percent of the billed premiums are paid late (in the third month after they are billed) and include a 10 percent penalty payment. Total billing notices in January were \$58,000; in February, \$62,000; in March, \$66,000; in April, \$65,000; in May, \$60,000; and in June, \$62,000. How much cash does the company expect to collect in May?

### LO 4 Cash Budget



**SE6.** The projections of direct materials purchases that follow are for Creek Corporation.

	Purchases on Account	Cash Purchases
December 2014	\$50,000	\$20,000
January 2015	70,000	30,000
February 2015	60,000	25,000
March 2015	70,000	35,000

The company pays for 60 percent of purchases on account in the month of purchase and 40 percent in the month following the purchase. Prepare a monthly schedule of expected cash payments for direct materials for the first quarter of 2015.

### LO 4 Cash Budget



**SE7.** Eagles Limited needs a cash budget for the month of November. The following information is available:

- The cash balance on November 1 is \$5,000.
- Sales for October and November are \$80,000 and \$60,000, respectively. Cash collections on sales are 30 percent in the month of sale and 68 percent in the month after the sale; 2 percent of sales are uncollectible.
- General expenses budgeted for November are \$26,000 (depreciation represents \$2,000 of this amount).
- Inventory purchases will total \$30,000 in October and \$40,000 in November. The company pays for half of its inventory purchases in the month of purchase and for the other half the month after purchase.

- The company will pay \$4,000 in cash for office furniture in November. Sales commissions for November are budgeted at \$13,000.
- The company maintains a minimum ending cash balance of \$4,000 and can borrow from the bank in multiples of \$100. All loans are repaid after 60 days.

Prepare a cash budget for Eagles Limited for the month of November.

**LO 4 Budgeted Balance Sheet**

**SE8.** Bulldog Corporation's budgeted balance sheet for the coming year shows total assets of \$4,000,000 and total liabilities of \$1,900,000. Common stock and retained earnings make up the entire stockholders' equity section of the balance sheet. Common stock remains at its beginning balance of \$1,500,000. The projected net income for the year is \$350,000. The company pays no cash dividends. What is the balance of retained earnings at the beginning of the budget period?

**LO 5 Budgeting in a Retail Organization**

**SE9. BUSINESS APPLICATION** ► In a discount department store, the shoe department manager's goal for the next year is to increase the number of pairs of shoes sold by 20 percent. The department sold 8,000 pairs of shoes last year. Two salespeople currently work in the department. What types of budgets should the manager use to help him achieve his sales goal? What kinds of information should those budgets provide?

**LO 5 Budgetary Control**

**SE10. BUSINESS APPLICATION** ► The owner of a tree nursery analyzes her business's results by comparing actual operating results with figures budgeted at the beginning of the year. When the business generates large profits, she often overlooks the differences between actual and budgeted data. But when profits are low, she spends many hours analyzing the differences. If you owned the business, would you use her approach to budgetary control? If not, what changes would you make?

## EXERCISES: SET A

**LO 2 Components of a Master Budget**

**E1A.** Assigning the numbers 1 through 7, identify the order in which the following budgets are prepared.

- direct labor budget
- production budget
- selling, administrative, and general expenses budget
- budgeted income statement
- sales budget
- budgeted balance sheet
- cash budget

**LO 3 Sales Budget**

**E2A.** Outside Company's quarterly and annual sales for this year follow. Prepare a sales budget for next year based on the estimated percentage increases shown by product class. Show both quarterly and annual totals for each product class.

*(Continued)*

**Outside Company**  
**Actual Sales Revenue**  
**For the Year Ended December 31**

Product Class	January– March	April– June	July– September	October– December	Annual Totals	Estimated Percent Increases by Product Class
Backcountry products	\$ 44,500	\$ 45,500	\$ 48,200	\$ 47,900	\$ 186,100	20%
Marine products	36,900	32,600	34,100	37,200	140,800	5%
Walking products	29,800	29,700	29,100	27,500	116,100	30%
Hiking products	38,800	37,600	36,900	39,700	153,000	10%
Running products	47,700	48,200	49,400	49,900	195,200	25%
Biking products	65,400	65,900	66,600	67,300	265,200	20%
Totals	<u>\$263,100</u>	<u>\$259,500</u>	<u>\$264,300</u>	<u>\$269,500</u>	<u>\$1,056,400</u>	

**LO 3 Production Budget**

**E3A.** Southside Corporation produces and sells a single product. Expected sales for September are 13,000 units; for October, 14,000 units; for November, 9,000 units; for December, 10,000 units; and for January, 15,000 units. The company's desired level of ending finished goods inventory at the end of a month is 10 percent of the following month's expected sales in units. At the end of August, 1,200 units were on hand. How many units need to be produced in the fourth quarter?

**LO 3 Direct Materials Purchases Budget**

**E4A.** Eco Door Company manufactures garage door units. The units include hinges, door panels, and other hardware. The controller has provided the information that follows.

Part	Units Needed	Cost
Hinges	4 sets per door	\$6.00 per set
Door panels	4 panels per door	\$27.00 per panel
Other hardware	1 lock per door	\$31.00 per lock
	1 handle per door	\$22.50 per handle
	2 roller tracks per door	\$16.00 per set of 2 roller tracks
	8 rollers per door	\$4.00 per roller

Prepare a direct materials purchases budget for the first quarter of the year based on the budgeted production of 25,000 garage door units. Assume no beginning or ending quantities of direct materials inventory.

**LO 2, 3 Purchases Budget**

**E5A.** Spartan Corporation projects the dollar value of the company's cost of goods sold to be \$160,000 in June, \$169,000 in July, and \$154,000 in August. The dollar value of its desired ending inventory is 25 percent of the following month's cost of goods sold.

Compute the total purchases in dollars budgeted for June and the total purchases in dollars budgeted for July.

**LO 3 Direct Labor Budget**

**E6A.** Crimson Company has two departments—Dye and Dry—and manufactures three products. Budgeted unit production for the coming year is 21,000 of Product J, 36,000 of Product C, and 30,000 of Product B. The company is currently analyzing direct labor hour requirements for the coming year. Data for each department follow.

	Dye	Dry
Estimated hours per unit:		
Product J	2.0	3.0
Product C	1.0	4.0
Product B	2.5	5.0
Hourly labor rate	\$10	\$4

Prepare a direct labor budget for the coming year that shows the budgeted direct labor costs for each department and for the company as a whole.

### LO 3 Overhead Budget

**E7A.** As part of the budgeting process, Northview Corporation's CFO is developing the overhead budget for next year for its Evans Division. The division estimates that it will manufacture 150,000 units during the year. The budgeted cost information follows.

	Variable Rate per Unit	Fixed Costs
Indirect materials	\$1.00	
Indirect labor	4.00	
Supplies	0.40	
Repairs and maintenance	3.00	\$ 50,000
Electricity	0.10	120,000
Factory supervision		160,000
Insurance		25,000
Property taxes		25,000
Depreciation—machinery		82,000
Depreciation—building		72,000

Prepare the division's overhead budget for next year.

### LO 4 Cash Collections



**E8A.** Five Bros., Inc., is an automobile maintenance and repair company with outlets throughout the western United States. The company controller is starting to assemble the cash budget for the fourth quarter. Projected sales for the quarter follow.

	On Account	Cash
October	\$400,000	\$190,000
November	690,000	220,000
December	750,000	245,000

Cash collection records pertaining to sales on account indicate the following collection pattern:

Month of sale	40%
First month following sale	30%
Second month following sale	28%
Uncollectible	2%

Sales on account during August were \$346,000. During September, sales on account were \$390,000.

Compute the amount of cash to be collected from customers during each month of the fourth quarter.

### LO 4 Cash Collections



**E9A.** NSW Company collects payment on 50 percent of credit sales in the month of sale, 40 percent in the month following the sale, and 5 percent in the second month following the sale. Its sales budget follows.

(Continued)



Month	Cash Sales	Credit Sales
May	\$24,000	\$ 40,000
June	30,000	60,000
July	50,000	80,000
August	70,000	100,000

Compute NSW's total cash collections in July and its total cash collections in August.

#### LO 4 Cash Budget

##### CASH FLOW

**E10A.** Queensland Enterprises needs a cash budget for the month of June. The following information is available:

- The cash balance on June 1 is \$13,000.
- Sales for May and June are \$40,000 and \$50,000, respectively. Cash collections on sales are 45 percent in the month of sale and 50 percent in the month after the sale; 5 percent of sales are uncollectible.
- General expenses budgeted for June are \$20,000 (depreciation represents \$1,000 of this amount).
- Inventory purchases will total \$40,000 in May and \$30,000 in June. The company pays for half of its inventory purchases in the month of purchase and for the other half the month after purchase.
- The company will pay \$5,000 in cash for office furniture in June. Sales commissions for June are budgeted at \$3,000.
- The company maintains a minimum ending cash balance of \$5,000 and can borrow from the bank in multiples of \$100. All loans are repaid after 60 days.

Prepare a cash budget for Queensland for the month of June.

#### LO 4 Cash Budget

##### CASH FLOW

**E11A.** Citizens Produce Co-op is one of the biggest produce operations in northern Texas. Credit sales to retailers in the area constitute 80 percent of Citizens Produce's business; cash sales to customers at the company's retail outlet make up the other 20 percent. Collection records indicate that Citizens Produce collects payment on 50 percent of all credit sales during the month of sale, 30 percent in the month after the sale, and 20 percent in the second month after the sale.

The company's total sales in May were \$60,000; in June, they were \$70,000. Anticipated sales in July are \$75,000; in August, \$80,000; and in September, \$90,000. The company's produce purchases are expected to total \$45,000 in July, \$51,000 in August, and \$60,000 in September. The company pays for all purchases in cash.

Projected monthly costs for the quarter include \$1,000 for heat, light, and power; \$400 for bank fees; \$2,000 for rent; \$1,120 for supplies; \$1,705 for depreciation of equipment; \$1,285 for equipment repairs; and \$500 for miscellaneous expenses. Other projected costs for the quarter are salaries and wages of \$18,700 in July, \$19,500 in August, and \$20,600 in September.

The company's cash balance at June 30 was \$2,000. Effective July 1, the company has a new policy of maintaining a minimum monthly cash balance of \$3,000 and can borrow from the bank in multiples of \$100.

1. Prepare a monthly cash budget for Citizens Produce Co-op for the quarter ended September 30.
2. **ACCOUNTING CONNECTION** ► Should Citizens Produce anticipate taking out a loan during the quarter? If so, how much should it borrow, and when?

#### LO 4, 5 Budgeted Income Statement

**E12A.** Plenair, Inc., is located in France and organizes and coordinates art shows and auctions throughout the world. Its budgeted and actual costs for last year follow.

	Budgeted Cost	Actual Cost
Total operating expenses	€3,140,000	€3,176,868
Net receipts	6,200,000	6,369,200

Because the company sells only services, there is no cost of goods sold (net receipts equal gross margin). Plenair has budgeted the following fixed costs for the coming year: salaries, €1,000,000; advertising expense, €190,000; insurance, €150,000; and space rental costs, €300,000.

Additional information:

- Net receipts are estimated at €6,400,000.
  - Travel costs are expected to be 11 percent of net receipts.
  - Auctioneer services will be billed at 15 percent of net receipts.
  - Printing costs are expected to be €190,000.
  - Home office costs are budgeted for €30,000.
  - Shipping costs are expected to be 20 percent higher than the €105,000 budgeted in the last year.
  - Miscellaneous expenses for the coming year will be budgeted at €8,000.
- Prepare the company's budgeted income statement for the coming year using a 40 percent income tax rate,
  - ACCOUNTING CONNECTION** ► Should the budget committee be worried about the trend in the company's operations? Explain your answer.

#### LO 5 Characteristics of Budgets

**E13A. BUSINESS APPLICATION** ► You recently attended a workshop on budgeting and overheard the following comments as you walked to the refreshment table:

- "Budgets are the same regardless of the size of an organization or management's role in the budgeting process."
- "Budgets can include financial or nonfinancial data. In our organization, we plan the number of hours to be worked and the number of customer contacts we want our salespeople to make."

Do you agree or disagree with each comment? Explain your answers.

#### LO 5 Budgeting and Goals

**E14A. BUSINESS APPLICATION** ► Effective planning of long- and short-term goals has contributed to the success of Multitasker Calendars, Inc. Described below are the actions that the company's management team took during a recent planning meeting. Indicate whether the goals related to those actions are short-term or long-term.

- Based on the 10-year forecast, the management team made decisions about next year's sales, personnel, material purchases, and profit targets.
- In forecasting the next 10-year period, the management team considered economic and industry forecasts, product and service projections, and the long-term capital needs of the business.

#### LO 5 Budgeting and Goals

**E15A. BUSINESS APPLICATION** ► Assume that you work in the accounting department of a small shipping services company. Inspired by a recent seminar on budgeting, the company's president wants to develop a budgeting system and has asked you to direct it. Identify the points concerning the initial steps in the budgeting process that you should communicate to the president. Concentrate on principles related to long-term goals and short-term goals.

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 3 Preparing Operating Budgets

- ✓ 2: October total manufacturing costs budgeted: \$1,486,080
- ✓ 2: Quarter cost of goods manufactured budget: \$4,293,120

**P1.** Enterprises, Inc.'s principal product is a hammer that carries a lifetime guarantee. Cost and production data for the hammer follow.

Direct materials:

Anodized steel: 1 kilograms per hammer at \$2 per kilogram

Leather strapping for the handle: 0.5 square meter per hammer at \$4 per square meter

Direct labor:

Forging operation: \$24 per labor hour; 6 minutes per hammer

Leather-wrapping operation: \$20 per direct labor hour; 12 minutes per hammer

Overhead:

Forging operation: rate equals 40 percent of department's direct labor dollars

Leather-wrapping operation: rate equals 60 percent of department's direct labor dollars

In October, November, and December, Enterprises expects to produce 108,000, 104,000, and 100,000 hammers, respectively. The company has no beginning or ending balances of direct materials inventory or work in process inventory for the year.

#### REQUIRED

- For the three-month period ending December 31, prepare monthly production cost information for the hammer. Classify the costs as direct materials, direct labor, or overhead, and show your computations.
- Prepare a cost of goods manufactured budget for the hammer. Show monthly cost data and combined totals for the quarter for each cost category.

### LO 3, 4

#### SPREADSHEET

- ✓ 1: Total annual sales: \$102,000
- ✓ 3: Total annual cost of direct materials purchases: \$6,928

### Preparing a Comprehensive Budget

**P2.** Bathworks produces hair and bath products. Bathworks' owner would like to have an estimate of the company's net income in the coming year.

#### REQUIRED

Project Bathworks's net income next year by completing the operating budgets and budgeted income statement that follows. Assume that the selling price will remain constant.

- Sales budget:

<b>Bathworks Sales Budget For the Year Ended December 31</b>					
	<b>Quarter</b>				<b>Year</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	
Sales in units	4,000	3,000	5,000	5,000	17,000
Selling price per unit	× \$6	× ?	× ?	× ?	× ?
Total sales	<u>\$24,000</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>

## 2. Production budget:

<b>Bathworks Production Budget For the Year Ended December 31</b>					
	Quarter				Year
	1	2	3	4	
Sales in units	4,000	?	?	?	?
Plus desired units of ending finished goods inventory <sup>a</sup>	<u>300</u>	<u>?</u>	<u>?</u>	<u>600</u>	<u>600</u>
Desired total units	4,300	?	?	?	?
Less desired units of beginning finished goods inventory <sup>b</sup>	<u>400</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>400</u>
Total production units	<u><u>3,900</u></u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>

<sup>a</sup>Desired units of ending finished goods inventory = 10% of next quarter's budgeted sales.

<sup>b</sup>Desired units of beginning finished goods inventory = 10% of current quarter's budgeted sales.

## 3. Direct materials purchases budget:

<b>Bathworks Direct Materials Purchases Budget For the Year Ended December 31</b>					
	Quarter				Year
	1	2	3	4	
Total production units	3,900	3,200	5,000	5,100	17,200
Ounces per unit	<u>× 4</u>	<u>× 4</u>	<u>× 4</u>	<u>× 4</u>	<u>× 4</u>
Total production needs in ounces	15,600	?	?	?	?
Plus desired ounces of ending direct materials inventory <sup>a</sup>	<u>2,560</u>	<u>?</u>	<u>?</u>	<u>3,600</u>	<u>3,600</u>
	18,160	?	?	?	?
Less desired ounces of beginning direct materials inventory <sup>b</sup>	<u>3,120</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>3,120</u>
Total ounces of direct materials to be purchased	15,040	?	?	?	?
Cost per ounce	<u>× \$0.10</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>
Total cost of direct materials purchases	<u><u>\$ 1,504</u></u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>

<sup>a</sup>Desired ounces of ending direct materials inventory = 20% of next quarter's budgeted production needs in ounces.

<sup>b</sup>Desired ounces of beginning direct materials inventory = 20% of current quarter's budgeted production needs in ounces.

## 4. Direct labor budget:

<b>Bathworks Direct Labor Budget For the Year Ended December 31</b>					
	Quarter				Year
	1	2	3	4	
Total production units	3,900	?	?	?	?
Direct labor hours per unit	<u>× 0.10</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>
Total direct labor hours	390	?	?	?	?
Direct labor cost per hour	<u>× \$20</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>
Total direct labor cost	<u><u>\$7,800</u></u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>

(Continued)

## 5. Overhead budget:

<b>Bathworks Overhead Budget For the Year Ended December 31</b>					
	Quarter				Year
	1	2	3	4	
Variable overhead costs:					
Factory supplies (\$0.05)	\$ 195	\$ ?	\$ ?	\$ ?	\$ ?
Employee benefits (\$0.25)	975	?	?	?	?
Inspection (\$0.10)	390	?	?	?	?
Maintenance and repairs (\$0.15)	585	?	?	?	?
Utilities (\$0.05)	195	?	?	?	?
Total variable overhead costs	<u>\$2,340</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>
Total fixed overhead costs	4,300	?	?	?	?
Total overhead costs	<u>\$6,640</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

Note: The figures in parentheses are variable costs per unit.

## 6. Selling and administrative expenses budget:

<b>Bathworks Selling and Administrative Expenses Budget For the Year Ended December 31</b>					
	Quarter				Year
	1	2	3	4	
Variable selling and administrative expenses:					
Delivery expenses (\$0.10)	\$ 400	\$ ?	\$ ?	\$ ?	\$ ?
Sales commissions (\$0.15)	600	?	?	?	?
Accounting (\$0.05)	200	?	?	?	?
Other administrative expenses (\$0.20)	800	?	?	?	?
Total variable selling and administrative expenses	<u>\$2,000</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>
Total fixed selling and administrative expenses	5,000	?	?	?	?
Total selling and administrative expenses	<u>\$7,000</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

Note: The figures in parentheses are variable costs per unit.

## 7. Cost of goods manufactured budget:

<b>Bathworks Cost of Goods Manufactured Budget For the Year Ended December 31</b>		
Direct materials used:		
Direct materials inventory, beginning	\$ ?	
Purchases	?	
Cost of direct materials available for use	<u>\$ ?</u>	
Less direct materials inventory, ending	?	
Cost of direct materials used		\$ ?
Direct labor costs		?
Overhead costs		?
Total manufacturing costs		<u>\$ ?</u>
Work in process inventory, beginning		?
Less work in process inventory, ending*		<u>?</u>
Cost of goods manufactured		<u>\$ ?</u>
Units produced		<u>÷ ?</u>
Manufactured cost per unit		<u>\$ ?</u>

\* It is the company's policy to have no units in process at the end of the year.

8. Budgeted income statement:

<b>Bathworks</b>	
<b>Budgeted Income Statement</b>	
<b>For the Year Ended December 31</b>	
Sales	\$ ?
Cost of goods sold:	
Finished goods inventory, beginning	\$ ?
Cost of goods manufactured	?
Cost of goods available for sale	\$ ?
Less finished goods inventory, ending	?
Cost of goods sold	?
Gross margin	\$ ?
Selling and administrative expenses	?
Income from operations	\$ ?
Income taxes expense (30% tax rate)	?
Net income	\$ ?

LO 4

### Cash Budget



**P3.** All Eyes Security Services Company provides security monitoring services. It employs four security specialists. Each specialist works an average of 180 hours a month. The company's controller has compiled the information that follows.

✓ Ending cash balance: \$11,260

	<b>Actual Data for</b>		<b>Forecasted Data for</b>		
	<b>Last Year</b>		<b>Current Year</b>		
	<b>November</b>	<b>December</b>	<b>January</b>	<b>February</b>	<b>March</b>
Security billings (sales)	\$30,000	\$35,000	\$25,000	\$20,000	\$30,000
Selling and admin. expenses	10,000	11,000	9,000	8,000	10,500
Operating supplies	2,500	3,500	2,500	2,000	3,000
Service overhead	3,000	3,500	3,000	2,500	3,000

Sixty percent of the client billings are cash sales collected during the month of sale; 30 percent are collected in the first month following the sale; and 10 percent are collected in the second month following the sale. Operating supplies are paid for in the month of purchase. Selling and administrative expenses and service overhead are paid in the month following the cost's incurrence.

The company has a bank loan of \$12,000 at a 12 percent annual interest rate. Interest is paid monthly, and \$2,000 of the loan principal is due on February 28. Income taxes of \$2,500 for the last calendar year are due and payable on March 15. The four security specialists each earn \$15 an hour, and all payroll-related employee benefit costs are included in service overhead. The company anticipates no capital expenditures for the first quarter of the coming year. It expects its cash balance on December 31 to be \$15,000.

#### REQUIRED

Prepare a monthly cash budget for All Eyes for the three-month period ended March 31.

LO 4

### Budgeted Income Statement and Budgeted Balance Sheet

✓ 2: Net income: \$107,982  
✓ 3: Total assets: \$742,288

**P4.** Local Bank has asked Wonderware Products, Inc.'s president for a budgeted income statement and budgeted balance sheet for the quarter ended June 30. These pro forma financial statements are needed to support Wonderware's request for a loan.

Wonderware routinely prepares a quarterly master budget. The operating budgets prepared for the quarter ending June 30 have provided the following information:

*(Continued)*

Projected sales for April are \$220,400; for May, \$164,220; and for June, \$165,980. Direct materials purchases for the period are estimated at \$96,840; direct materials usage, at \$102,710; direct labor expenses, at \$71,460; overhead, at \$79,940; selling and administrative expenses, at \$143,740; capital expenditures, at \$125,000 (to be spent on June 29); cost of goods manufactured, at \$252,880; and cost of goods sold, at \$251,700.

Balance sheet account balances at March 31 were as follows: Accounts Receivable, \$26,500; Materials Inventory, \$23,910; Work in Process Inventory, \$31,620; Finished Goods Inventory, \$36,220; Prepaid Expenses, \$7,200; Plant, Furniture, and Fixtures, \$498,600; Accumulated Depreciation—Plant, Furniture, and Fixtures, \$141,162; Patents, \$90,600; Accounts Payable, \$39,600; Notes Payable, \$105,500; Common Stock, \$250,000; and Retained Earnings, \$200,988.

Projected monthly cash balances for the second quarter are as follows: April 30, \$20,490; May 31, \$35,610; and June 30, \$39,320. During the quarter, accounts receivable are expected to increase by 30 percent, patents to go up by \$6,500, prepaid expenses to remain constant, and accounts payable to go down by 10 percent (Wonderware will make a \$5,000 payment on a note payable, \$4,100 of which is principal reduction). The federal income tax rate is 30 percent, and the second quarter's tax is paid in July. Depreciation for the quarter will be \$6,420, which is included in the overhead budget. The company will pay no dividends.

#### REQUIRED

1. Determine the June 30 ending balances for Materials Inventory, Work in Process Inventory, and Finished Goods Inventory.
2. Prepare a budgeted income statement for the quarter ended June 30.
3. Prepare a budgeted balance sheet as of June 30.

LO 4, 5

#### CASH FLOW

- ✓ March cash receipts from sales on account: \$87,360
- ✓ 1: Ending cash balance: \$10,020

#### Basic Cash Budget

**P5.** Xeriscape Nurseries, Inc., has four divisions. The corporation's controller has been asked to prepare a cash budget for the Northern Division for the first quarter. Projected data supporting this budget follow.

Sales (60% on credit)		Purchases	
November	\$160,000	December	\$ 90,000
December	200,000	January	98,000
January	120,000	February	100,000
February	160,000	March	104,000
March	140,000		

Collection records of accounts receivable have shown that 40 percent of all credit sales are collected in the month of sale, 50 percent in the month following the sale, and 8 percent in the second month following the sale; 2 percent of the sales are uncollectible. All purchases are paid for in the month of the purchase. Salaries and wages are projected to be \$25,000 in January, \$33,000 in February, and \$21,000 in March. Estimated monthly costs are utilities, \$4,220; collection fees, \$1,700; rent, \$5,300; equipment depreciation, \$5,440; supplies, \$2,480; small tools, \$3,140; and miscellaneous, \$1,900. Each of the corporation's divisions maintains a \$10,000 minimum cash balance and can borrow from the bank in multiples of \$100, as needed. As of December 31, the Southern Division had a cash balance of \$10,000.

#### REQUIRED

1. Prepare a monthly cash budget for Xeriscape Nurseries' Northern Division for the first quarter.
2. **ACCOUNTING CONNECTION** ► Should Xeriscape Nurseries anticipate taking out a loan for the Northern Division during the quarter? If so, how much should it borrow, and when?



## ALTERNATE PROBLEMS

### LO 3

- ✓ 1: January total manufacturing costs budgeted: \$780,000
- ✓ 2: Quarter cost of goods manufactured budget: \$2,242,500

### Preparing Operating Budgets

**P6.** Bobble, Inc.'s principal product is a stainless steel water bottle that carries a lifetime guarantee. Cost and production data for the water bottle follow.

Direct materials:

- Stainless steel: 0.25 kilogram per bottle at \$8.00 per kilogram
- Clip for the handle: 1 per bottle at \$0.10 each

Direct labor:

- Stamping operation: \$30 per labor hour; 2 minutes per bottle

Overhead:

- Stamping operation: rate equals 80 percent of department's direct labor dollars

In January, February, and March, Waterworks expects to produce 200,000, 225,000, and 150,000 bottles, respectively. The company has no beginning or ending balances of direct materials inventory or work in process inventory for the year.

#### REQUIRED

- For the three-month period ending March 31, prepare monthly production cost information for the metal water bottle. Classify the costs as direct materials, direct labor, or overhead, and show your computations. (Round to the nearest dollar.)
- Prepare a cost of goods manufactured budget for the water bottle. Show monthly cost data and combined totals for the quarter for each cost category.

### LO 3, 4

#### SPREADSHEET

- ✓ 1: Total annual sales: \$175,000
- ✓ 3: Total annual cost of direct materials purchases: \$36,240
- ✓ 8: Net income: \$60,725

### Preparing a Comprehensive Budget

**P7.** Ginnie Springs Company has been bottling and selling water since 1940. The company's current owner would like to know how a new product would affect the company's net income in the coming year.

#### REQUIRED

Calculate Ginnie Springs' net income for the new product in the coming year by completing the operating budgets and budgeted income statement that follow. Assume that the selling price will remain constant.

- Sales budget:

**Ginnie Springs Company  
Sales Budget  
For the Year Ended December 31**

	Quarter				Year
	1	2	3	4	
Sales in units	40,000	30,000	50,000	55,000	175,000
Selling price per unit	× \$1	× ?	× ?	× ?	× ?
Total sales	<u>\$40,000</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

*(Continued)*

## 2. Production budget:

**Ginnie Springs Company**  
**Production Budget**  
**For the Year Ended December 31**

	Quarter				Year
	1	2	3	4	
Sales in units	40,000	?	?	?	?
Plus desired units of ending finished goods inventory <sup>a</sup>	<u>3,000</u>	<u>?</u>	<u>?</u>	6,000	6,000
Desired total units	43,000	?	?	?	?
Less desired units of beginning finished goods inventory <sup>b</sup>	<u>4,000</u>	<u>?</u>	<u>?</u>	<u>?</u>	4,000
Total production units	<u>39,000</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>

<sup>a</sup>Desired units of ending finished goods inventory = 10% of next quarter's budgeted sales.

<sup>b</sup>Desired units of beginning finished goods inventory = 10% of current quarter's budgeted sales.

## 3. Direct materials purchases budget:

**Ginnie Springs Company**  
**Direct Materials Purchases Budget**  
**For the Year Ended December 31**

	Quarter				Year
	1	2	3	4	
Total production units	39,000	32,000	50,500	55,500	?
Ounces per unit	<u>× 20</u>	<u>× 20</u>	<u>× 20</u>	<u>× 20</u>	<u>× 20</u>
Total production needs in ounces	780,000	?	?	?	?
Plus desired ounces of ending direct materials inventory <sup>a</sup>	<u>128,000</u>	<u>?</u>	<u>?</u>	240,000	240,000
	908,000	?	?	?	?
Less desired ounces of beginning direct materials inventory <sup>b</sup>	<u>156,000</u>	<u>?</u>	<u>?</u>	<u>?</u>	156,000
Total ounces of direct materials to be purchased	752,000	?	?	?	?
Cost per ounce	<u>× \$0.01</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>
Total cost of direct materials purchases	<u>\$ 7,520</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>

<sup>a</sup>Desired ounces of ending direct materials inventory = 20% of next quarter's budgeted production needs in ounces.

<sup>b</sup>Desired ounces of beginning direct materials inventory = 20% of current quarter's budgeted production needs in ounces.

## 4. Direct labor budget:

**Ginnie Springs Company**  
**Direct Labor Budget**  
**For the Year Ended December 31**

	Quarter				Year
	1	2	3	4	
Total production units	39,000	?	?	?	?
Direct labor hours per unit	<u>× 0.001</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>
Total direct labor hours	39.0	?	?	?	?
Direct labor cost per hour	<u>× \$8</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>	<u>× ?</u>
Total direct labor cost	<u>\$ 312</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

## 5. Overhead budget:

**Ginnie Springs Company**  
**Overhead Budget**  
**For the Year Ended December 31**

	Quarter				Year
	1	2	3	4	
Variable overhead costs:					
Factory supplies (\$0.01)	\$ 390	\$ ?	\$ ?	\$ ?	\$ ?
Employee benefits (\$0.05)	1,950	?	?	?	?
Inspection (\$0.01)	390	?	?	?	?
Maintenance and repairs (\$0.02)	780	?	?	?	?
Utilities (\$0.01)	390	?	?	?	?
Total variable overhead costs	<u>\$3,900</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>
Total fixed overhead costs	<u>1,416</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>
Total overhead costs	<u>\$5,316</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

Note: The figures in parentheses are variable costs per unit.

## 6. Selling and administrative expenses budget:

**Ginnie Springs Company**  
**Selling and Administrative Expenses Budget**  
**For the Year Ended December 31**

	Quarter				Year
	1	2	3	4	
Variable selling and administrative expenses:					
Delivery expenses (\$0.01)	\$ 400	\$ ?	\$ ?	\$ ?	\$ ?
Sales commissions (\$0.02)	800	?	?	?	?
Accounting (\$0.01)	400	?	?	?	?
Other administrative expenses (\$0.01)	<u>400</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>
Total variable selling and administrative expenses	\$2,000	\$ ?	\$ ?	\$ ?	\$ ?
Total fixed selling and administrative expenses	<u>5,000</u>	<u>?</u>	<u>?</u>	<u>?</u>	<u>?</u>
Total selling and administrative expenses	<u>\$7,000</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>	<u>\$ ?</u>

Note: The figures in parentheses are variable costs per unit.

## 7. Cost of goods manufactured budget:

**Ginnie Springs Company**  
**Cost of Goods Manufactured Budget**  
**For the Year Ended December 31**

Direct materials used:		
Direct materials inventory, beginning	\$ ?	
Purchases	<u>?</u>	
Cost of direct materials available for use	\$ ?	
Less direct materials inventory, ending	<u>?</u>	
Cost of direct materials used		\$ ?
Direct labor costs		?
Overhead costs		<u>?</u>
Total manufacturing costs		\$ ?
Work in process inventory, beginning*		?
Less work in process inventory, ending*		<u>?</u>
Cost of goods manufactured		\$ ?
Units produced		<u>÷ ?</u>
Manufactured cost per unit		\$ ?

\* It is the company's policy to have no units in process at the end of the year.

(Continued)

## 8. Budgeted income statement:

<b>Ginnie Springs Company</b>		
<b>Budgeted Income Statement</b>		
<b>For the Year Ended December 31</b>		
Sales		\$ ?
Cost of goods sold:		
Finished goods inventory, beginning	\$ ?	
Cost of goods manufactured	?	
Cost of goods available for sale	\$ ?	
Less finished goods inventory, ending	?	
Cost of goods sold		?
Gross margin		\$ ?
Selling and administrative expenses		?
Income from operations		\$ ?
Income taxes expense (30% tax rate)		?
Net income		\$ ?

## LO 4

**Cash Budget**

CASH FLOW

SPREADSHEET

**P8.** Forensics Company provides fraud monitoring services. It employs five fraud specialists. Each specialist works an average of 200 hours a month. The company's controller has compiled the information that follows.

✓ Ending cash balance: \$41,330

	Actual Data for Last Year		Forecasted Data for the Current Year		
	November	December	January	February	March
Billings (sales)	\$100,000	\$80,000	\$60,000	\$50,000	\$70,000
Selling and administrative expenses	15,000	12,000	8,000	7,000	10,000
Operating supplies	2,500	3,500	2,500	2,000	3,000
Service overhead	14,000	13,500	13,000	12,500	13,000

Of the client billings, 70 percent are cash sales collected during the month of sale; 20 percent are collected in the first month following the sale; and 10 percent are collected in the second month following the sale. Operating supplies are paid in the month of purchase. Selling and administrative expenses and service overhead are paid in the month the cost is incurred.

The company has a bank loan of \$12,000 at a 6 percent annual interest rate. Interest is paid monthly, and \$2,000 of the loan principal is due on February 28. Income taxes of \$6,500 for last calendar year are due and payable on March 15. The five security specialists each earn \$24.00 an hour, and all payroll-related employee benefit costs are included in service overhead. The company anticipates no capital expenditures for the first quarter of the coming year. It expects its cash balance on December 31 to be \$5,000.

**REQUIRED**

Prepare a monthly cash budget for Forensics for the three-month period ended March 31.

## LO 4

**Budgeted Income Statement and Budgeted Balance Sheet**

✓ 2: Net income: \$55,580  
✓ 3: Total assets: \$385,316

**P9.** Video Company, Inc., produces and markets two popular video games, *High Ranger* and *Star Bounder*. The closing account balances on the company's balance sheet for last year are as follows: Cash, \$18,735; Accounts Receivable, \$19,900; Materials Inventory, \$18,510; Work in Process Inventory, \$24,680; Finished Goods Inventory, \$21,940; Prepaid Expenses, \$3,420; Plant and Equipment, \$262,800; Accumulated Depreciation—Plant and Equipment, \$55,845; Other Assets, \$9,480; Accounts Payable,

\$52,640; Mortgage Payable, \$70,000; Common Stock, \$90,000; and Retained Earnings, \$107,804.

Operating budgets for the first quarter of the coming year show the following estimated costs: direct materials purchases, \$58,100; direct materials usage, \$62,400; direct labor expense, \$42,880; overhead, \$51,910; selling expenses, \$35,820; general and administrative expenses, \$60,240; cost of goods manufactured, \$163,990; and cost of goods sold, \$165,440. Estimated ending cash balances are as follows: January, \$34,610; February, \$60,190; and March, \$51,626. The company will have no capital expenditures during the quarter.

Sales are projected to be \$125,200 in January, \$105,100 in February, and \$112,600 in March. Accounts receivable are expected to double during the quarter, and accounts payable are expected to decrease by 20 percent. Mortgage payments for the quarter will total \$6,000, of which \$2,000 will be interest expense. Prepaid expenses are expected to go up by \$20,000, and other assets are projected to increase by 50 percent over the budget period. Depreciation for plant and equipment (already included in the overhead budget) averages 5 percent of total plant and equipment per year. Federal income taxes (30 percent of profits) are payable in April. The company pays no dividends.

#### REQUIRED

1. Determine the March 31 ending balances for Materials Inventory, Work in Process Inventory, and Finished Goods Inventory.
2. Prepare a budgeted income statement for the quarter ended March 31.
3. Prepare a budgeted balance sheet as of March 31.

#### LO 4



✓ Ending cash balance: \$36,105

#### Comprehensive Cash Budget

**P10.** Pur Centers, Inc., operates three fully equipped fitness centers, as well as a medical center that specializes in preventive medicine. The data that follow pertain to the corporation's first quarter.

##### Cash receipts:

Memberships: December, 870; January, 880; February, 910; March, 1,030  
 Membership dues: \$100 per month, payable on the 10th of the month (80 percent collected on time; 20 percent collected one month late)  
 Medical examinations: January, \$35,610; February, \$41,840; March, \$45,610  
 Special aerobics classes: January, \$4,020; February, \$5,130; March, \$7,130  
 High-protein food sales: January, \$4,890; February, \$5,130; March, \$6,280

##### Cash payments:

###### Salaries and wages:

Corporate officers: 2 at \$18,000 per month  
 Physicians: 2 at \$7,000 per month  
 Nurses: 3 at \$2,900 per month  
 Clerical staff: 2 at \$1,500 per month  
 Aerobics instructors: 3 at \$1,100 per month  
 Clinic staff: 6 at \$1,700 per month  
 Maintenance staff: 3 at \$900 per month  
 Health-food servers: 3 at \$750 per month

###### Purchases:

Muscle-toning machines: January, \$14,400; February, \$13,800 (no purchases in March)  
 Pool supplies: \$520 per month  
 Health food: January, \$3,290; February, \$3,460; March, \$3,720  
 Medical supplies: January, \$10,400; February, \$11,250; March, \$12,640  
 Medical uniforms and disposable garments: January, \$7,410; February, \$3,900; March, \$3,450

(Continued)

Medical equipment: January, \$11,200; February, \$3,400; March \$5,900  
 Advertising: January, \$2,250; February, \$1,190; March, \$2,450  
 Utilities expense: January, \$5,450; February, \$5,890; March, \$6,090

Insurance:

Fire: January, \$3,470  
 Liability: March, \$3,980

Property taxes: \$3,760 due in January

Federal income taxes: Last year's taxes of \$21,000 due in March

Miscellaneous: January, \$2,625; February, \$2,800; March, \$1,150

Pur Centers' controller anticipates that the beginning cash balance on January 1 will be \$14,000.

### REQUIRED

Prepare a cash budget for Pur Centers for the first quarter of the year. Use January, February, March, and Quarter as the column headings.

## CASES

LO 1, 2, 4, 5

### Conceptual Understanding: Policies for Budget Development

**C1. BUSINESS APPLICATION** ► Raiders Corporation is a company with annual sales of \$50 million. Its budget committee has created the following policy that the company uses each year in developing its master budget for the following calendar year:

- May The company's controller and other members of the budget committee meet to discuss plans and objectives for next year. The controller conveys all relevant information from this meeting to division managers and department heads.
- June Division managers, department heads, and the controller meet to discuss the corporate plans and objectives for next year. They develop a timetable for developing next year's budget data.
- July Division managers and department heads develop budget data. The vice president of sales provides them with final sales estimates, and they complete monthly sales estimates for each product line.
- Aug. Estimates of next year's monthly production activity and inventory levels are completed. Division managers and department heads communicate these estimates to the controller, who distributes them to other operating areas.
- Sept. All operating areas submit their revised budget data. The controller integrates their labor requirements, direct materials requirements, unit cost estimates, cash requirements, and profit estimates into a preliminary master budget.
- Oct. The budget committee meets to discuss the preliminary master budget and to make any necessary corrections, additions, or deletions. The controller incorporates all authorized changes into a final draft of the master budget.
- Nov. The controller submits the final draft to the budget committee for approval. If the committee approves it, it is distributed to all corporate officers, division managers, and department heads.

1. Comment on this policy.
2. What changes would you recommend?

LO 3, 5

### Ethical Dilemma: Ethical Considerations in Budgeting

**C2. BUSINESS APPLICATION** ► Joakim Keynes is the manager of the Repairs and Maintenance Department of JB Industries. He is responsible for preparing his department's annual budget. Most managers in the company inflate their budget numbers by at least 10 percent because their bonuses depend upon how much below budget their

departments operate. Keynes turned in the following information for his department's budget for next year to the company's budget committee:

	<b>Budget This Year</b>	<b>Actual This Year</b>	<b>Budget Next Year</b>
Supplies	\$ 20,000	\$ 16,000	\$ 24,000
Labor	80,000	82,000	96,000
Utilities	8,500	8,000	10,200
Tools	12,500	9,000	15,000
Hand-carried equipment	25,000	16,400	30,000
Cleaning materials	4,600	4,200	5,520
Miscellaneous	2,000	2,100	2,400
Totals	<u>\$152,600</u>	<u>\$137,700</u>	<u>\$183,120</u>

Because the figures for next year are 20 percent above those in this year's budget, the budget committee questioned them. Keynes defended them by saying that he expects a significant increase in activity in his department next year.

What do you think are the real reasons for the increase in the budgeted amounts? What ethical considerations enter into this situation?

## LO 4



### Conceptual Understanding: Budgeting for Cash Flows

**C3.** The nature of a company's business affects its need to budget for cash flows.

- **H&R Block** is a service company whose main business is preparing tax returns. Most tax returns are prepared after January 31 and before April 15. For a fee and interest, the company will advance cash to clients who are due refunds. The clients are expected to repay the cash advances when they receive their refunds. Although H&R Block has some revenues throughout the year, it devotes most of the nontax season to training potential employees in tax preparation procedures and to laying the groundwork for the next tax season.
- **Toys“R”Us** is a toy retailer whose sales are concentrated in October, November, and December of one year and January of the next year. Sales continue at a steady but low level during the rest of the year. The company purchases most of its inventory between July and September.
- **Johnson & Johnson** sells the many health care products that it manufactures to retailers, and the retailers sell them to the final customer. Johnson & Johnson offers retailers credit terms.

Discuss the nature of cash receipts and cash disbursements over a calendar year in the three companies we have just described. What are some key estimates that the management of these companies must make when preparing a cash budget?

## LO 4, 5

### Interpreting Management Reports: Budgeting Procedures

**C4. BUSINESS APPLICATION** ► Since Smart Enterprises inaugurated participative budgeting 10 years ago, everyone in the organization—from maintenance personnel to the president's staff—has had a voice in the budgeting process. Until recently, participative budgeting has worked in the best interests of the company as a whole. Now, however, it is becoming evident that some managers are using the practice solely to benefit their own divisions. The budget committee has therefore asked you, the company's controller, to analyze this year's divisional budgets carefully before incorporating them into the company's master budget.

The Gadget Division was the first of the company's six divisions to submit its budget request for next year. The division's budgeted income statement follows.

*(Continued)*



**Smart Enterprises  
Gadget Division  
Budgeted Income Statement  
For the Years Ended December 31**

	Budget for This Year	Budget for Next Year	Increase (Decrease)
Net sales:			
Radios	\$ 850,000	\$ 910,000	\$ 60,000
Appliances	680,000	740,000	60,000
Telephones	270,000	305,000	35,000
Miscellaneous	84,400	90,000	5,600
Net sales	<u>\$1,884,400</u>	<u>\$2,045,000</u>	<u>\$160,600</u>
Less cost of goods sold	750,960	717,500 <sup>a</sup>	(33,460)
Gross margin	<u>\$1,133,440</u>	<u>\$1,327,500</u>	<u>\$194,060</u>
Operating expenses:			
Wages			
Warehouse	\$ 94,500	\$ 102,250	\$ 7,750
Purchasing	77,800	84,000	6,200
Delivery/shipping	69,400	74,400	5,000
Maintenance	42,650	45,670	3,020
Salaries:			
Supervisory	60,000	92,250	32,250
Executive	130,000	164,000	34,000
Purchases, supplies	17,400	20,500	3,100
Maintenance	72,400	82,000	9,600
Depreciation	62,000	74,000 <sup>b</sup>	12,000
Building rent	96,000	102,500	6,500
Sales commissions	188,440	204,500	16,060
Insurance:			
Fire	12,670	20,500	7,830
Liability	18,200	20,500	2,300
Utilities	14,100	15,375	1,275
Taxes			
Property	16,600	18,450	1,850
Payroll	26,520	41,000	14,480
Miscellaneous	4,610	10,250	5,640
Total operating expenses	<u>\$1,003,290</u>	<u>\$1,172,145</u>	<u>\$168,855</u>
Income from operations	<u>\$ 130,150</u>	<u>\$ 155,355</u>	<u>\$ 25,205</u>

<sup>a</sup> Less expensive merchandise will be purchased in the next year to boost profits.

<sup>b</sup> Depreciation is increased because additional equipment must be bought to handle increased sales.

1. Recast the Gadget Division's budgeted income statement in the following format (round percentages to two decimal places):

Account	Budget for This Year		Budget for Next Year	
	Amount	Percentage of Net Sales	Amount	Percentage of Net Sales

2. Actual results for this year revealed the following information about revenues and cost of goods sold:

	Amount	Percentage of Net Sales
Net sales:		
Radios	\$ 780,000	43.94%
Appliances	640,000	36.06
Telephones	280,000	15.77
Miscellaneous	75,000	4.23
Net sales	<u>\$1,775,000</u>	<u>100.00%</u>
Less cost of goods sold	763,425	43.01
Gross margin	<u>\$1,011,575</u>	<u>56.99%</u>

On the basis of this information and your analysis in **1**, what do you think the budget committee should say to the Gadget Division's managers? Identify any specific areas of the budget that may need to be revised, and explain why the revision is needed.

LO 3, 4

SPREADSHEET

### The Budgeting Process

**C5.** Refer to our development of Framecraft Company's master budget in this chapter. Suppose that because of a new customer in Canada, the company management has decided to increase budgeted sales in the first quarter by 5,000 units. The expenses for this sale will include direct materials, direct labor, variable overhead, and variable selling and administrative expenses. The delivery expense for the Canadian customer will be \$0.18 per unit rather than the regular \$0.08 per unit. The desired units of beginning finished goods inventory will remain at 1,000 units.

1. Using a spreadsheet, revise Framecraft's budgeted income statement and the operating budgets that support it to reflect the changes described above. (Round manufactured cost per unit to three decimal places, and round income tax expense to the nearest dollar.)
2. What is the change in income from operations? Would you recommend accepting the order from the Canadian customer? If so, why?

### Continuing Case: Cookie Company

**C6.** In this segment of our continuing case, you have decided to open a store where you will sell your company's cookies, as well as coffee, tea, and other beverages. You believe that the store will be able to provide excellent service and undersell the local competition. To fund operations, you are applying for a loan from the Small Business Administration. The loan application requires you to submit two financial budgets—a pro forma income statement and a pro forma balance sheet—within six weeks.

How do the four *w*'s of preparing an accounting report apply in this situation—that is, *why* are you preparing these financial budgets, *who* needs them, *what* information do you need to prepare them, and *when* are they due?



# CHAPTER 23

## Flexible Budgets and Performance Analysis

### BUSINESS INSIGHT

#### Winter Wonderland Resort

Winter Wonderland Resort is a full-service resort and spa. When guests check in, they are issued an “all-in-one” charge card, which they can use to pay for anything they might buy at the resort, including meals or snacks, skiing or snowboarding lessons, lift tickets, treatments at the spa, or merchandise from one of the resort’s retail shops.

Guests like the all-in-one card because of its convenience, and they can earn points toward free lodging, meals, or lift tickets. The resort’s managers like the card system because it is a simple way of collecting vast amounts of both financial and nonfinancial information. Each time a guest makes a purchase, the all-in-one card is electronically scanned. The new data then become part of an integrated management information system, which managers use in a variety of ways to measure and evaluate the resort’s performance.

- 1. CONCEPT** ► *How do managers use the concepts of understandability and comparability when they evaluate performance?*
- 2. ACCOUNTING APPLICATION** ► *How will managers use flexible budgets and other performance measures to analyze the financial and nonfinancial performance of responsibility centers?*
- 3. BUSINESS APPLICATION** ► *How can managers achieve a balanced view of a business’s well-being and how to improve it?*

### LEARNING OBJECTIVES

- LO 1** Define a *performance management and evaluation system and responsibility accounting*, and describe the roles they play in performance analysis.
- LO 2** Use flexible budgets and variable costing to analyze cost center and profit center performance.
- LO 3** Analyze investment centers using return on investment, residual income, and economic value added.
- LO 4** Describe how the balanced scorecard aligns performance with organizational goals.
- LO 5** Explain how properly linked performance incentives and measures add value for all stakeholders in performance management and evaluation.



Blend Images/Fotolia LLC

## SECTION 1

## CONCEPTS

## CONCEPTS

- Comparability
- Understandability

RELEVANT  
LEARNING OBJECTIVE

**LO 1** Define a *performance management and evaluation system* and *responsibility accounting*, and describe the roles they play in performance analysis.

## LO 1 Concepts Underlying Performance Analysis

Managers use the concepts of *understandability* and *comparability* as they manage a wide range of financial and nonfinancial data to guide and evaluate performance. If they want satisfactory results, managers must understand the cause-and-effect relationships between their actions and their performance. By measuring and tracking the causal relationships for which they are accountable, managers can improve performance as they command, control, and evaluate the organization.

A **performance management and evaluation system** is a set of procedures that account for and report on both financial and nonfinancial performance so that a company can *understand* how well it is doing, where it is going, and what improvements will make it more profitable. **Performance measures** are quantitative tools that gauge and *compare* an organization's performance in relation to a specific goal or an expected outcome.

- Financial performance measures use monetary information to measure and *compare* the performance of a profit-generating organization or its divisions, departments, product lines, sales territories, or operating activities. Examples include return on investment, net income as a percentage of sales, and the costs of poor quality as a percentage of sales.
- Nonfinancial performance measures use statistics to *understand* how to reduce or eliminate waste and inefficiencies in operating activities. Examples include the number of times an activity occurs or the time taken to perform a task, such as the number of customer complaints; number of orders shipped the same day; or the time taken to fill an order.

## What to Measure, How to Measure

**Performance measurement** is the use of quantitative tools to *understand* an organization's performance in relation to a specific goal or an expected outcome. For performance measurement to succeed, managers must be able to distinguish between what is being measured and the actual measures used to monitor performance and *compare* results. For instance, product or service quality is not a performance measure. It is part of management's strategy to produce the highest-quality product or service possible, given the resources available. Product or service quality thus is what management wants to measure and compare.

As part of their performance management systems, organizations assign resources to specific areas of responsibility and track how the managers of those areas use those resources. For example, Winter Wonderland Resort assigns resources to its Lodging, Dining, Retail and Rental, Ski School, and Real Estate divisions and holds the managers of those divisions responsible for generating revenue and managing costs. Within each division, other managers are assigned responsibility for such areas as Children and Adult Ski School, Snowboard School, or Private Lessons.

All managers at all levels are then evaluated in terms of their ability to manage their areas of responsibility. To assist in performance management and evaluation, many organizations use responsibility accounting. **Responsibility accounting** is an information system that classifies data according to areas of responsibility and reports each area's activities by including only the revenue, cost, and resource categories that the assigned manager can control. A **responsibility center** is an organizational unit whose manager has been assigned the responsibility of managing a portion of the organization's resources. The

activities of a responsibility center dictate the extent of a manager’s responsibility. Thus, responsibility accounting establishes accountability—the foundation of performance analysis—by grounding user *comparisons* and *understanding* of an organization.

A report for a responsibility center should contain only the costs, revenues, and resources that the manager of that center can control. Such costs and revenues are called **controllable costs and revenues**, because they are the result of a manager’s actions, influence, or decisions. A responsibility accounting system ensures that managers will not be held responsible for items that they cannot change.

## Types of Responsibility Centers

There are five types of responsibility centers:

- cost center
- discretionary cost center
- revenue center
- profit center
- investment center

The key characteristics of each type of responsibility center are summarized in Exhibit 1.

**Exhibit 1**  
Types of Responsibility Centers

Responsibility Center	Manager Responsibility	Performance Measures	Examples
Cost center	Only controllable costs, where there are well-defined links between the costs of resources and the resulting products or services	<ul style="list-style-type: none"> <li>• Comparison of actual costs with flexible and master budget costs</li> <li>• Analysis of resulting variances</li> </ul>	<b>Product:</b> Manufacturing assembly plants <b>Service:</b> Food service for hospital patients
Discretionary cost center	Only controllable costs; the links between the costs of resources and the resulting products or services are <i>not</i> well defined	<ul style="list-style-type: none"> <li>• Comparison of actual noncost-based measures with targets</li> <li>• Determination of compliance with preapproved budgeted spending limits</li> </ul>	<b>Product or service:</b> Administrative activities such as accounting, human resources, and research and development
Revenue center	Revenue generation	<ul style="list-style-type: none"> <li>• Comparison of actual revenue with budgeted revenue</li> <li>• Analysis of resulting variances</li> </ul>	<b>Product:</b> Phone or e-commerce sales for pizza delivery <b>Service:</b> Reservation center on Internet
Profit center	Operating income resulting from controllable revenues and costs	<ul style="list-style-type: none"> <li>• Comparison of actual variable costing income statement with the budgeted income statement</li> </ul>	<b>Product or service:</b> Local store of a national chain
Investment center	Controllable revenues, costs, and the investment of resources to achieve organizational goals	<ul style="list-style-type: none"> <li>• Return on investment</li> <li>• Residual income</li> <li>• Economic value added</li> </ul>	<b>Product:</b> A division of a multinational corporation <b>Service:</b> A national office of a multinational consulting firm

© Cengage Learning 2014



**Cost Center** A responsibility center whose manager is accountable only for controllable costs that have well-defined relationships between the center's resources and certain products or services is called a **cost center**. Manufacturing companies like **Apple** use cost centers to manage assembly plants, where the causal relationship between the costs of resources (direct material, direct labor) and the resulting products is well defined. Service organizations use cost centers to manage activities in which resources are clearly linked with a service that is provided at no additional charge. For example, in nursing homes and hospitals, there is a clear relationship between the costs of food and direct labor and the number of inpatient meals served.

The performance of a cost center is usually evaluated by *comparing* an activity's actual cost with its budgeted cost and analyzing the resulting variances. You will learn more about this performance evaluation process in the chapter on standard costing.

**Discretionary Cost Center** A responsibility center whose manager is accountable for costs only and in which the relationship between resources and the products or services produced is not well defined is called a **discretionary cost center**. Departments that perform administrative activities, such as accounting, human resources, and legal services, are typical examples of discretionary cost centers. These centers, like cost centers, have approved budgets that set spending limits.

Because the spending and use of resources in discretionary cost centers are not clearly linked to the production of a product or service, cost-based measures usually cannot be used to evaluate performance (although such centers are penalized if they exceed their approved budgets). For example, among the performance measures used to evaluate the research and development activities are the number of patents obtained and the number of cost-saving innovations that are developed. At service organizations, such as **United Way**, a common measure of administrative activities is how low their costs are as a percentage of total contributions.

**Revenue Center** A responsibility center whose manager is accountable primarily for revenue and whose success is based on its ability to generate revenue is called a **revenue center**. Examples of revenue centers are **Hertz's** national car reservation center and **Amazon's** ecommerce order department.

A revenue center's performance is usually evaluated by *comparing* its actual revenue with its budgeted revenue and analyzing the resulting variances. Performance measures may include sales dollars, number of customer sales, or sales revenue per minute.

**Profit Center** A responsibility center whose manager is accountable for both revenue and costs and for the resulting operating income is called a **profit center**. A good example is a local store of a national chain, such as **Wal-Mart** or **Jiffy Lube**.

The performance of a profit center is usually evaluated by *comparing* the figures on its actual income statement with the figures on its master or flexible budget income statement.

**Investment Center** A responsibility center whose manager is accountable for profit generation and who can also make significant decisions about the resources that the center uses is called an **investment center**. For example, the president of **Harley-Davidson's** Buell subsidiary and the president of **Brinker International's** Chili's Grill and Bar can control revenues, costs, and the investment of assets to achieve organizational goals.

The performance of these centers is evaluated using such measures as return on investment, residual income, and economic value added, (which will be discussed later in the chapter). These measures are used in all types of organizations, both manufacturing and service.

Research and development units are a type of discretionary cost center in which a manager is accountable for costs only and the relationship between resources and products or services produced is not well defined. A common performance measure used to evaluate research and development activities is the number of patents obtained.



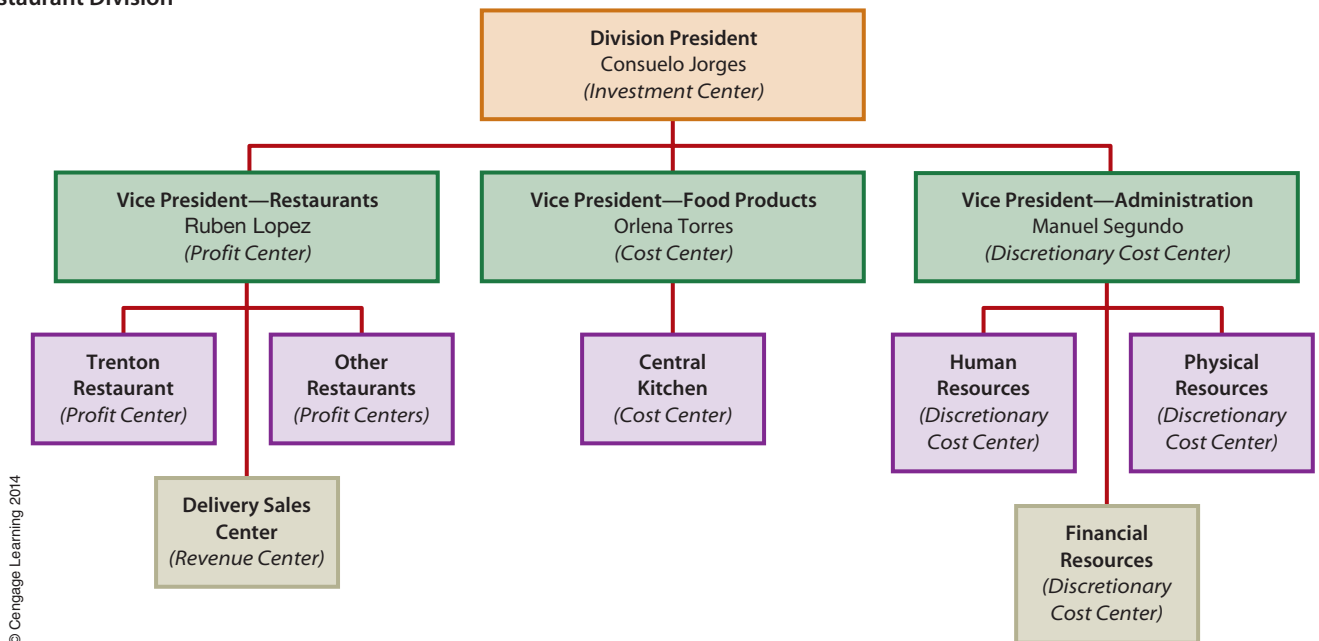


## Organizational Structure and Performance Reports

Much can be learned about an organization by examining how its managers organize activities and resources. A company’s organizational structure formalizes its lines of managerial authority and control. An **organization chart** is a visual representation of an organization’s hierarchy of responsibility for the purposes of management control. Within an organization chart, the five types of responsibility centers are arranged by level of management authority and control.

Exhibit 2 shows a typical corporate organization chart for part of the management structure for the Restaurant Division of a hospitality corporation like Winter Wonderland. Notice that all five types of responsibility centers are represented.

**Exhibit 2**  
Partial Organization Chart  
of the Restaurant Division



© Cengage Learning 2014

In a responsibility accounting system, the performance reports for each level of management are tailored to each manager’s individual needs for information. As information moves up the organizational chart, it is usually condensed. Performance reporting by responsibility level enables an organization to trace the source of a cost, revenue, or resource to the manager who controls it and to evaluate that manager’s performance accordingly.

**STUDY NOTE:** Only controllable items should be included on a manager’s performance report.

Because performance reports contain information about costs, revenues, and resources, they allow *comparisons* between actual performance and budget expectations. Such comparisons allow management to *understand* and evaluate an individual’s performance with respect to responsibility center and company-wide objectives and to recommend changes. Performance reports should contain only costs, revenues, and resources that the manager can control. If a performance report includes items that the manager cannot control, the credibility of the entire responsibility accounting system can be called into question. The content and format of a performance report depend on the nature of the responsibility center. It is up to management to structure and interpret them fairly.

Although performance reports vary in format, they have some common themes:

- All responsibility center reports compare actual results to budgeted figures and focus on the differences.
- Often, comparisons are made to a flexible budget (to be discussed in the next section) as well as to the master budget.
- Only the items that the manager can control are included in the performance report.
- Nonfinancial measures are also examined to achieve a more balanced view of the manager's responsibilities.

## APPLY IT!

Identify the most appropriate type of responsibility center for each of the following organizational units:

1. A pizza store in a pizza chain
2. The ticket sales center of a major airline
3. The food service function at a nursing home
4. A subsidiary of a business conglomerate
5. The information technology area of a company

### SOLUTION

1. profit center
2. revenue center
3. cost center
4. investment center
5. discretionary cost center

**TRY IT! SE1, E1A, E2A, E1B, E2B**

## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Create a flexible budget
- Create a variable costing income statement
- Compute return on investment (ROI)
- Compute residual income (RI)
- Compute economic value added (EVA)

## RELEVANT LEARNING OBJECTIVES

**LO 2** Use flexible budgets and variable costing to analyze cost center and profit center performance.

**LO 3** Analyze investment centers using return on investment, residual income, and economic value added.

## LO 2 Performance Evaluation of Cost Centers and Profit Centers

The accuracy of performance analysis depends to a large extent on the type of budget that managers use when *comparing* actual results to a budget. Static, or fixed, budgets forecast revenues and expenses for just one level of sales and just one level of output. The budgets that make up a master budget are usually based on a single level of output; but many things can cause actual output to differ from the estimated output. If a company produces more products than predicted, total production costs will almost always be greater than predicted. Thus, a comparison of actual production costs with master budgeted costs will inevitably show variances.

### Flexible Budgets and Performance Analysis

To judge a product or division's performance accurately, the company's managers can use a **flexible budget** (or *variable budget*), which is a summary of expected costs for a range of activity levels. Unlike a static budget, a flexible budget provides forecasted data that can be adjusted for changes in the level of output. In terms of *comparability*, flexible budgets allow managers to compare budgeted and actual costs at any level of output. An important element in preparing a flexible budget is the **flexible budget formula**, an equation that determines the expected, or budgeted, cost for any level of output. The flexible budget formula can be used to create a budget for any level of output in the range of levels given and is computed as follows.

$$\text{Flexible Budgeted Costs} = \left( \text{Variable Cost per Unit} \times \text{Number of Units Produced} \right) + \text{Budgeted Fixed Costs}$$

We will use Winter Wonderland to illustrate how managers use flexible budgets. In the Restaurant Division of Winter Wonderland, the central kitchen evaluates the performance of each food item produced. The flexible budget formula for one of its products, House Dressing, would be computed as follows.

$$\text{House Dressing Flexible Budget Formula} = (\$0.33 \times \text{Gallons Produced}) + \$5$$

A flexible budget for Winter Wonderland's House Dressing appears in Exhibit 3, which shows the estimated costs for 1,000, 1,200, and 1,500 gallons of salad dressing output.

#### Exhibit 3 Flexible Budget for House Dressing

Winter Wonderland—Restaurant Division House Dressing Flexible Budget Current Year			
Cost Category	Units Produced		
	1,000	1,200	1,500
Direct materials (\$0.25 per gallon)	\$250	\$300	\$375
Direct labor (\$0.05 per gallon)	50	60	75
Variable overhead (\$0.03 per gallon)	30	36	45
Total variable costs (\$0.33 per gallon)	\$330	\$396	\$495
Fixed overhead costs	5	5	5
Total costs	\$335	\$401	\$500

## Evaluating Cost Center Performance Using Flexible Budgeting

In the Restaurant Division of a major hospitality company like Winter Wonderland, the central kitchen is where the food products that the restaurants sell are prepared. It is a cost center because its costs have well-defined relationships with the resulting products, which are then transferred to the restaurants for further processing and sale. To ensure each food item is meeting its performance goals, the manager will evaluate each product by *comparing* its actual costs with the corresponding amounts from the budget.

The performance report on House Dressing presented in Exhibit 4 compares data from Winter Wonderland's master budget (prepared at the beginning of the period) and flexible budget (prepared at the end of the period) with the actual results for the period. As you can see, actual costs exceeded budgeted costs. Most managers would consider such a cost overrun significant. But was there really a cost overrun if the amounts budgeted in the master budget are based on an output of 1,000 units of dressing and the actual output was 1,200 units of dressing?

To judge the central kitchen's performance accurately, the company needs to change the budgeted data in the master budget to reflect an output of 1,200 units, as illustrated in Exhibit 4. The flexible budget is used primarily as an evaluation tool at the end of a period. Favorable (positive, or F) and unfavorable (negative, or U) variances between actual costs and the flexible budget can be further examined by using standard costing to compute specific variances for direct materials, direct labor, and variable and fixed overhead.\*

**Exhibit 4**  
Central Kitchen's Performance  
Report on House Dressing

	Actual Results	Variance	Flexible Budget	Variance	Master Budget
<b>Gallons produced</b>	<b>1,200</b>	<b>0</b>	<b>1,200</b>	<b>200 (F)</b>	<b>1,000</b>
Center costs:					
Direct materials (\$0.25 per gallon)	\$312	\$12 (U)	\$300	\$50 (U)	\$250
Direct labor (\$0.05 per gallon)	72	12 (U)	60	10 (U)	50
Variable overhead (\$0.03 per gallon)	33	(3) (F)	36	6 (U)	30
Fixed overhead	2	(3) (F)	5	0	5
Total cost	<u>\$419</u>	<u>\$18 (U)</u>	<u>\$401</u>	<u>\$66 (U)</u>	<u>\$335</u>
Performance measures:					
Defect-free gallons to total produced	0.98	0.01 (U)	N/A	N/A	0.99
Average throughput minutes per gallon	11	1 (F)	N/A	N/A	12

*Note:* In this exhibit and others that appear later in this chapter, (F) indicates a favorable variance, and (U) indicates an unfavorable variance.

© Cengage Learning 2014

## Evaluating Profit Center Performance Using Variable Costing

Restaurants are profit centers, since each is accountable for its own revenues and costs and for the resulting operating income. A profit center's performance is usually evaluated by *comparing* its actual income statement results to its budgeted income statement.

One method of preparing profit center performance reports is **variable costing**, which classifies a manager's controllable costs as either variable or fixed. Variable costing produces a variable costing income statement instead of a traditional income statement (also called a *full costing* or *absorption costing income statement*), which is used for external reporting purposes. It is an internally prepared income statement that is useful in performance management and evaluation because it focuses on cost variability and the

\* Refer to the chapter on standard costing for further information on performance evaluation using variances or the flexible budget.

**STUDY NOTE:** A variable costing income statement has a similar format to the contribution margin income statement used in cost-volume-profit analysis.

profit center’s contribution to operating income. Under variable costing, variable costs include direct materials costs, direct labor costs, variable overhead costs, and variable selling, administrative, and general costs. Fixed costs include fixed manufacturing costs, like fixed overhead, and fixed selling, administrative, and general costs. The format of a variable costing income statement follows.

Sales
<u>– Variable costs</u>
Contribution margin
<u>– Fixed costs</u>
Operating income

The variable costing income statement differs from the traditional income statement prepared for financial reporting, as shown by the two income statements in Exhibit 5 for Trenton Restaurant, which is part of Winter Wonderland’s Restaurant Division. In the traditional income statement, all manufacturing costs are assigned to the cost of goods sold. In the variable costing income statement, only the variable manufacturing costs are included in the variable cost of goods sold. Fixed manufacturing costs are considered costs of the current period and are listed with fixed selling expenses after the contribution margin has been computed.

**Exhibit 5**  
Variable Costing Income Statement Versus Traditional Income Statement for Trenton Restaurant (Amounts in Thousands)

Variable Costing Income Statement		Traditional Income Statement	
Sales	\$ 2,500	Sales	\$ 2,500
Variable cost of goods sold	(1,575)	Cost of goods sold	
Variable selling expenses	(325)		(1,745)
Contribution margin	<u>\$ 600</u>	Gross margin	<u>\$ 755</u>
Fixed manufacturing costs	(170)	Variable selling expenses	(325)
Fixed selling expenses	(230)	Fixed selling expenses	(230)
Profit center operating income	<u><u>\$ 200</u></u>	Profit center operating income	<u><u>\$ 200</u></u>

© Cengage Learning 2014

**Exhibit 6**  
Performance Report Based on Variable Costing and Flexible Budgeting for Trenton Restaurant (Amounts in Thousands)

In addition to tracking financial performance measures, a manager of a profit center may also want to measure and evaluate nonfinancial information, such as the number of food orders processed and the average amount of a sales order at Trenton Restaurant. The resulting report, based on variable costing and flexible budgeting, is shown in Exhibit 6.

	Actual Results	Variance	Flexible Budget	Variance	Master Budget
<b>Meals served</b>	<u>750</u>	<u>0</u>	<u>750</u>	<u>250 (U)</u>	<u>1,000</u>
Sales (average meal \$2.85)	\$ 2,500.00	\$ 362.50 (F)	\$ 2,137.50	\$ 712.50 (U)	\$ 2,850.00
Controllable variable costs:					
Variable cost of goods sold (\$1.50)	(1,575.00)	(450.00) (U)	(1,125.00)	(375.00) (F)	(1,500.00)
Variable selling expenses (\$0.40)	(325.00)	(25.00) (U)	(300.00)	(100.00) (F)	(400.00)
Contribution margin	<u>\$ 600.00</u>	<u>\$ 112.50 (U)</u>	<u>\$ 712.50</u>	<u>\$ 237.50 (U)</u>	<u>\$ 950.00</u>
Controllable fixed costs:					
Fixed manufacturing expenses	(170.00)	(30.00) (F)	(200.00)	0.00	(200.00)
Fixed selling expenses	(230.00)	(20.00) (F)	(250.00)	0.00	(250.00)
Profit center operating income	<u><u>\$ 200.00</u></u>	<u><u>\$ 62.50 (U)</u></u>	<u><u>\$ 262.50</u></u>	<u><u>\$ 237.50 (U)</u></u>	<u><u>\$ 500.00</u></u>
Nonfinancial performance measures:					
Number of orders processed	300	50 (F)	N/A	N/A	250
Average sales order	\$8.34	\$3.06 (U)	N/A	N/A	\$11.40

© Cengage Learning 2014

## APPLY IT!

Complete the following performance report for a profit center for the month ended December 31:

	Actual Results	Variance	Master Budget
Sales	\$ ?	\$ 20 (F)	\$ 120
Controllable variable costs:			
Variable cost of goods sold	(25)	(10) (U)	?
Variable selling and administrative expenses	(15)	? (?)	(5)
Contribution margin	\$100	\$ ? (?)	\$ 100
Controllable fixed costs	?	10 (F)	60
Profit center income	\$ 50	\$ 10 (F)	\$ ?
Nonfinancial performance measures:			
Number of orders processed	50	20 (F)	?
Average daily sales	\$?	\$0.66 (F)	\$4.00
Number of units sold	100	40 (F)	?

### SOLUTION

Profit Center Performance Report For the Month Ended December 31			
	Actual Results	Variance	Master Budget
Sales	\$140	\$ 20 (F)	\$120
Controllable variable costs:			
Variable cost of goods sold	(25)	(10) (U)	(15)
Variable selling and administrative expenses	(15)	(10) (U)	(5)
Contribution margin	\$100	\$ 0	\$100
Controllable fixed costs	50	10 (F)	60
Profit center operating income	\$ 50	\$ 10 (F)	\$ 40
Nonfinancial performance measures:			
Number of orders processed	50	20 (F)	30
Average daily sales	\$4.66	\$0.66 (F)	\$4.00
Number of units sold	100	40 (F)	60

TRY IT! SE2, SE3, SE4, E3A, E4A, E5A, E6A, E3B, E4B, E5B, E6B

## LO 3 Performance Evaluation of Investment Centers

The evaluation of an investment center's performance requires more than a comparison of controllable revenues and costs with budgeted amounts. Because the managers of investment centers also control resources and invest in assets, other performance measures must be used to hold them accountable for revenues, costs, and the capital investments that they control. In this section, we focus on the traditional performance evaluation measures of return on investment and residual income and the relatively new performance measure of economic value added.

### RATIO

## Return on Investment

Traditionally, the most common performance measure that takes into account both operating income and the assets invested to earn that income is **return on investment (ROI)**, which is computed as follows.

### Computing Return on Investment (ROI)

#### Formula

$$\text{Return on Investment (ROI)} = \frac{\text{Operating Income}}{\text{Assets Invested}}$$

In this formula, assets invested is the average of the beginning and ending asset balances for the period.

Properly measuring the income and the assets specifically controlled by a manager is critical to the quality of this performance measure. Using ROI, it is possible to evaluate the manager of any investment center, whether it is an entire company or a unit within a company, such as a subsidiary, division, or other business segment.

**Example** Winter Wonderland's Restaurant Division had actual operating income of \$610, and the average assets invested were \$800. The master budget called for \$890 in operating income and \$1,000 in invested assets. As shown in Exhibit 7, the budgeted

**Exhibit 7**  
Performance Report Based  
on Return on Investment for  
the Restaurant Division

© Cengage Learning 2014

	<u>Actual Results</u>	<u>Variance</u>	<u>Master Budget</u>
Operating income	\$610	\$(280) (U)	\$890
Assets invested	\$800	\$200 (F)	\$1,000
Performance measure:			
ROI*	76%	(13%) (U)	89%
*ROI = Operating Income ÷ Assets Invested			
Actual = \$890 ÷ \$1,000			
= 0.89 = <u>89%</u>			
Master = \$610 ÷ \$800			
= 0.7625 = <u>76%</u> (rounded)			

ROI for the division would be 89 percent, and the actual ROI would be 76 percent. The actual ROI was lower than the budgeted ROI because the division's actual operating income was lower than expected relative to the actual assets invested.

**STUDY NOTE:** Profit margin focuses on the income statement, and asset turnover focuses on the balance sheet aspects of ROI.

The basic ROI equation, Operating Income ÷ Assets Invested, can be rewritten to show the many elements within the aggregate ROI number that a manager can influence. Two important indicators of performance are profit margin and asset turnover.

- **Profit margin** is the ratio of operating income to sales. It represents the percentage of each sales dollar that results in profit.
- **Asset turnover** is the ratio of sales to average assets invested. It indicates the productivity of assets, or the number of sales dollars generated by each dollar invested in assets.

A single ROI number is a composite index of many cause-and-effect relationships and interdependent financial elements. The following formula recognizes the many interrelationships that affect ROI:

$$\text{ROI} = \frac{\text{Operating Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Assets Invested}} = \frac{\text{Operating Income}}{\text{Assets Invested}}$$

$$\text{ROI} = \text{Profit Margin} \times \text{Asset Turnover}$$

Profit margin and asset turnover help explain changes in return on investment for a single investment center or differences in return on investment among investment centers. Therefore, the formula  $\text{ROI} = \text{Profit Margin} \times \text{Asset Turnover}$  is useful for analyzing and interpreting the elements that make up a business's overall return on investment.

ROI is affected by a manager's decisions about pricing, product sales mix, capital budgeting for new facilities, product sales volume, and other financial matters. A manager can improve ROI by increasing sales, decreasing costs, or decreasing assets.

**Business Application** If ROI is overemphasized, investment center managers may react by making business decisions that favor their personal ROI performance at the expense of company-wide profits or the long-term success of other investment centers. To avoid such problems, other performance measures should always be used in conjunction with ROI—for example, *comparisons* of revenues, costs, and operating income with budget amounts or past trends; sales growth percentages; market share percentages; or other key variables in the organization's activity. ROI should also be compared with budgeted goals and with past ROI trends because changes in this ratio over time can be more revealing than any single number.



## Residual Income

Because of the pitfalls of using ROI as a performance measure, **residual income (RI)** is another approach to evaluating investment centers. Residual income is the operating income that an investment center earns above a minimum desired return on invested assets. Residual income is not a ratio but a dollar amount—the amount of profit left after subtracting a predetermined desired income target for an investment center.

### Computing Residual Income (RI)

#### Formula

$$\text{Residual Income} = \text{Operating Income} - (\text{Desired ROI} \times \text{Assets Invested})$$

As in the computation of ROI, assets invested is the average of the center's beginning and ending asset balances for the period.

The desired RI will vary from investment center to investment center depending on the type of business and the level of risk assumed.

**Example** Exhibit 8 shows Winter Wonderland's Restaurant Division's performance report based on residual income. The residual income performance target is to exceed a 20 percent return on assets invested in the division.

#### Exhibit 8 Performance Report Based on Residual Income for the Restaurant Division

	<u>Actual Results</u>	<u>Variance</u>	<u>Master Budget</u>
Operating income	\$610	\$(280) (U)	\$890
Assets invested	\$800	\$200 (F)	\$1,000
Desired ROI			20%
Performance measures:			
ROI	76%	(13%) (U)	89%
Residual income*	\$450	\$(240) (U)	\$690

\*Residual Income = Operating Income – (Desired ROI × Assets Invested)

$$\text{Actual} = \$610 - (20\% \times \$800)$$

$$= \underline{\underline{\$450}}$$

$$\text{Master} = \$890 - (20\% \times \$1,000)$$

$$= \underline{\underline{\$690}}$$

© Cengage Learning 2014

Note that the division's residual income is \$450, which was lower than the \$690 that was projected in the master budget.

*Comparisons* with other residual income figures will strengthen the analysis. To add context to the analysis of the division and its manager, questions such as the following need to be answered:

- How did the division's residual income this year compare with its residual income in previous years?
- Did the actual residual income exceed the budgeted residual income?
- How did this division's residual income compare with the amounts generated by other investment centers of the company?

**Concept** For their residual income figures to be *comparable*, all investment centers must have equal access to resources and similar asset investment bases. Some managers may be able to produce larger residual incomes simply because their investment centers are larger rather than because their performance is better.

## Economic Value Added

More and more businesses are using the shareholder wealth created by an investment center, or the **economic value added (EVA™)**, as an indicator of performance.<sup>1</sup> The calculation of EVA can be quite complex because it makes various cost of capital and accounting principles adjustments. The **cost of capital** is the minimum desired rate of return on an investment, such as the assets invested in an investment center.

Basically, the computation of EVA is similar to that of RI, except that after-tax operating income is used instead of pretax operating income. Also, a cost of capital percentage is multiplied by the center's invested assets less current liabilities instead of a desired ROI percentage being multiplied by invested assets. Like RI, EVA is expressed in dollars. EVA is computed as follows.

### Computing Economic Value Added (EVA)

#### Formula

$$\text{EVA} = \text{After-Tax Operating Income} - [\text{Cost of Capital} \times (\text{Total Assets} - \text{Current Liabilities})]$$

**Example** Exhibit 9 shows a basic computation of EVA for Winter Wonderland's Restaurant Division. The division's after-tax operating income is \$400, its cost of capital is 12 percent, its total assets are \$800, and its current liabilities are \$250. The report shows that the division has added \$334 to its economic value after taxes and cost of capital. In other words, the division produced after-tax profits of \$334 in excess of the cost of capital required to generate those profits.

**STUDY NOTE:** The EVA number is a composite index drawn from many cause-and-effect relationships and interdependent financial elements.

#### Exhibit 9 Performance Report Based on Economic Value Added for the Restaurant Division

© Cengage Learning 2014

	Actual Results	Variance	Master Budget
Performance measures:			
ROI	76%	(13%) (U)	89%
Residual income	\$450	\$(240) (U)	\$690
Economic value added*	\$334		
*EVA = After-Tax Operating Income – [Cost of Capital × (Total Assets – Current Liabilities)]			
= \$400 – [12% × (\$800 – \$250)]			
= \$334			

The factors that affect the computation of EVA are the managers' decisions on pricing, product sales volume, taxes, cost of capital, capital investments, and other financial matters. A manager can improve the economic value of an investment center by increasing sales, decreasing costs, decreasing assets, or lowering the cost of capital.

**Concept** The economic value of an investment center and its cost of capital will be more meaningful if the current economic value added is *compared* to EVAs from previous periods, target EVAs, and EVAs from other investment centers.

## APPLY IT!

Brew Mountain Company sells coffee and hot beverages. Its Coffee Cart Division sells to skiers as they come off the mountain. The Coffee Cart Division's balance sheet showed that the company had invested assets of \$30,000 at the beginning of the year and \$50,000 at the end of the year. During the year, the division's operating income was \$80,000 on sales of \$120,000.

1. Compute the division's residual income if the desired ROI is 20 percent.
2. Compute the return on investment for the division.
3. Compute the economic value added for the company if total corporate assets are \$600,000, current liabilities are \$80,000, after-tax operating income is \$70,000, and the cost of capital is 12 percent.

### SOLUTION

1.  $\$80,000 - \{20\% \times [(\$30,000 + \$50,000) \div 2]\} = \underline{\$72,000}$
2.  $\$80,000 \div [(\$30,000 + \$50,000) \div 2] = \underline{200\%}$
3.  $\$70,000 - [12\% \times (\$600,000 - \$80,000)] = \underline{\$7,600}$

**TRY IT! SE5, SE6, SE7, E7A, E8A, E9A, E7B, E8B, E9B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Balanced scorecard
- Benchmarking
- Planning
- Performing
- Evaluating
- Communicating

RELEVANT  
LEARNING OBJECTIVES

**Lo 4** Describe how the balanced scorecard aligns performance with organizational goals.

**Lo 5** Explain how properly linked performance incentives and measures add value for all stakeholders in performance management and evaluation.

## Lo 4 Performance Measurement

To be effective, a performance management system must consider both operating results and multiple performance measures, such as return on investment, residual income, and economic value added. Comparing actual results to budgeted figures adds meaning to the evaluation. Performance measures such as ROI, RI, and EVA indicate whether an investment center is effective in coordinating its own goals with company-wide goals because these measures take into account both operating income and the assets used to produce that income. However, all three measures are limited by their focus on short-term financial performance. To obtain a fuller picture, management needs to *understand* and *compare* all stakeholders' performance perspectives to ensure a more balanced view of a business's well-being and how to improve it. To do this, managers must collaborate with other managers to develop a group of measures, such as the balanced scorecard.

### Organizational Goals and the Balanced Scorecard

The **balanced scorecard** is a framework that links the perspectives of an organization's four basic stakeholder groups—financial (investor), learning and growth (employee), internal business processes, and customer—with the organization's mission and vision, performance measures, strategic and tactical plans, and resources. To succeed, an organization must add value for all groups in both the short and the long term. Thus, an organization will determine each group's objectives and translate them into performance measures that have specific, quantifiable performance targets. Ideally, managers should be able to see how their actions contribute to the achievement of organizational goals and understand how their compensation is related to their actions. The balanced scorecard assumes that an organization will get only what it measures. The balanced scorecard adds dimension to the management process. Managers plan, perform, evaluate, and communicate the organization's performance from multiple perspectives. By balancing the needs of all stakeholders, managers are more likely to achieve their objectives in both the short and the long term. We will use Winter Wonderland to illustrate how managers use the balanced scorecard.

**Planning** During the planning stage, the balanced scorecard provides a framework that enables managers to translate their organization's vision and strategy into operational terms. Managers evaluate the company's vision from the perspective of each stakeholder group and seek to answer one key question for each group:

- **Financial (investor):** To achieve our organization's vision, how should we appear to our shareholders?
- **Learning and growth (employee):** To achieve our organization's vision, how should we sustain our ability to improve and change?
- **Internal business processes:** To succeed, in which business processes must our organization excel?
- **Customer:** To achieve our organization's vision, how should we appeal to our customers?

These key questions align the organization's strategy from all perspectives.

The answers to the questions result in performance objectives that are mutually beneficial to all stakeholders. Once the organization's objectives are set, managers can select performance measures and set performance targets to translate the objectives into

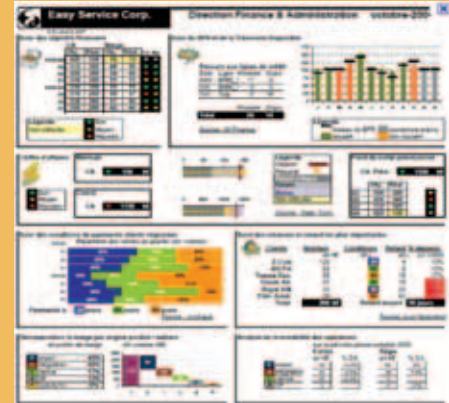


## Business Perspective

### “Tableau de Bord and the Balanced Scorecard”

The *tableau de bord*, or “dashboard,” was developed by French engineers around 1900 as a concise performance measurement system that helped managers understand the cause-and-effect relationships between their decisions and the resulting performance. The indicators, both financial and nonfinancial, allowed managers at all levels to monitor their progress in terms of the mission and objectives of their unit and of their company overall. The dashboard focuses on and supports an organization’s strategic plan.

Source: Reprinted from *Management Accounting Research*, Vol. 15, Issue 2, Annick Bourguignon, “The American Balanced Scorecard versus the French Tableau de Bord: The Ideological Dimension,” pp. 107–134. Copyright © 2004, with permission from Elsevier.



an action plan. For example, if Winter Wonderland’s collective vision and strategy is to please guests, its managers might establish the following overall objectives:

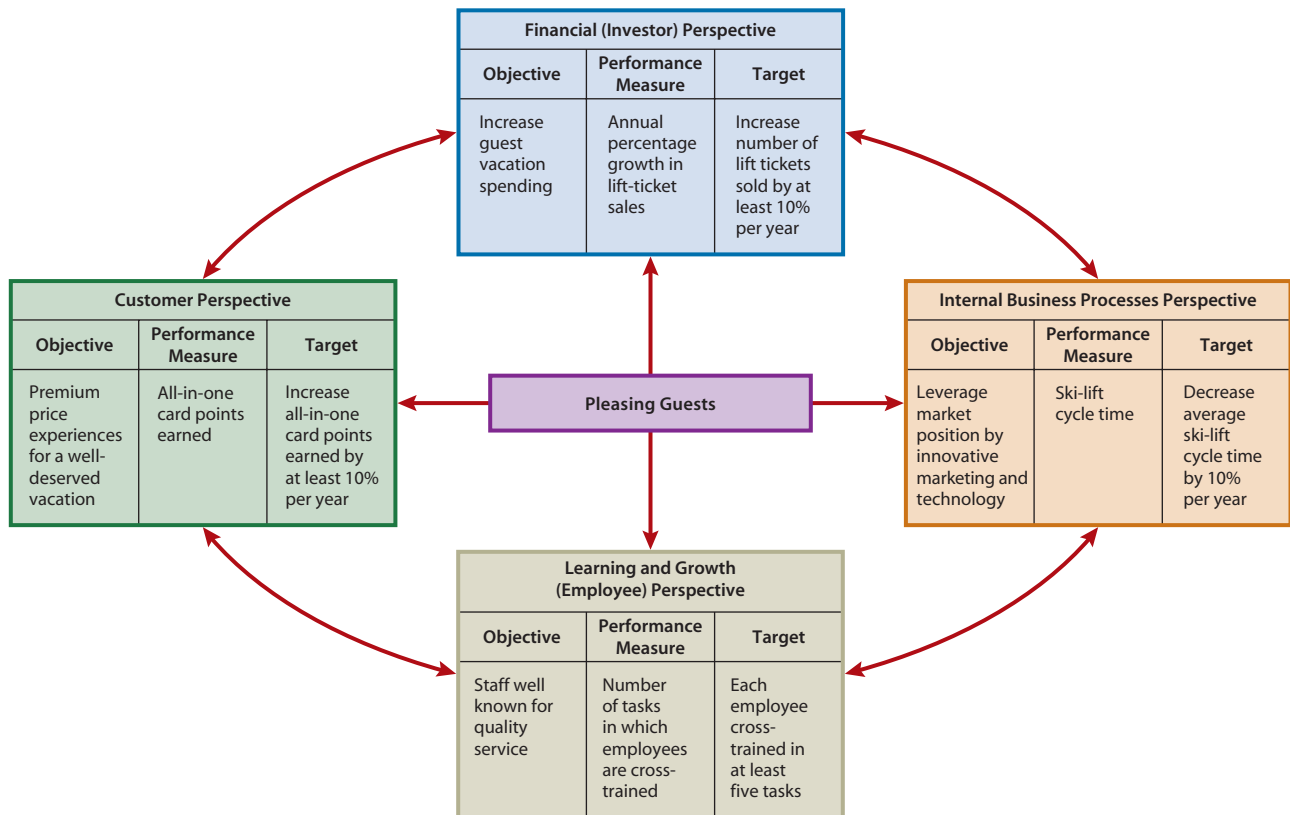
Perspective	Objective
Financial (investor)	Increase guests’ spending at the resort.
Learning and growth (employee)	Continually cross-train employees in each other’s duties to sustain premium-quality service for guests.
Internal business processes	Leverage market position by introducing and improving innovative marketing and technology-driven advances that clearly benefit guests.
Customer	Create new premium-price experiences and facilities for vacations in all seasons.

These overall objectives are then translated into specific performance objectives and measures for specific managers. Exhibit 10 summarizes how Winter Wonderland’s managers might link their organization’s vision and strategy to objectives, then link the objectives to logical performance measures, and, finally, set performance targets for a ski lift manager. As a result, a ski lift manager will have a variety of performance measures that balance the perspectives and needs of all stakeholders.

**STUDY NOTE:** Although their perspectives differ, stakeholder groups may be interested in the same measurable performance goals. For example, both the customer and internal business processes perspectives desire high-quality products.

**Performing** Managers use the mutually agreed-upon strategic and tactical objectives for the entire organization as the basis for decision making within their individual areas of responsibility. This practice ensures that they consider the needs of all stakeholder groups and shows how measuring and managing performance for some stakeholder groups can lead to improved performance for another stakeholder group. Specifically, improving the performance of leading indicators like internal business processes and learning and growth will create improvements for customers, which in turn will result in improved financial performance (a lagging indicator). For example, when making decisions about available ski lift capacity, the ski lift manager will balance such factors as lift ticket sales, snow conditions, equipment reliability, trained staff availability, and length of wait for ski lifts.

The balanced scorecard provides a way of linking the lead performance indicators of employees, internal business processes, and customer needs to the lag performance indicator of external financial results. In other words, if managers can foster excellent

**Exhibit 10****Sample Balanced Scorecard of Linked Objectives, Performance Measures, and Targets**

© Cengage Learning 2014

**Source:** Adapted from Robert S. Kaplan and David Norton, "Using the Balanced Scorecard as a Strategic Management System," *Harvard Business Review*, January–February 1996.

performance for three of the stakeholder groups, good financial results will occur for the investor stakeholder group. When managers understand the causal and linked relationship between their actions and their company's overall performance, they can see new ways to be more effective. For example, a ski lift manager may hypothesize that shorter waiting lines for the ski lifts would improve customer satisfaction and lead to more visits to the ski lift. The manager could test this possible cause-and-effect relationship by measuring and tracking the length of ski lift waiting lines and the number of visits to the ski lift. If a causal relationship exists, the manager can improve the performance of the ski lift operation by doing everything possible to ensure that waiting lines are short because a quicker ride to the top will result in improved results for the operation and for other perspectives as well.

**Evaluating** The balanced scorecard enables a company to determine whether it is making continuous improvement in its operations. Managers *compare* performance objectives and targets with actual results to determine if the targets were met, what measures need to be changed, and what strategies or objectives need revision. For example, the ski lift manager would analyze the reasons for performance gaps and make recommendations to improve the performance of the ski lift area.

A company will also *compare* its performance with that of similar companies in the same industry. **Benchmarking** determines a company's competitive advantage by comparing its performance with that of its closest competitors. **Benchmarks** are measures of the best practices in an industry.

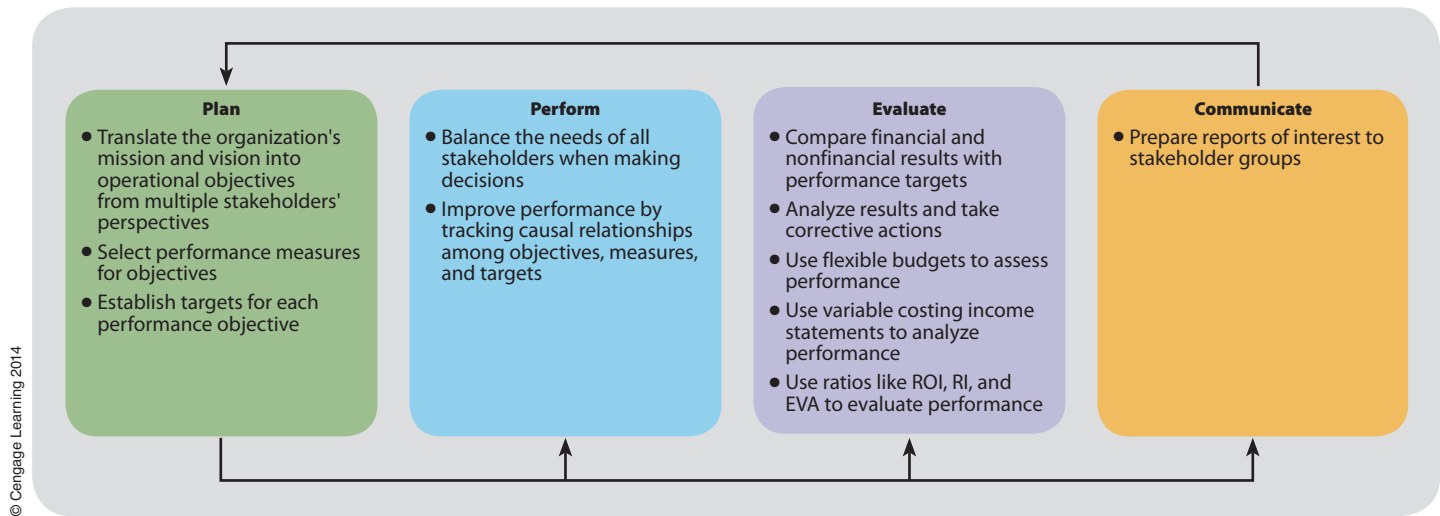
**Communicating** A variety of reports enable managers to monitor and evaluate performance measures that add value for stakeholder groups. For example, a database

makes it possible to prepare financial performance reports, customer statements, internal business process reports for targeted performance measures and results, and performance appraisals of individual employees.

## Performance Evaluation and the Management Process

Exhibit 11 summarizes the ways in which performance measures and evaluation support and inform the management process.

**Exhibit 11**  
Performance Evaluation and the Management Process



### APPLY IT!

Connie's Takeout caters to resort employees who want a good meal at home but do not have time to prepare it. Connie's has developed the following business objectives:

1. To provide fast, courteous service
2. To manage the inventory of food carefully
3. To have repeat customers
4. To be profitable and grow

Connie's has also developed the following performance measures:

5. Growth in revenues per quarter and net income
6. Average unsold food at the end of the business day as a percentage of the total food purchased that day
7. Average customer time at the counter before being waited on
8. Percentage of customers providing repeat business

Match each of these objectives and performance measures with the four perspectives of the balanced scorecard: financial perspective, learning and growth perspective, internal business processes perspective, and customer perspective.

### SOLUTION

Financial perspective: 4, 5; learning and growth perspective: 1, 7; internal business processes perspective: 2, 6; customer perspective: 3, 8

**TRY IT! SE8, SE9, E10A, E11A, E12A, E13A, E10B, E11B, E12B, E13B**



## LO 5 Performance Incentives and Goals

The effectiveness of a performance management and evaluation system depends on how well it coordinates the goals of responsibility centers, managers, and the entire company. Two factors are key to the successful coordination of goals:

- The logical linking of goals to measurable objectives and targets
- The tying of appropriate compensation incentives to the achievement of the targets—that is, performance-based pay

### Linking Goals, Performance Objectives, Measures, and Performance Targets

The causal links among an organization's goals, performance objectives, measures, and targets must be apparent. For example, if a company seeks to be an environmental steward, as Winter Wonderland does, it may choose the following linked goal, objective, measure, and performance target:

Goal	Objective	Measure	Performance Target
To be an environmental steward	To reduce, reuse, and recycle	Number of tons recycled per year	To recycle at least one pound per guest

You may recall that the balanced scorecard also links objectives, measures, and targets, as shown in Exhibit 10.

### Performance-Based Pay

The tying of appropriate compensation incentives to performance targets increases the likelihood that the goals of responsibility centers, managers, and the entire organization will be well coordinated. Unfortunately, this linkage does not always happen. Responsibility center managers are more likely to achieve their performance targets if their compensation depends on it. **Performance-based pay** is the linking of employee compensation to the achievement of measurable business targets.

Cash bonuses, awards, profit-sharing plans, and stock options are common types of incentive compensation. Cash bonuses are usually given to reward an individual's short-term performance. A bonus may be stated as a fixed dollar amount or as a percentage of a target figure, such as 5 percent of operating income or 10 percent of the dollar increase in operating income. An award may be a trip or some other form of recognition for desirable individual or group performance. For example, many companies sponsor a trip for all managers who have met their performance targets during a specified period. Other companies award incentive points that employees may redeem for goods or services. (Awards can be used to encourage both short-term and long-term performance.) Profit-sharing plans reward employees with a share of the company's profits. Employees often receive company stock as recognition of their contribution to a profitable period. Using stock as a reward encourages employees to think and act as both investors and employees and encourages a stable work force. In terms of the balanced scorecard, employees assume two stakeholder perspectives and take both a short- and a long-term viewpoint. Companies use stock to motivate employees to achieve financial targets that increase the company's stock price.

### The Coordination of Goals

What performance incentives and measures should a company use to manage and evaluate performance? What actions and behaviors should an organization reward? Which



incentive compensation plans work best? The answers to such questions depend on the facts and circumstances of each organization. To determine the right performance incentives for their organization, employees and managers must answer several questions:

- When should the reward be given—now or sometime in the future?
- Whose performance should be rewarded—that of responsibility centers, individual managers, or the entire company?
- How should the reward be computed?
- On what should the reward be based?
- What performance criteria should be used?
- Does the performance incentive plan address the interests of all stakeholders?

The effectiveness of a performance management and evaluation system relies on the coordination of responsibility center, managerial, and company goals. Performance can be optimized by linking goals to measurable objectives and targets and by tying appropriate compensation incentives to the achievement of the targets. Each organization's unique circumstances will determine the correct mix of measures and compensation incentives for that organization. If management values the perspectives of all of its stakeholder groups, its performance management and evaluation system will balance and benefit all interests.

## APPLY IT!

Necessary Toys, Inc., has adopted the balanced scorecard to motivate its managers to work toward the companywide goal of leading its industry in innovation. Identify the four stakeholder perspectives that would link to the following objectives, measures, and targets:

Perspective	Objective	Measure	Target
	Successful product introductions	New-product market share	Capture 80 percent of new-product market within one year
	Agile product design and production processes	Time to market (the time between a product idea and its first sales)	Time to market less than one year for 80 percent of product introductions
	Workforce with cutting-edge skills	Percentage of employees cross-trained on work- group tasks	100 percent of work group cross-trained on new tasks within 30 days
	Profitable new products	New-product ROI	New-product ROI of at least 75 percent

### SOLUTION

**Goal:** To lead the industry in innovation

Perspective	Objective	Measure	Target
Customer	Successful product introductions	New-product market share	Capture 80 percent of new-product market within one year
Internal business processes	Agile product design and production processes	Time to market (the time between a product idea and its first sales)	Time to market less than one year for 80 percent of product introductions
Learning and growth (employee)	Workforce with cutting-edge skills	Percentage of employees cross-trained on work- group tasks	100 percent of work group cross-trained on new tasks within 30 days
Financial (investor)	Profitable new products	New-product ROI	New-product ROI of at least 75 percent

### TRY IT! SE10, E14A, E15A, E14B, E15B

## TriLevel Problem



Blend Images/Fotolia LLC

### Winter Wonderland Resorts

The beginning of this chapter focused on Winter Wonderland Resorts, a full-service resort and spa. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

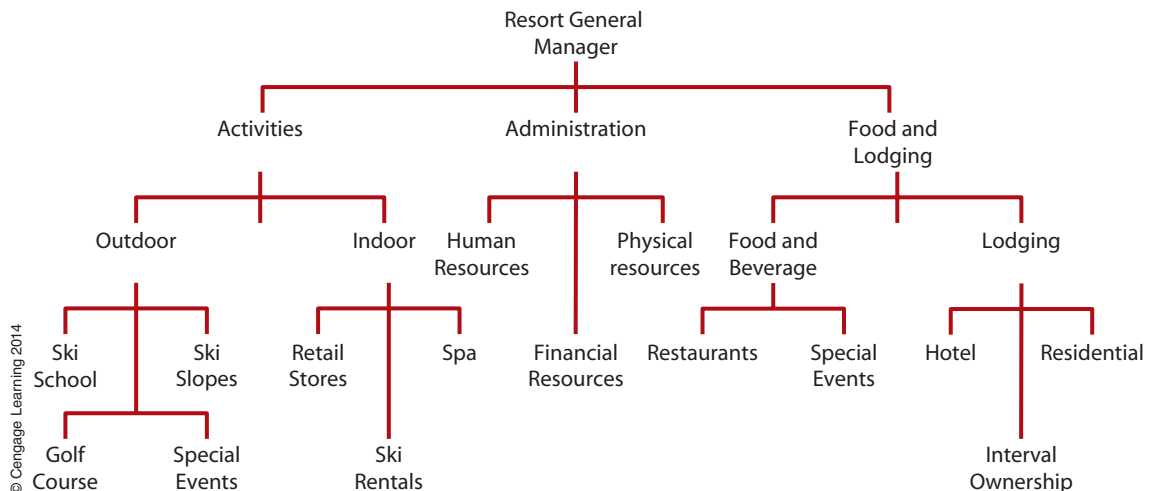
#### Section 1: Concepts

How do managers use the concepts of understandability and comparability when they evaluate performance?

#### Section 2: Accounting Applications

How will managers use flexible budgets and other performance measures to analyze the financial and nonfinancial performance of responsibility centers?

Winter Wonderland's general manager is responsible for guest activities, administration, and food and lodging and is also solely responsible for Winter Wonderland's capital investments. The following organization chart shows the resort's various activities and the levels of authority that the general manager has established:



Three divisional managers receive compensation based on their division's performance and have the authority to make employee compensation decisions for their division. Alexandra Patel manages the Food and Lodging Division. The Food and Lodging Division's master budget and actual results for the year ended June 30 follow.

	A	B	C
1	<b>Winter Wonderland Resort</b>		
2	<b>Food and Lodging Division</b>		
3	<b>For the Year Ended June 30</b>		
4	(Dollar amounts in thousands)		
5		<b>Master</b>	<b>Actual</b>
6		<b>Budget</b>	<b>Results</b>
7	Guest days	4,000	4,100
8	Sales (\$9.50 per unit)	\$38,000	\$40,000
9	Variable cost of sales (\$6.00 per unit)	24,000	25,000
10	Variable selling and administrative expenses (\$1.00 per unit)	4,000	4,250
11	Fixed cost of sales	2,000	1,800
12	Fixed selling and administrative expenses	2,500	2,500
13			

1. What types of responsibility centers are (a) Administration, (b) Food and Lodging, and (c) Resort General Manager?
2. Assume that Food and Lodging is a profit center. Prepare a performance report using variable costing and flexible budgeting. Determine the variances between actual results and the corresponding figures in the flexible budget and the master budget.
3. Assume that the divisional managers have been assigned responsibility for capital expenditures and that their divisions are thus investment centers. Food and Lodging is expected to generate a desired ROI of at least 30 percent on average assets invested of \$10,000,000.
  - a. Compute the division's return on investment and residual income using the average assets invested in both the actual and budget calculations. (Round ROI to two decimal places.)
  - b. Using the ROI and residual income, evaluate Alexandra Patel's performance as divisional manager.
4. Compute the division's actual economic value added if the division's assets are \$12,000,000, current liabilities are \$3,000,000, after-tax operating income is \$4,500,000, and the cost of capital is 20 percent.

### Section 3: Business Applications

*How can managers achieve a balanced view of a business's well-being and how to improve it? To answer this question, match this chapter's manager responsibilities with when they occur within the management process.*

- |  |  |
|--|--|
| <ol style="list-style-type: none"> <li>a. Plan</li> <li>b. Perform</li> <li>c. Evaluate</li> <li>d. Communicate</li> </ol> | <ol style="list-style-type: none"> <li>1. Establish performance targets of each objective</li> <li>2. Track causal relationships to improve performance</li> <li>3. Use flexible budgets to assess performance</li> <li>4. Translate the organization's mission and vision into objectives from multiple stakeholder perspectives</li> <li>5. Use variable costing income statements to analyze performance</li> <li>6. Prepare reports</li> <li>7. When making decisions, balance all stakeholder needs</li> <li>8. Use ratios like ROI, RI, and EVA to evaluate performance</li> <li>9. Compare results with performance targets</li> <li>10. Analyze results and take corrective actions</li> <li>11. Select performance measures for objectives</li> </ol> |
|--|--|

**SOLUTION****Section 1: Concepts**

Managers use the concepts of *understandability* and *comparability* as they manage a wide range of financial and nonfinancial data to guide and evaluate performance. If they want satisfactory results for their responsibility centers, managers must understand the cause-and-effect relationships between their actions and their responsibility center's performance. To do this, managers use performance analysis tools like flexible budgets; variable costing income statements; and ROI, RI, and EVA ratio analyses to compare plans, actions, and results. By measuring and tracking the causal relationships that they are accountable for, managers can improve performance and thereby add value for all of their organization's stakeholders. A balanced scorecard approach enables managers to understand and compare the perspectives of all the organization's stakeholders—financial (investor), learning and growth (employee), internal business processes, and customer—as they command, control, and evaluate the organization.

**Section 2: Accounting Applications**

1. (a) discretionary cost center  
(b) profit center  
(c) investment center

2.

	A			B		C	
1	<b>Winter Wonderland Resort</b>						
2	<b>Food and Lodging Division</b>						
3	<b>For the Year Ended June 30</b>						
4	(Dollar amounts in thousands)						
5		<b>Actual</b>		<b>Flexible</b>		<b>Master</b>	
6		<b>Results</b>	<b>Variance</b>	<b>Budget</b>	<b>Variance</b>	<b>Budget</b>	
7	Guest days	4,100	—	4,100	100	(F)	4,000
8	Sales	\$40,000	\$1,050 (F)	\$38,950	\$950	(F)	\$38,000
9	Controllable variable costs						
10	Variable cost of sales	25,000	(400) (U)	24,600	(600)	(U)	24,000
11	Variable selling and						
12	administrative						
13	expenses	4,250	(150) (U)	4,100	(100)	(U)	4,000
14	Contribution margin	\$10,750	\$ 500 (F)	\$10,250	\$250	(F)	\$10,000
15	Controllable fixed costs						
16	Fixed cost of sales	1,800	200 (F)	2,000	—		2,000
17	Fixed selling and						
18	administrative						
19	expenses	2,500	—	2,500	—		2,500
20	Division operating income	\$ 6,450	\$ 700 (F)	\$ 5,750	\$250	(F)	\$ 5,500
21							

3. (a) Return on investment (Operating Income ÷ Assets Invested):

$$\text{Actual results: } \$6,450,000 \div \$10,000,000 = \underline{64.50\%}$$

$$\text{Flexible budget: } \$5,750,000 \div \$10,000,000 = \underline{57.50\%}$$

$$\text{Master budget: } \$5,500,000 \div \$10,000,000 = \underline{55.00\%}$$

Residual income [Operating Income – (Desired ROI × Assets Invested)]:

$$\text{Actual results: } \$6,450,000 - (30\% \times \$10,000,000) = \underline{\$3,450,000}$$

$$\text{Flexible budget: } \$5,750,000 - (30\% \times \$10,000,000) = \underline{\$2,750,000}$$

$$\text{Master budget: } \$5,500,000 - (30\% \times \$10,000,000) = \underline{\$2,500,000}$$

- (b) Alexandra Patel's performance as the divisional manager of Food and Lodging exceeds company performance expectations. Actual ROI was 64.5 percent, whereas the company expected an ROI of 30 percent, and the flexible budget and the master budget showed projections of 57.5 percent and 55.0 percent, respectively. Residual income also exceeded expectations. The Food and Lodging Division generated \$3,450,000 in residual income when the flexible budget and master budget had projected RIs of \$2,750,000 and \$2,500,000, respectively.
4. Economic value added {After-Tax Operating Income – [Cost of Capital × (Total Assets – Current Liabilities)]}:

$$\$4,500,000 - [20\% \times (\$12,000,000 - \$3,000,000)] = \underline{\underline{\$2,700,000}}$$

### Section 3: Business Applications

- |      |       |
|------|-------|
| 1. a | 7. b  |
| 2. b | 8. c  |
| 3. c | 9. c  |
| 4. a | 10. c |
| 5. c | 11. a |
| 6. d |       |

## Chapter Review

**Define a performance management and evaluation system and responsibility accounting, and describe the roles they play in performance analysis.** **Lo 1**

An effective performance management and evaluation system accounts for and reports on both financial and nonfinancial performance so that an organization can understand how well it is doing, where it is going, and what improvements will make it more profitable. Each organization must develop a unique set of performance measures to compare and evaluate based on areas of responsibility that are appropriate to its specific situation. Responsibility accounting classifies data according to areas of responsibility and reports each area's activities by including only the revenue, cost, and resource categories that the assigned manager can control. There are five types of responsibility centers: cost, discretionary cost, revenue, profit, and investment. Performance reporting by responsibility center allows the source of a cost, revenue, or resource to be traced to the manager who controls it and thus makes it easier to understand, compare, and evaluate a manager's performance. The content and format of a performance report depend on the nature of the responsibility center.

**Use flexible budgets and variable costing to analyze cost center and profit center performance.** **Lo 2**

The performance of a cost center can be evaluated by comparing its actual costs with the corresponding amounts in the flexible and master budgets. A flexible budget is a summary of anticipated costs for a range of activity levels. It provides forecasted cost data that can be adjusted for changes in the level of output. A flexible budget is derived by multiplying actual unit output by predetermined standard unit costs for each cost item in the report. The resulting variances between actual costs and the flexible budget can be examined further by using standard costing to compute specific variances for direct materials, direct labor, and overhead.

The performance of a profit center is usually evaluated by comparing the profit center's actual income statement results with its budgeted income statement. When variable costing is used, the controllable costs of the profit center's manager are classified as variable or fixed. The resulting performance report takes the form of a contribution

margin income statement instead of a traditional income statement. The variable costing income statement is useful because it focuses on cost variability and the profit center's contribution to operating income.

Analyze investment centers using return on investment, residual income, and economic value added. **LO 3**

Traditionally, the most common performance measure has been return on investment (ROI). The basic formula is  $ROI = \text{Operating Income} \div \text{Assets Invested}$ . Return on investment can also be examined in terms of profit margin and asset turnover. In this case,  $ROI = \text{Profit Margin} \times \text{Asset Turnover}$ , where  $\text{Profit Margin} = \text{Operating Income} \div \text{Sales}$ , and  $\text{Asset Turnover} = \text{Sales} \div \text{Assets Invested}$ . Residual income (RI) is the operating income that an investment center earns above a minimum desired return on invested assets. It is expressed as a dollar amount:  $\text{Residual Income} = \text{Operating Income} - (\text{Desired ROI} \times \text{Assets Invested})$ . It is the amount of profit left after subtracting a predetermined desired income target for an investment. Today, businesses are increasingly using the shareholder wealth created by an investment center, or economic value added (EVA), as a performance measure. The calculation of economic value added can be quite complex because of the various adjustments it involves. Basically, it is similar to the calculation of residual income:  $EVA = \text{After-Tax Operating Income} - [\text{Cost of Capital} \times (\text{Total Assets} - \text{Current Liabilities})]$ . A manager can improve the economic value of an investment center by increasing sales, decreasing costs, decreasing assets, or lowering the cost of capital.

Describe how the balanced scorecard aligns performance with organizational goals. **LO 4**

Besides answering basic questions about what to measure and how to measure, management must collaborate to develop a group of measures, such as the balanced scorecard, that will help them determine how to improve performance. The balanced scorecard is a framework that links the perspectives of an organization's four basic stakeholder groups—financial (investor), learning and growth (employee), internal business processes, and customer—with its mission and vision, performance measures, strategic and tactical plans, and resources. The balanced scorecard assumes that an organization will get what it measures. Ideally, managers should see how their actions help to achieve organizational goals and understand how their compensation is linked to their actions. Managers may use benchmarking to determine a company's competitive advantage by comparing its performance with that of its industry peers.

Explain how properly linked performance incentives and measures add value for all stakeholders in performance management and evaluation. **LO 5**

The effectiveness of a performance management and evaluation system depends on how well it coordinates the goals of responsibility centers, managers, and the entire company. Performance can be optimized by linking goals to measurable objectives and targets and tying appropriate compensation incentives to the achievement of those targets. Common types of incentive compensation are cash bonuses, awards, profit-sharing plans, and stock options. If management values the perspectives of all of its stakeholder groups, its performance management and evaluation system will balance and benefit all interests.

## Key Terms and Ratios

**balanced scorecard** 1018 (LO4)  
**benchmarking** 1020 (LO4)  
**benchmarks** 1020 (LO4)  
**controllable costs and revenues** 1007 (LO1)  
**cost center** 1008 (LO1)  
**cost of capital** 1017 (LO3)  
**discretionary cost center** 1008 (LO1)  
**economic value added (EVA)** 1017 (LO3)

**flexible budget** 1011 (LO2)  
**flexible budget formula** 1011 (LO2)  
**investment center** 1008 (LO1)  
**organization chart** 1009 (LO1)  
**performance-based pay** 1022 (LO5)  
**performance management and evaluation system** 1006 (LO1)  
**performance measurement** 1006 (LO1)  
**performance measures** 1006 (LO1)  
**profit center** 1008 (LO1)

**residual income (RI)** 1016 (LO3)  
**responsibility accounting** 1006 (LO1)  
**responsibility center** 1006 (LO1)  
**revenue center** 1008 (LO1)  
**variable costing** 1012 (LO2)

### RATIOS

**asset turnover** 1015 (LO3)  
**profit margin** 1015 (LO3)  
**return on investment (ROI)** 1014 (LO3)

# Chapter Assignments

## DISCUSSION QUESTIONS

- LO 1 **DQ1. CONCEPT** ► Jackie Jefferson, a new employee at Foster, Inc., is learning about the various types of performance reports. Describe the typical contents of a performance report for each type of responsibility center. Why do these reports enhance the understandability and comparability of the data presented?
- LO 2, 3, 4 **DQ2. CONCEPT** ► What tools can managers use to enhance the understandability and comparability of performance analysis?
- LO 2 **DQ3. CONCEPT** ► How does the flexible budget formula enhance understandability and comparability when preparing a flexible budget?
- LO 2 **DQ4. CONCEPT** ► Why is a variable costing income statement more useful than a traditional income statement for understanding and evaluating a profit center's performance?
- LO 4, 5 **DQ5. CONCEPT** ► **BUSINESS APPLICATION** ► How does the balanced scorecard empower managers to understand and compare the interests of all the organization's stakeholders?

## SHORT EXERCISES

### LO 1 Responsibility Centers

**SE1.** Identify each of the following as a cost center, a discretionary cost center, a revenue center, a profit center, or an investment center:

- Center A's manager is responsible for generating cash inflows and incurring costs with the goal of making money for the company. The manager has no responsibility for assets.
- Center B produces a product that is not sold to an external party but transferred to another center for further processing.
- Center C's manager is responsible for the telephone order operations of a large retailer.
- Center D designs, produces, and sells products to external parties. The manager makes both long-term and short-term decisions.
- Center E provides human resource support for the other centers in the company.

### LO 2 Preparing a Flexible Budget

**SE2.** Prepare a flexible budget for 20,000, 22,000, and 24,000 units of output, using the information that follows.

Variable costs:	
Direct materials	\$1.00 per unit
Direct labor	\$4.00 per unit
Variable overhead	\$8.00 per unit
Total budgeted fixed overhead	\$180,800

### LO 2 Cost Center Performance Report

**SE3.** Complete the following performance report for cost center S for the month ended September 30:

*(Continued)*



	<b>Actual Results</b>	<b>Variance</b>	<b>Flexible Budget</b>	<b>Variance</b>	<b>Master Budget</b>
<b>Units produced</b>	<b>80</b>	<b>0</b>	<b>?</b>	<b>(20) (U)</b>	<b>100</b>
Center costs:					
Direct materials	\$ 84	\$ ?	\$ 80	\$ ?	\$100
Direct labor	150	?	?	40 (F)	200
Variable overhead	?	(20) (U)	240	?	300
Fixed overhead	270	?	250	?	250
Total cost	<u>\$ ?</u>	<u>\$(34) (U)</u>	<u>\$ ?</u>	<u>\$120 (F)</u>	<u>\$850</u>
Performance measures:					
Defect-free units to total produced	80%	?	N/A	N/A	90%
Average throughput minutes per unit	11	?	N/A	N/A	10

### LO 2 Profit Center Performance Report

**SE4.** Complete the following performance report for profit center P for the month ended December 31:

	<b>Actual Results</b>	<b>Variance</b>	<b>Master Budget</b>
Sales	\$ ?	\$ 20 (F)	\$120
Controllable variable costs:			
Variable cost of goods sold	(25)	(10) (U)	?
Variable selling and administrative expenses	(15)	? (?)	(5)
Contribution margin	\$100	\$ ? (?)	\$100
Controllable fixed costs	?	20 (F)	60
Profit center operating income	<u>\$ 60</u>	<u>\$ 20 (F)</u>	<u>\$ ?</u>
Performance measures:			
Number of orders processed	50	20 (F)	?
Average daily sales	\$ ?	\$0.68 (F)	\$4.00
Number of units sold	100	40 (F)	?

### LO 3 Return on Investment

**RATIO**

**SE5.** Complete the profit margin, asset turnover, and return on investment calculations for investment centers D and V. (Round to two decimal places.)

	<b>Center D</b>	<b>Center V</b>
Sales	\$1,600	\$2,000
Operating income	\$400	\$200
Average assets invested	\$3,200	\$1,250
Profit margin	?	?
Asset turnover	?	?
ROI	?	?

### LO 3 Residual Income

**SE6.** Complete the operating income, ending assets invested, average assets invested, and residual income calculations for investment centers H and F.

	<b>Center H</b>	<b>Center F</b>
Sales	\$20,000	\$25,000
Operating income	\$1,500	\$?
Beginning assets invested	\$4,000	\$500
Ending assets invested	\$6,000	\$?
Average assets invested	\$?	\$1,000
Desired ROI	20%	20%
Residual income	\$?	\$600

LO 3 **Economic Value Added**

**SE7.** Complete the current liabilities, total assets – current liabilities, and economic value added calculations for investment centers M and N.

	<b>Center M</b>	<b>Center N</b>
Sales	\$15,000	\$18,000
After-tax operating income	\$1,000	\$1,100
Total assets	\$4,000	\$5,000
Current liabilities	\$1,000	\$?
Total assets – current liabilities	\$?	\$3,500
Cost of capital	15%	15%
Economic value added	\$?	\$?

LO 4 **The Balanced Scorecard: Stakeholder Values**

**SE8. BUSINESS APPLICATION** ► In the balanced scorecard approach, stakeholder groups with different perspectives value different performance goals. Sometimes, however, they may be interested in the same goal. Indicate which stakeholder groups—financial (F), learning and growth (L), internal business processes (P), and customer (C)—value the performance goals that follow.

- high wages
- safe products
- low-priced products
- improved return on investment
- job security
- cost-effective production processes

LO 4 **Balanced Scorecard**

**SE9. BUSINESS APPLICATION** ► One of your college's overall goals is customer satisfaction. In light of that goal, match each of the stakeholders' perspectives that follow with the appropriate objective.

<b>Perspective</b>	<b>Objective</b>
a. Financial (investor)	1. Customer satisfaction means that the faculty (employees) engages in cutting-edge research.
b. Learning and growth (employee)	2. Customer satisfaction means that students receive their degrees in four years.
c. Internal business processes	3. Customer satisfaction means that the college has a winning athletics program.
d. Customer	4. Customer satisfaction means that fund-raising campaigns are successful.

LO 5 **Coordination of Goals**

**SE10. BUSINESS APPLICATION** ► One of your college's goals is customer satisfaction. In view of that goal, identify each of the following as a linked objective, a measure, or a performance target.

- To have successful fund-raising campaigns
- Number of publications per year per tenure-track faculty
- To increase the average donation by 10 percent
- Average number of dollars raised per donor
- To have faculty engage in cutting-edge research
- To increase the number of publications per faculty member by at least one per year

## EXERCISES: SET A

### LO 1 Responsibility Centers

**E1A.** Identify the most appropriate type of responsibility center for each of the organizational units that follow.

- The sheets and towels laundry facility of a large hotel chain
- The online order department of a retailer
- A manufacturing department of a large corporation
- An urgent care clinic in a community hospital
- A famous brand of a large corporation

### LO 1 Organization Chart

**E2A.** Higgly Industries wants to formalize its management structure by designing an organization chart. The company has a president, a board of directors, and two vice presidents. Four discretionary cost centers—Business Office, Personnel, Technology Services, and Physical Plant—report to one of the vice presidents. The other vice president has one production facility with three cost centers reporting to her. Draw the company's organization chart.

### LO 2 Preparing a Flexible Budget

**E3A.** Bexar Company's fixed overhead costs for the year are expected to be as follows: depreciation, \$80,000; supervisory salaries, \$90,000; property taxes and insurance, \$25,000; and other fixed overhead, \$15,000. Total fixed overhead is thus expected to be \$210,000. Variable costs per unit are expected to be as follows: direct materials, \$15.00; direct labor, \$10.00; operating supplies, \$2.00; indirect labor, \$3.50; and other variable overhead costs, \$2.50. Prepare a flexible budget for the following levels of production: 25,000 units, 30,000 units, and 35,000 units. What is the flexible budget formula for the year ended December 31?

### LO 2 Performance Report for a Cost Center

**E4A.** Keystone, LLC, owns a peach processing plant. Last month, the plant generated the following information: peaches processed, 60,000 pounds; direct materials, \$6,200; direct labor, \$12,500; variable overhead, \$17,600; and fixed overhead, \$15,000. There were no beginning or ending inventories. Average daily pounds processed (25 business days) were 2,400. Average rate of processing was 300 pounds per hour.

At the beginning of the month, Keystone had budgeted costs of peaches, \$5,000; direct labor, \$10,000; variable overhead, \$15,000; and fixed overhead, \$14,000. The monthly master budget was based on producing 50,000 pounds of peaches each month. This means that the plant had been projected to process 2,000 pounds daily at the rate of 250 pounds per hour.

Prepare a performance report for the month for the peach processing plant. Include a flexible budget and the computation of variances in your report. Indicate whether the variances are favorable (F) or unfavorable (U) to the performance of the plant.

### LO 2 Variable Costing Income Statement

**E5A.** Vegan, LLC, owns a chain of gourmet vegetarian take-out markets. Vegan's income statement in the traditional reporting format for the month follows.

**Vegan, LLC**  
**Income Statement**  
**For the Month**

Sales	\$890,000
Cost of goods sold	607,000
Gross margin	\$283,000
Selling and administrative expenses:	
Variable	(44,500)
Fixed	(72,300)
Operating income	<u>\$166,200</u>

Total fixed production costs for the month were \$140,000.

Prepare an income statement for Vegan, LLC, for the month, using the variable costing format.

**LO 2** **Traditional and Variable Costing Income Statements**

**E6A.** Roofing tile is Tops Corporation's major product. It sold 88,400 cases of tile during the year. Variable cost of goods sold was \$848,640; variable selling expenses were \$132,600; fixed overhead was \$166,680; fixed selling expenses were \$152,048; and fixed administrative expenses were \$96,450. The selling price was \$18 per case. There were no partially completed jobs in process at the beginning or the end of the year. Finished goods inventory had been used up at the end of the previous year. Prepare the calendar year-end income statement for Tops using:

1. the traditional reporting format
2. the variable costing format

**LO 3** **Investment Center Performance**

**RATIO**

**E7A. ACCOUNTING CONNECTION** ► Flowers Associates is evaluating the performance of three divisions: Daisies, Pansies, and Tulips. Using the data that follow, compute the return on investment and residual income for each division, compare the divisions' performance, and comment on the factors that influenced performance.

	<b>Daisies</b>	<b>Pansies</b>	<b>Tulips</b>
Sales	\$50,000	\$50,000	\$50,000
Operating income	\$10,000	\$10,000	\$20,000
Assets invested	\$25,000	\$12,500	\$25,000
Desired ROI	30%	30%	30%

**LO 3** **Economic Value Added**

**E8A. ACCOUNTING CONNECTION** ► Game, LLP, is evaluating the performance of three divisions: Rock, Scissors, and Paper. Using the data that follow, compute the economic value added by each division, and comment on each division's performance.

	<b>Rock</b>	<b>Scissors</b>	<b>Paper</b>
Sales	\$50,000	\$50,000	\$50,000
After-tax operating income	\$5,000	\$5,000	\$20,000
Total assets	\$25,000	\$12,500	\$25,000
Current liabilities	\$5,000	\$5,000	\$5,000
Cost of capital	15%	15%	15%

**LO 3** **Return on Investment and Economic Value Added**

**RATIO**

**E9A.** The balance sheet for NuBone Corporation's New Products Division showed invested assets of \$200,000 at the beginning of the year and \$300,000 at the end of the year. During the year, the division's operating income was \$12,500 on sales of \$500,000.

*(Continued)*

1. Compute the division's residual income if the desired ROI is 6 percent.
2. Compute the following performance measures for the division: (a) profit margin, (b) asset turnover, and (c) return on investment. (Round profit margin percentage to one decimal place.)
3. Recompute the division's ROI under each of the following independent assumptions.
  - a. Sales increase from \$500,000 to \$600,000, causing operating income to rise from \$12,500 to \$30,000.
  - b. Invested assets at the beginning of the year are reduced from \$200,000 to \$100,000. (Round percentage to two decimal places.)
  - c. Operating expenses are reduced, causing operating income to rise from \$12,500 to \$20,000.
4. Compute the company's EVA if total corporate assets are \$500,000, current liabilities are \$80,000, after-tax operating income is \$50,000, and the cost of capital is 8 percent.

**LO 4** **Balanced Scorecard**

**E10A. BUSINESS APPLICATION** ► Online Products is considering adopting the balanced scorecard and has compiled the following list of possible performance measures. Select the balanced scorecard perspective that best matches each performance measure.

**Balanced Scorecard Perspective**

- a. Financial (investor)
- b. Learning and growth (employee)
- c. Internal business processes
- d. Customer

**Performance Measure**

1. Economic value added
2. Employee turnover
3. Average daily sales
4. Defect-free units
5. Number of repeat customer visits
6. Employee training hours

**LO 4** **Performance Measures**

**E11A. BUSINESS APPLICATION** ► Wendy Jefferson wants to measure her division's product quality. Link an appropriate performance measure with each balanced scorecard perspective.

**Product Quality**

- a. Financial (investor)
- b. Learning and growth (employee)
- c. Internal business processes
- d. Customer

**Possible Performance Measures**

1. Number of defective products returned
2. Number of products failing inspection
3. Increased market share
4. Savings from employee suggestions

**LO 4** **The Balanced Scorecard**

**E12A. BUSINESS APPLICATION** ► Unique Exclusive sells antiques to discerning clients. The business has developed the following business objectives:

1. To buy only the antiques that sell
2. To have repeat customers
3. To be profitable and grow
4. To keep employee turnover low

The business also developed the following performance measures:

5. Growth in revenues and net income per quarter
6. Average unsold antiques at the end of the month as a percentage of the total antiques purchased that month
7. Number of unemployment claims
8. Percentage of repeat customers

Match each of these objectives and performance measures with the four perspectives of the balanced scorecard: financial perspective, learning and growth perspective, internal business processes perspective, and customer perspective.

LO 4 **The Balanced Scorecard**

**E13A. BUSINESS APPLICATION** ► Your college's overall goal is to add value to the communities it serves. In light of that goal, match each of the stakeholders' perspectives that follow with the appropriate objective.

**Perspective**

- Financial (investor)
- Learning and growth (employee)
- Internal business processes
- Customer

**Objective**

- Adding value means that the annual operating budget balances.
- Adding value means that students can enroll in courses of their choice.
- Adding value means that the college has winning interscholastic teams.
- Adding value means that the faculty engages in meaningful teaching and research.

LO 5 **Performance Incentives**

**E14A. BUSINESS APPLICATION** ► MOG Consulting is advising Triangle Industries on the short-term and long-term effectiveness of cash bonuses, awards, profit sharing, and stock as performance incentives. Prepare a chart identifying the effectiveness of each incentive as either long-term or short-term or both.

LO 5 **Goal Congruence**

**E15A. BUSINESS APPLICATION** ► Tech Toys, Inc., has adopted the balanced scorecard to motivate its managers to work toward the companywide goal of leading its industry in innovation. Identify the four stakeholder perspectives that would link to the following objectives, measures, and targets:

Perspective	Objective	Measure	Target
	Agile production processes	Time to market (the time between a product idea and its first sales)	Time to market less than 8 months for 70 percent of product introductions
	Profitable new products	New-product RI	New-product RI of at least \$50,000
	Successful product introductions	New-product market share	Capture 65 percent of new-product market within 8 months
	Workforce with cutting-edge skills	Percentage of employees cross-trained on work-group tasks	80 percent of work group cross-trained on new tasks within 20 days

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS**LO 2 **Preparing a Flexible Budget and Evaluating Performance**

- ✓ 1: Total variable overhead cost per unit: \$0.35
- ✓ 1: Total costs using 55,000 units: \$29,750
- ✓ 3: Total variable overhead costs over budget: \$794.00

**P1.** Beverage Products Company specializes in 12-ounce drinking glasses. The president asks the controller to prepare a performance report for April. The following report was handed to her a few days later:

*(Continued)*

Cost Category (Variable Unit Cost)	Budgeted Costs*	Actual Costs	Difference Under (Over) Budget
Direct materials (\$0.10)	\$ 5,000	\$ 4,975	\$ 25
Direct labor (\$0.12)	6,000	5,850	150
Variable overhead:			
Indirect labor (\$0.03)	1,500	1,290	210
Supplies (\$0.02)	1,000	960	40
Heat and power (\$0.03)	1,500	1,325	175
Other (\$0.05)	2,500	2,340	160
Fixed overhead:			
Heat and power	3,500	3,500	—
Depreciation	4,200	4,200	—
Insurance and taxes	1,200	1,200	—
Other	1,600	1,600	—
Totals	<u>\$28,000</u>	<u>\$27,240</u>	<u>\$760</u>

\*Based on normal capacity of 50,000 units.

In discussing the report with the controller, the president stated, “Profits have been decreasing in recent months, but this report indicates that our production process is operating efficiently.”

#### REQUIRED

1. Prepare a flexible budget for the company using production levels of 45,000 units, 50,000 units, and 55,000 units.
2. What is the flexible budget formula?
3. Assume that the company produced 45,560 units in April and that all fixed costs remained constant. Prepare a revised performance report similar to the one above, using actual production in units as a basis for the budget column. (Do not round your answers.)
4. **ACCOUNTING CONNECTION** ► Which report is more meaningful for performance evaluation, the original one or the revised one? Why?

#### LO 1, 2

#### SPREADSHEET

East Coast plant:

- ✓ 1: Total variance between actual results and flexible budget: \$0
- ✓ 1: Total variance between flexible budget and master budget: \$752,000F
- ✓ 1: Performance measure: Cans processed per hour: 4,566U

#### Evaluating Cost Center Performance

**P2.** Metal Products, LLC, manufactures metal beverage containers. The division that manufactures soft-drink beverage cans for the North American market has two plants that operate 24 hours a day, 365 days a year. The plants are evaluated as cost centers. Small tools and supplies are considered variable overhead. Depreciation and rent are considered fixed overhead. For the month, the master budget for a plant and the actual operating results of the two North American plants, East Coast and West Coast, follow.

	Master Budget	East Coast Actual	West Coast Actual
Center costs:			
Rolled aluminum (\$0.01)	\$4,000,000	\$3,492,000	\$5,040,000
Lids (\$0.005)	2,000,000	1,980,000	2,016,000
Direct labor (\$0.0025)	1,000,000	864,000	1,260,000
Small tools and supplies (\$0.0013)	520,000	432,000	588,000
Depreciation and rent	480,000	480,000	480,000
Total cost	<u>\$8,000,000</u>	<u>\$7,248,000</u>	<u>\$9,384,000</u>
Performance measures:			
Cans processed per hour	45,662	41,096	47,945
Average daily pounds of scrap metal	5	6	7
Cans processed (in millions)	400	360	420



**REQUIRED**

1. Prepare a performance report for the East Coast plant. Include a flexible budget and variance analysis.
2. Prepare a performance report for the West Coast plant. Include a flexible budget and variance analysis.
3. **ACCOUNTING CONNECTION** ► Compare the two plants, and comment on their performance.
4. **ACCOUNTING CONNECTION** ► Explain why a flexible budget should be prepared.

LO 1, 2, 3

RATIO

SPREADSHEET

✓ 1: Total variance between actual and flexible budget operating income: \$1,900U

✓ 1: Total variance between flexible and master budget operating income: \$1,800U

**Evaluating Profit and Investment Center Performance**

**P3.** The managing partner of the law firm Sewell, Bagan, and Clark, LLP, makes asset acquisition and disposal decisions for the firm. As managing partner, she supervises the partners in charge of the firm's three branch offices. Those partners have the authority to make employee compensation decisions. The partners' compensation depends on the profitability of their branch office. Vanessa Smith manages the City Branch, which has the following master budget and actual results for the year ended December 31.

	Master Budget	Actual Results
Billed hours	5,000	4,900
Revenue	\$ 250,000	\$ 254,800
Controllable variable costs:		
Direct labor	(120,000)	(137,200)
Variable overhead	(90,000)	(34,300)
Contribution margin	\$ 90,000	\$ 83,300
Controllable fixed costs:		
Rent	(30,000)	(30,000)
Other administrative expenses	(45,000)	(42,000)
Branch operating income	<u>\$ 15,000</u>	<u>\$ 11,300</u>

**REQUIRED**

1. Assume that the City Branch is a profit center. Prepare a performance report that includes a flexible budget. Determine the variances between actual results, the flexible budget, and the master budget.
2. **ACCOUNTING CONNECTION** ► Evaluate Vanessa Smith's performance as manager of the City Branch.
3. Assume that the branch managers are assigned responsibility for capital expenditures and that the branches are thus investment centers. City Branch is expected to generate a desired ROI of at least 30 percent on average invested assets of \$40,000.
  - a. Compute the branch's return on investment and residual income. (Round percentages to two decimal places.)
  - b. **ACCOUNTING CONNECTION** ► Using the ROI and residual income, evaluate Vanessa Smith's performance as branch manager.

LO 3

RATIO

✓ 1: This year return on investment: 31.08%

✓ 2: This year residual income: \$32,232

**Return on Investment and Residual Income**

**P4.** The financial results for the past two years for Ornamental Iron, a division of Iron Horse Company, follow.

*(Continued)*

**Iron Horse Company  
Ornamental Iron Division  
Balance Sheet  
December 31**

	<b>This Year</b>	<b>Last Year</b>
<b>Assets</b>		
Cash	\$ 5,000	\$ 3,000
Accounts receivable	10,000	8,000
Inventory	30,000	32,000
Other current assets	600	600
Plant assets	<u>128,300</u>	<u>120,300</u>
Total assets	<u>\$173,900</u>	<u>\$163,900</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities	\$ 13,900	\$ 10,000
Long-term liabilities	90,000	93,900
Stockholders' equity	<u>70,000</u>	<u>60,000</u>
Total liabilities and stockholders' equity	<u>\$173,900</u>	<u>\$163,900</u>

**Iron Horse Company  
Ornamental Iron Division  
Income Statement  
For the Years Ended December 31**

	<b>This Year</b>	<b>Last Year</b>
Sales	\$ 180,000	\$160,000
Cost of goods sold	(100,000)	(90,000)
Selling and administrative expenses	<u>(27,500)</u>	<u>(26,500)</u>
Operating income	\$ 52,500	\$ 43,500
Income taxes	<u>17,850</u>	<u>14,790</u>
After-tax operating income	<u>\$ 34,650</u>	<u>\$ 28,710</u>

**REQUIRED**

1. Compute the division's profit margin, asset turnover, and return on investment for this year and last year. Beginning total assets for last year were \$157,900. Round to two decimal places.
2. The desired return on investment for the division has been set at 12 percent. Compute the division's residual income for this year and last year.
3. The cost of capital for the division is 8 percent. Compute the division's economic value added for this year and last year.
4. **ACCOUNTING CONNECTION** ► Before drawing conclusions about this division's performance, what additional information would you want?

**LO 4 The Balanced Scorecard and Benchmarking**

**P5. BUSINESS APPLICATION** ► Howski Associates is an independent insurance agency that sells business, automobile, home, and life insurance. Maya Doyle, senior partner of the agency, recently attended a workshop at the local university in which the balanced scorecard was presented as a way of focusing all of a company's functions on its mission. After the workshop, she met with her managers in a weekend brainstorming session. The group determined that Howski's mission was to provide high-quality, innovative, risk-protection services to individuals and businesses. To ensure that the agency would fulfill this mission, the group established the following objectives:

- To provide a sufficient return on investment by increasing sales and maintaining the liquidity needed to support operations
- To add value to the agency's services by training employees to be knowledgeable and competent
- To retain customers and attract new customers
- To operate an efficient and cost-effective office support system for customer agents

To determine the agency's progress in meeting these objectives, the group established the following performance measures:

- Number of new ideas for customer insurance
- Percentage of customers who rate services as excellent
- Average time for processing insurance applications
- Number of dollars spent on training
- Growth in revenues for each type of insurance
- Average time for processing claims
- Percentage of employees who complete 40 hours of training during the year
- Percentage of new customer leads that result in sales
- Cash flow
- Number of customer complaints
- Return on assets
- Percentage of customers who renew policies
- Percentage of revenue devoted to office support system (information systems, accounting, orders, and claims processing)

#### REQUIRED

1. Prepare a balanced scorecard for Howski by stating the agency's mission and matching its four objectives to the four stakeholder perspectives: the financial, learning and growth, internal business processes, and customer. Indicate which of the agency's performance measures would be appropriate for each objective.
2. Howski is a member of an association of independent insurance agents that provides industry statistics about many aspects of operating an insurance agency. What is benchmarking, and in what ways would the industry statistics assist Howski in further developing its balanced scorecard?

## ALTERNATE PROBLEMS

### LO 2

#### Flexible Budgets and Performance Evaluation

✓ 2: Budgeted variable cost per home:  
\$10,922.50

✓ 3: Operating income under budget: \$10,003

**P6.** Realtors, Inc., specializes in the sale of residential properties. It earns its revenue by charging a percentage of the sales price. Commissions for sales persons, listing agents, and listing companies are its main costs. Business has improved steadily over the last 10 years. The managing partner of Realtors, Inc., receives a report summarizing the company's performance each year. The report for the most recent year follows.

**Realtors, Inc.  
Performance Report  
For the Year Ended December 31**

	Budget*	Actual**	Difference Under (Over) Budgeted
Total selling fees	\$2,052,000	\$2,242,200	\$(190,200)
Variable costs:			
Sales commissions	\$1,102,950	\$1,205,183	\$(102,233)
Automobile	36,000	39,560	(3,560)
Advertising	93,600	103,450	(9,850)
Home repairs	77,400	89,240	(11,840)
General overhead	656,100	716,970	(60,870)
Total variable costs	\$1,966,050	\$2,154,403	\$(188,353)
Fixed costs:			
General overhead	60,000	62,300	(2,300)
Total costs	\$2,026,050	\$2,216,703	\$(190,653)
Operating income	\$ 25,950	\$ 25,497	\$ 453

\*Budgeted data are based on 180 units sold.

\*\*Actual data for 200 units sold.

(Continued)

**REQUIRED**

1. **ACCOUNTING CONNECTION** ► Analyze the performance report. What does it say about the company's performance? Is the performance report reliable? Explain your answer.
2. Calculate the budgeted selling fee and budgeted variable costs per home sale.
3. Prepare a performance report using a flexible budget based on the actual number of home sales.
4. **ACCOUNTING CONNECTION** ► Analyze the report you prepared in requirement 3. What does it say about the company's performance? Is the report reliable? Explain your answer.
5. **ACCOUNTING CONNECTION** ► What recommendations would you make to improve the company's performance next year?

## LO 1, 2

## SPREADSHEET

North plant:

- ✓ 1: Total variance between actual results and flexible budget: \$52,000F
- ✓ 1: Total variance between flexible budget and master budget: \$775,000F
- ✓ 1: Performance measure: Bottles processed per hour: 7,450U

**Evaluating Cost Center Performance**

**P7.** Reuse Products, LLC, manufactures plastic beverage bottles. The division that manufactures water bottles for the North American market has two plants that operate 24 hours a day, 365 days a year. The plants are evaluated as cost centers. Small tools and supplies are considered variable overhead. Depreciation and rent are considered fixed overhead. For the month, the master budget for a plant and the actual operating results of the two North American plants, North and South, follow.

Cost Category (Variable Unit Cost)	Master Budget	North Actual	South Actual
Center costs:			
Plastic pellets (\$0.009)	\$4,500,000	\$3,880,000	\$5,500,000
Caps (\$0.004)	2,000,000	1,990,000	2,000,000
Direct labor (\$0.002)	1,000,000	865,000	1,240,000
Small tools and supplies (\$0.0005)	250,000	198,000	280,000
Depreciation and rent	450,000	440,000	480,000
Total cost	<u>\$8,200,000</u>	<u>\$7,373,000</u>	<u>\$9,500,000</u>
Performance measures:			
Bottles processed per hour	69,450	62,000	70,250
Average daily pounds of scrap	5	6	7
Bottles processed (in millions)	500	450	520

**REQUIRED**

1. Prepare a performance report for the North plant. Include a flexible budget and variance analysis.
2. Prepare a performance report for the South plant. Include a flexible budget and variance analysis.
3. **ACCOUNTING CONNECTION** ► Compare the two plants, and comment on their performance.
4. **ACCOUNTING CONNECTION** ► Explain why a flexible budget should be prepared.

## LO 1, 2, 3

## RATIO

## SPREADSHEET

- ✓ 1: Total variance between actual and flexible budget operating income: \$6,000F
- ✓ 1: Total variance between flexible and master budget operating income: \$20,000U

**Evaluating Profit and Investment Center Performance**

**P8.** Thomas Carter is the president of a company that owns six multiplex movie theaters. Carter has delegated decision-making authority to the theater managers for all decisions except those relating to capital expenditures and film selection. The theater managers' compensation depends on the profitability of their theaters. Morris Burgman, the manager of the Park Theater, had the following master budget and actual results for the month:

	Master Budget	Actual Results
Tickets sold	120,000	110,000
Revenue—tickets	\$ 840,000	\$ 880,000
Revenue—concessions	480,000	330,000
Total revenue	<u>\$1,320,000</u>	<u>\$1,210,000</u>
Controllable variable costs:		
Concessions	(120,000)	(99,000)
Direct labor	(420,000)	(330,000)
Variable overhead	(540,000)	(550,000)
Contribution margin	<u>\$ 240,000</u>	<u>\$ 231,000</u>
Controllable fixed costs:		
Rent	(55,000)	(55,000)
Other administrative expenses	(45,000)	(50,000)
Theater operating income	<u>\$ 140,000</u>	<u>\$ 126,000</u>

**REQUIRED**

- Assuming that the theaters are profit centers, prepare a performance report for the Park Theater. Include a flexible budget. Determine the variances between actual results, the flexible budget, and the master budget.
- ACCOUNTING CONNECTION** ▶ Evaluate Burgman's performance as manager of the Park Theater.
- Assume that the managers are assigned responsibility for capital expenditures and that the theaters are thus investment centers. Park Theater is expected to generate a desired ROI of at least 6 percent on average invested assets of \$2,000,000.
  - Compute the theater's return on investment and residual income. (Round percentages to one decimal place.)
  - ACCOUNTING CONNECTION** ▶ Using the ROI and residual income, evaluate Burgman's performance as manager.

LO 3

**Return on Investment and Residual Income****RATIO****P9.** LET Company's financial results for the past two years follow.

- ✓ 1: This year return on investment: 36.40%  
 ✓ 2: This year residual income: \$50,160

**LET Company**  
**Balance Sheet**  
**December 31**

	This Year	Last Year
<b>Assets</b>		
Cash	\$ 9,000	\$ 4,000
Accounts receivable	40,000	50,000
Inventory	30,000	25,000
Other current assets	1,000	1,000
Plant assets	120,000	100,000
Total assets	<u>\$200,000</u>	<u>\$180,000</u>
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities	\$ 10,000	\$ 10,000
Long-term liabilities	20,000	10,000
Stockholders' equity	170,000	160,000
Total liabilities and stockholders' equity	<u>\$200,000</u>	<u>\$180,000</u>

*(Continued)*

**LET Company**  
**Income Statement**  
**For the Years Ended December 31**

	<b>This Year</b>	<b>Last Year</b>
Sales	\$ 247,000	\$ 204,000
Cost of goods sold	(150,000)	(115,000)
Selling and administrative expenses	<u>(27,840)</u>	<u>(17,600)</u>
Operating income	\$ 69,160	\$ 71,400
Income taxes	<u>20,160</u>	<u>29,400</u>
After-tax operating income	<u>\$ 49,000</u>	<u>\$ 42,000</u>

**REQUIRED**

1. Compute the company's profit margin, asset turnover, and return on investment for this year and last year. Beginning total assets for last year were \$160,000. (Round percentages to two decimal places.)
2. The desired return on investment for the company has been set at 10 percent. Compute LET's residual income for this year and last year.
3. The cost of capital for the company is 5 percent. Compute the company's economic value added for this year and last year.
4. **ACCOUNTING CONNECTION** ► Before drawing conclusions about this company's performance, what additional information would you want?

**LO 4 The Balanced Scorecard and Benchmarking**

**P10. BUSINESS APPLICATION** ► Resource College is a liberal arts school that provides local residents the opportunity to take college courses and earn bachelor's degrees. Yolanda Howard, the school's provost, recently attended a workshop in which the balanced scorecard was presented as a way of focusing all of an organization's functions on its mission. After the workshop, she met with her administrative staff and college deans in a weekend brainstorming session. The group determined that the college's mission was to provide high-quality courses and degrees to individuals to add value to their lives. To ensure that the college would fulfill this mission, the group established the following objectives:

- To provide a sufficient return on investment by increasing tuition revenues and maintaining the liquidity needed to support operations
- To add value to the college's courses by encouraging faculty to be lifelong learners
- To retain students and attract new students
- To operate efficient and cost-effective student support systems

To determine the college's progress in meeting these objectives, the group established the following performance measures:

- Number of faculty publications
- Percentage of students who rate college as excellent
- Average time for processing student applications
- Number of dollars spent on professional development
- Growth in revenues for each department
- Average time for processing transcript requests
- Percentage of faculty who annually do 40 hours of professional development
- Percentage of new student leads that result in enrollment
- Cash flow
- Number of student complaints
- Return on assets
- Percentage of returning students
- Percentage of revenue devoted to student services systems (registrar, computer services, financial aid, and student health)

**REQUIRED**

1. Prepare a balanced scorecard for Resource by stating the college's mission and matching its four objectives to the four stakeholder perspectives: the financial, learning and growth, internal business processes, and customer perspectives. Indicate which of the college's performance measures would be appropriate for each objective.
2. Resource College is a member of an association of independent liberal arts schools that provides industry statistics about many aspects of operating a college. What is benchmarking, and in what ways would the association's statistics assist Resource College in further developing its balanced scorecard?

**CASES****LO 1 Interpreting Management Reports: Responsibility Centers**

**C1.** Wood4Fun makes wooden playground equipment for the institutional and consumer markets. The company strives for low-cost, high-quality production because it operates in a highly competitive market in which product price is set by the marketplace and is not based on production costs. The company is organized into responsibility centers. The vice president of manufacturing is responsible for three manufacturing plants. The vice president of sales is responsible for four sales regions. Recently, these two vice presidents began to disagree about whether the manufacturing plants are cost centers or profit centers. The vice president of manufacturing views the plants as cost centers because the managers of the plants control only product-related costs. The vice president of sales believes the plants are profit centers because product quality and product cost strongly affect company profits.

1. Identify the controllable performance that Wood4Fun values and wants to measure. Give at least three examples of performance measures that Wood4Fun could use to monitor such performance.
2. For the manufacturing plants, what type of responsibility center is most consistent with the controllable performance Wood4Fun wants to measure?
3. For the sales regions, what type of responsibility center is most appropriate?

**LO 1, 2 Conceptual Understanding: Types of Responsibility Centers**

**C2.** Yuma Foods acquired Aldo's Tortillas several years ago. Aldo's has continued to operate as an independent company, except that Yuma Foods has exclusive authority over capital investments, production quantity, and pricing decisions because Yuma has been Aldo's only customer since the acquisition. Yuma uses return on investment to evaluate the performance of Aldo's manager. The most recent performance report follows.

**Yuma Foods  
Performance Report for Aldo's Tortillas  
For the Year Ended June 30**

Sales	\$ 6,000
Variable cost of goods sold	(3,000)
Variable administrative expenses	(1,000)
Variable corporate expenses (% of sales)	(600)
Contribution margin	<u>\$ 1,400</u>
Fixed overhead (includes depreciation of \$100)	(400)
Fixed administrative expenses	(500)
Operating income	<u>\$ 500</u>
Average assets invested	<u>\$ 5,500</u>
Return on investment	<u>9.09%*</u>

\*Rounded

(Continued)



1. Analyze the items listed in the performance report, and identify the items that Aldo controls and those that Yuma controls. In your opinion, what type of responsibility center is Aldo's Tortillas? Explain your response. (Round to two decimal places.)
2. Prepare a revised performance report for Aldo's Tortillas and an accompanying memo to the president of Yuma Foods that explains why it is important to change the content of the report. Cite some basic principles of responsibility accounting to support your recommendation.

LO 3

**Decision Analysis: Return on Investment and Residual Income**

RATIO

SPREADSHEET

**C3.** Suppose Alexandra Patel, the manager of the Food and Lodging Division at Winter Wonderland Resort, has hired you as a consultant to help her examine her division's performance under several different circumstances.

1. Type the data that follow into a spreadsheet to compute the division's actual return on investment and residual income. (Data are from parts 3 and 4 of this chapter's TriLevel Problem.) Match your data entries to the rows and columns shown below. (*Hint:* Remember to format each cell for the type of numbers it holds, such as percentage, currency, or general. Round profit margin to two decimal places.)

	A	B	C	D
1				<b>Investment Center</b>
2				<b>Food and Lodging Division</b>
3				<b>Actual Results</b>
4	Sales			\$40,000,000
5	Operating income			\$ 6,450,000
6	Average assets invested			\$10,000,000
7	Desired ROI			30%
8	Return on investment			=(D5/D6)
9	Profit margin			=(D5/D4)
10	Asset turnover			=(D4/D6)
11	Residual income			=(D5-(D7*D6))
12				

2. Patel would like to know how the figures would change if Food and Lodging had a desired ROI of 40 percent and average assets invested of \$10,000,000. Revise your spreadsheet from **1** to compute the division's return on investment and residual income under those conditions.
3. Patel also wants to know how the figures would change if Food and Lodging had a desired ROI of 30 percent and average assets invested of \$12,000,000. Revise your spreadsheet from **1** to compute the division's return on investment and residual income under those conditions.
4. Does the use of formatted spreadsheets simplify the computation of ROI and residual income? Do such spreadsheets make it easier to perform "what-if" analyses?

LO 3, 5

**Conceptual Understanding: Economic Value Added and Performance**

**C4.** Sevilla Consulting offers environmental consulting services worldwide. The managers of branch offices are rewarded for superior performance with bonuses based on the economic value that the office adds to the company. Last year's operating results for the entire company and for its three offices, expressed in millions of U.S. dollars, follow.

	Worldwide	Europe	Americas	Asia
Cost of capital	9%	10%	8%	12%
Total assets	\$210	\$70	\$70	\$70
Current liabilities	80	10	40	30
After-tax operating income	15	5	5	5

1. Compute the economic value added for each office worldwide. What factors affect each office's economic value added? How can an office improve its economic value added? (Round to two decimal places.)
2. **BUSINESS APPLICATION** ► If managers' bonuses are based on economic value added to office performance, what specific actions will managers be motivated to take?
3. Is economic value added the only performance measure needed to evaluate investment centers adequately? Explain your response.

LO 4, 5

### Group Activity: Performance Measures and the Balanced Scorecard

**C5. BUSINESS APPLICATION** ► Working in a group of four to six students, select a local business. The group should become familiar with the background of the business by interviewing its manager or accountant. Each group member should identify several performance objectives for the business and link each objective with a specific stakeholder's perspective from the balanced scorecard. (Select at least one performance objective for each perspective.) For each objective, ask yourself, "If I were the manager of the business, how would I set performance measures for each objective?" Then prepare an email stating the business's name, location, and activities and your linked performance objectives and perspectives. Also list possible measures for each performance objective.

In class, members of the group should compare their individual emails and compile them into a group report by having each group member assume a different stakeholder perspective (add government and community if you want more than four perspectives). Each group should be ready to present all perspectives and the group's report on performance objectives and measures in class.

### Continuing Case: Cookie Company

**C6.** As we continue with this case, assume that your cookie store is now part of a national chain. The store has been consistently profitable, and sales remain satisfactory despite a temporary economic downturn in your area.

At the first of the year, corporate headquarters set a targeted return on investment of 20 percent for your store. The store currently averages \$140,000 in invested assets (beginning invested assets, \$130,000; ending invested assets, \$150,000) and is projected to have an operating income of \$30,800. You are considering whether to take one or both of the following actions before the end of the year:

- Hold off recording and paying \$5,000 in bills owed until the start of the next fiscal year.
- Write down to zero value \$3,000 in store inventory (nonperishable containers) that you have been unable to sell.

Currently, your bonus is based on store profits. Next year, corporate headquarters is changing its performance incentive program so that bonuses will be based on a store's actual return on investment.

1. What effect would each of the actions that you are considering have on the store's operating income this year? In your opinion, is either action unethical?
2. Independent of question 1, how would the inventory write-down affect next year's income and return on investment if the inventory is sold for \$4,000 next year, when corporate headquarters changes its performance incentive plan for store managers? In your opinion, do you have an ethical dilemma? (Round ROI to the nearest whole percentage.)



# CHAPTER 24

## Standard Costing and Variance Analysis

### BUSINESS INSIGHT

#### ICU, Inc.

ICU, Inc., is known for its innovative use of robotic technology. One of the company's products is the Watch Dog, a mobile robot designed for home surveillance. The Watch Dog is equipped with a built-in video camera and audio component, and it connects wirelessly to any computer. While owners are away from home, they can use a computer or cell phone with an Internet connection to monitor the Watch Dog and observe or listen to anything that is happening in their home.

ICU is highly profitable. A key factor in its success is its managers' establishment of standard costs for each of the company's product lines. Managers use these standard costs as performance targets and as benchmarks against which they measure actual spending trends. As a result, the company is able to keep its operating costs low and to sell its products at affordable prices. With its relatively inexpensive price tag, the Watch Dog has become a popular alternative to other home security systems.

- 1. CONCEPT** ► *Why is standard costing and variance analysis useful?*
- 2. ACCOUNTING APPLICATION** ► *How can ICU's managers evaluate the performance of its cost centers?*
- 3. BUSINESS APPLICATION** ► *Why does the setting of performance standards help managers control costs and improve performance?*

### LEARNING OBJECTIVES

- LO 1** Define *standard costs*, and explain why standard costing is useful.
- LO 2** Compute standard unit costs, and describe the role of flexible budgets in variance analysis to control costs.
- LO 3** Compute and analyze direct materials variances.
- LO 4** Compute and analyze direct labor variances.
- LO 5** Compute and analyze overhead variances.
- LO 6** Explain how variances are used to evaluate a business's performance.



## SECTION 1

## CONCEPTS

## CONCEPTS

- Comparability
- Understandability

RELEVANT  
LEARNING OBJECTIVE

- LO 1** Define *standard costs*, and explain why standard costing is useful.

**LO 1** Concepts Underlying Standard Costing

Managers find standard costing useful due to the concepts of understandability and comparability. *Understandability* applies because the **standard costs** are realistic estimates of costs based on analyses of both past and projected operating costs and conditions. They are usually stated in terms of cost per unit. They provide a standard, or predetermined performance level for use in standard costing. *Comparability* applies because **standard costing** is a method of cost control that is used to compare the difference, or **variance**, between standard and actual performance. This method differs from actual and normal costing methods in that it uses estimated costs exclusively to compute all three elements of product cost—direct materials, direct labor, and overhead.

Standard costing is especially effective for understanding and managing cost centers. Recall that a *cost center* is a responsibility center in which there are well-defined links between the cost of the resources (direct materials, direct labor, and overhead) and the resulting products or services.

Managers find standard costing and variance analysis useful to develop budgets, to control costs, and to prepare reports. Managers set standard costs based on realistic estimates of operating costs and then use the standards to prepare flexible budgets. Flexible budgets improve the understanding and accuracy of their variance analysis since these budgets compare actual costs and a budget based on the same amount of output. By analyzing variances between standard and actual costs, managers gain insight into the causes of those differences. Once they have identified an operating problem that is causing a cost variance, they can devise a solution that results in better control of costs.

Standard costing can be used in any type of business. Both manufacturers and service businesses can use standard costing in conjunction with a job order costing, process costing, or activity-based costing system to compare actual performance results for materials, labor, and overhead with their predetermined performance standards. However, a disadvantage to using standard costing is that it can be expensive and time-consuming to gather all the needed information. The estimated costs are based not just on past costs, but also on engineering estimates, forecasted demand, worker input, time and motion studies, and type and quality of direct materials.

In the next section, we describe how standard unit costs are computed and used to prepare flexible budgets and how managers use the variance between standard and actual costs to evaluate performance and control costs.

**APPLY IT!**

Kellman Corporation is considering adopting the standard costing method. Dan Osterheld, the Midwest Division's manager, attended a corporate meeting at which the controller discussed the proposal. Osterheld asked, "How will this new method help me understand my division's performance? Does performance comparability improve if my division uses this new method?" Help prepare the controller's response to Osterheld by deciding whether the following statements are true or false. If false, make the statement true.

1. Standard costing helps managers compare actual cost results to a standard or predetermined performance level.
2. At the end of the period, variance analysis will only identify areas of cost efficiency.
3. Standard costing helps managers understand where to focus efforts for improvement.

**SOLUTION**

1. True
2. False  
At the end of the period, variance analysis will identify areas of cost efficiency and inefficiency.
3. True

**TRY IT! SE1, SE2, E1A, E1B**



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Compute standard unit costs
- Compute total flexible budget costs
- Compute and analyze direct materials variances
  - Direct materials price variance
  - Direct materials quantity variance
- Compute and analyze direct labor variances
  - Direct labor rate variance
  - Direct labor efficiency variance
- Compute and analyze overhead variances
  - Variable overhead spending variance
  - Variable overhead efficiency variance
  - Fixed overhead budget variance
  - Fixed overhead volume variance

## RELEVANT LEARNING OBJECTIVES

**LO 2** Compute standard unit costs, and describe the role of flexible budgets in variance analysis to control costs.

**LO 3** Compute and analyze direct materials variances.

**LO 4** Compute and analyze direct labor variances.

**LO 5** Compute and analyze overhead variances.

## LO 2 Variance Analysis

**Variance analysis** is the process of computing the differences between standard costs and actual costs and identifying the causes of those differences. By examining the differences, or variances, between standard and actual costs, managers can gather valuable information about improving the accuracy of variance analysis and controlling costs.

### Computing Standard Costs

A fully integrated standard costing system uses standard costs for all the elements of product cost: direct materials, direct labor, and overhead. Standard costs are recorded in inventory accounts for materials, work in process, and finished goods, as well as the Cost of Goods Sold account. Actual costs are recorded separately so that managers can compare what should have been spent (the standard costs) with the actual costs incurred in the cost center.

A standard unit cost for a manufactured product has the following six elements:

- Direct materials price standard
- Direct materials quantity standard
- Direct labor rate standard
- Direct labor time standard
- Variable overhead rate standard
- Fixed overhead rate standard

To compute a standard unit cost, it is necessary to identify and analyze each of these elements. (Note that a standard unit cost for a service includes only the elements that relate to direct labor and overhead.)

### Standard Direct Materials Cost

The **standard direct materials cost** is the price that should be paid for the materials and is computed as follows.

$$\text{Standard Direct Materials Cost} = \text{Direct Materials Price Standard} \times \text{Direct Materials Quantity Standard}$$

In this equation, the **direct materials price standard** is a careful estimate of the cost of a specific direct material in the next period. An organization's purchasing department is responsible for developing price standards for all direct materials and for making the actual purchases. When estimating a direct materials price standard, the purchasing department must take into account all possible price increases, changes in available quantities, and new sources of supply.

The **direct materials quantity standard** is an estimate of the amount of direct materials, including scrap and waste, that will be used in a period. It is influenced by product engineering specifications, the quality of direct materials, the age and productivity of machinery, and the quality and experience of the work force. Production managers or managerial accountants usually establish and monitor standards for direct materials quantity, but engineers, purchasing agents, and machine operators may also contribute to the development of these standards.

We will use ICU, which makes surveillance robots, to illustrate how standard costs are used to compute total unit cost. ICU has recently updated the standards for its Watch Dog product. Direct materials price standards are now \$9.20 per square foot for casing materials and \$20.17 for each mechanism. Direct materials quantity standards are 0.025 square foot of casing materials per robot and one mechanism per robot. Thus, the direct materials costs of making one robot are:

Direct materials costs:		
Casing (\$9.20 per sq. ft. × 0.025 sq. ft.)		\$ 0.23
One mechanism		20.17

## Standard Direct Labor Cost

The **standard direct labor cost** for a product, task, or job order is the cost necessary to produce that product, task, or job order and is computed as follows.

$$\text{Standard Direct Labor Cost} = \text{Direct Labor Rate Standard} \times \text{Direct Labor Time Standard}$$

In this equation, the **direct labor rate standard** is the hourly direct labor rate that is expected to prevail during the next period for each function or job classification. Although rate ranges are established for each type of worker and rates vary within those ranges according to each worker's experience and length of service, an average standard rate is developed for each task. Even if the person making the product is paid more or less than the standard rate, the standard rate is used to calculate the standard direct labor cost.

The **direct labor time standard** is the expected labor time required for each department, machine, or process to complete the production of one unit or one batch of output. In many cases, standard time per unit is a small fraction of an hour. Current time and motion studies of workers and machines, as well as records of their past performance, provide the data for developing this standard. The direct labor time standard should be revised whenever a machine is replaced or the quality of the labor force changes.

For ICU, for example, direct labor time standards are 0.01 hour per robot for the Case Stamping Department and 0.05 hour per robot for the Assembly Department. Direct labor rate standards are \$8.00 per hour for the Case Stamping Department and \$10.20 per hour for the Assembly Department. Thus, the direct labor costs of making one robot in each department are:

Direct labor costs:		
Case Stamping Department (\$8.00 per hour × 0.01 hour per robot)		\$0.08
Assembly Department (\$10.20 per hour × 0.05 hour per robot)		0.51

## Standard Overhead Cost

The **standard overhead cost** is the sum of the estimates of variable and fixed overhead costs in the next period. It is based on standard overhead rates that are computed in much the same way as the predetermined overhead rate discussed in an earlier chapter. Unlike that rate, however, the standard overhead rate has two parts:

- variable costs
- fixed costs

The reason for computing the standard variable and fixed overhead rates separately is that their cost behavior differs.

The **standard variable overhead rate** is computed by dividing the total budgeted variable overhead costs by an expression of capacity, such as the budgeted number of standard machine hours or standard direct labor hours.\* Using standard direct labor hours as the base, the formula is as follows.

$$\text{Standard Variable Overhead Rate} = \frac{\text{Total Budgeted Variable Overhead Costs}}{\text{Total Budgeted Number of Standard Direct Labor Hours}}$$

For ICU, for example, the standard variable overhead rate is \$12.00 per direct labor hour. Thus, the variable overhead cost of making one robot is:

Variable overhead cost (\$12.00 per hour × 0.06 hour per robot)	\$0.72
---	--------

The **standard fixed overhead rate** is computed by dividing the total budgeted fixed overhead costs by an expression of capacity, usually normal capacity in terms of standard

\* Other bases may be used if machine hours or direct labor hours are not good predictors, or drivers, of variable overhead costs.

**STUDY NOTE:** Both the direct labor rate standard and the direct labor time standard are based on an average of the different levels of skilled workers, and both are related to the production of one unit or batch.



hours or units. The denominator is expressed in the same terms as the variable overhead rate. Using normal capacity in terms of standard direct labor hours as the denominator, the formula is as follows.

$$\text{Standard Fixed Overhead Rate} = \frac{\text{Total Budgeted Fixed Overhead Costs}}{\text{Normal Capacity in Terms of Standard Direct Labor Hours}}$$

For ICU, for example, the standard fixed overhead rate is \$9.00 per direct labor hour. Thus, the fixed overhead cost of making one robot is:

$$\text{Fixed overhead cost } (\$9.00 \text{ per hour} \times 0.06 \text{ hour per robot}) \quad \$0.54$$

Recall that *normal capacity* is the level of operating capacity needed to meet expected sales demand. Using it as the application base ensures that all fixed overhead costs have been applied to units produced by the time normal capacity is reached.

### Total Standard Unit Cost

Using standard costs eliminates the need to calculate unit costs from actual cost data every week or month or for each batch of goods produced. Once standard costs for direct materials, direct labor, and variable and fixed overhead have been developed, a total standard unit cost can be computed at any time. We used ICU to illustrate how standard costs are used to compute total unit cost. The standard cost of making one robot would be computed as follows.

**STUDY NOTE:** The total standard unit cost of \$22.25 represents the desired cost of producing one robot.

Direct materials costs:	
Casing (\$9.20 per sq. ft. × 0.025 sq. ft.)	\$ 0.23
One mechanism	20.17
Direct labor costs:	
Case Stamping Department (\$8.00 per hour × 0.01 hour per robot)	0.08
Assembly Department (\$10.20 per hour × 0.05 hour per robot)	0.51
Variable overhead (\$12.00 per hour × 0.06 hour per robot)	<u>0.72</u>
Total standard variable cost of one robot	\$21.71
Fixed overhead (\$9.00 per hour × 0.06 hour per robot)	0.54
Total standard unit cost	<u><u>\$22.25</u></u>

The total standard unit cost of producing a video game controller or a robot like the Watch Dog represents the desired production cost. It is based on the standards established for direct materials costs, direct labor costs, and variable and fixed overhead.

### The Role of Flexible Budgets in Variance Analysis

The accuracy of variance analysis depends to a large extent on the type of budget that managers use when comparing variances. Static, or fixed, budgets forecast revenues and expenses for just one level of sales and just one level of output. The budgets that make up a master budget are usually based on a single level of output; but many things can cause actual output to differ from the estimated output. If a company produces more products than predicted, total production costs will almost always be greater than predicted. Thus, a comparison of actual production costs with fixed budgeted costs will inevitably show variances.

The performance report in Exhibit 1 compares data from ICU’s static master budget with the actual costs of the company’s Watch Division, the division responsible for manufacturing the Watch Dog. As you can see, actual costs exceeded budgeted costs by \$5,539. Most managers would consider such a cost overrun significant. But was there really a cost overrun? The budgeted amounts are based on an output of 17,500 units when the actual output was 19,100 units.



Beyond Fotomedia GmbH / Alamy

**Exhibit 1**  
Performance Report Using  
Data from a Static Budget

<b>ICU, Inc.</b> <b>Performance Report—Watch Division</b> <b>For the Year Ended December 31</b>			
<b>Cost Category</b>	<b>Master Budgeted Costs*</b>	<b>Actual Costs**</b>	<b>Difference Under (Over) Budget</b>
Direct materials	\$357,000	\$361,000	\$(4,000)
Direct labor	10,325	11,779	(1,454)
Variable overhead:			
Indirect materials	3,500	3,600	(100)
Indirect labor	5,250	5,375	(125)
Utilities	1,750	1,810	(60)
Other	2,100	2,200	(100)
Fixed overhead:			
Supervisory salaries	4,000	3,500	500
Depreciation	2,000	2,000	—
Utilities	450	450	—
Other	3,000	3,200	(200)
<b>Totals</b>	<u><u>\$389,375</u></u>	<u><u>\$394,914</u></u>	<u><u>\$(5,539)</u></u>

\*Budgeted costs are based on an output of 17,500 units.

\*\*Actual output was 19,100 units.

© Cengage Learning 2014

To judge the division's performance accurately, ICU's managers can use a flexible budget. Recall that a *flexible (or variable) budget* is a summary of expected costs for a range of activity levels. Unlike a static budget, a flexible budget provides forecasted data that can be adjusted for changes in the level of output. The flexible budget in Exhibit 2 is based on standard unit cost data from the static master budget in Exhibit 1. Variable unit costs have been multiplied by the 19,100 units actually produced to arrive at the

**Exhibit 2**  
Performance Report Using  
Data from a Flexible Budget

<b>ICU, Inc.</b> <b>Performance Report—Watch Division</b> <b>For the Year Ended December 31</b>			
<b>Cost Category</b>	<b>Flexible Budgeted Costs*</b>	<b>Actual Costs</b>	<b>Difference Under (Over) Budget</b>
Direct materials (\$20.40)**	\$389,640	\$361,000	\$28,640
Direct labor (\$0.59)	11,269	11,779	(510)
Variable overhead:			
Indirect materials (\$0.20)	3,820	3,600	220
Indirect labor (\$0.30)	5,730	5,375	355
Utilities (\$0.10)	1,910	1,810	100
Other (\$0.12)	2,292	2,200	92
Fixed overhead:			
Supervisory salaries	4,000	3,500	500
Depreciation	2,000	2,000	—
Utilities	450	450	—
Other	3,000	3,200	(200)
<b>Totals</b>	<u><u>\$424,111</u></u>	<u><u>\$394,914</u></u>	<u><u>\$29,197</u></u>

\*Budgeted costs are based on actual output of 19,100 units.

\*\*Amounts in parentheses in the Cost Category column are variable unit costs.

© Cengage Learning 2014

total flexible budgeted costs, and fixed overhead information has been carried over from Exhibit 1. In this report, actual costs are \$29,197 less than the amount budgeted. In other words, the flexible budget shows that the Watch Division’s performance in this period actually exceeded budget targets by \$29,197.

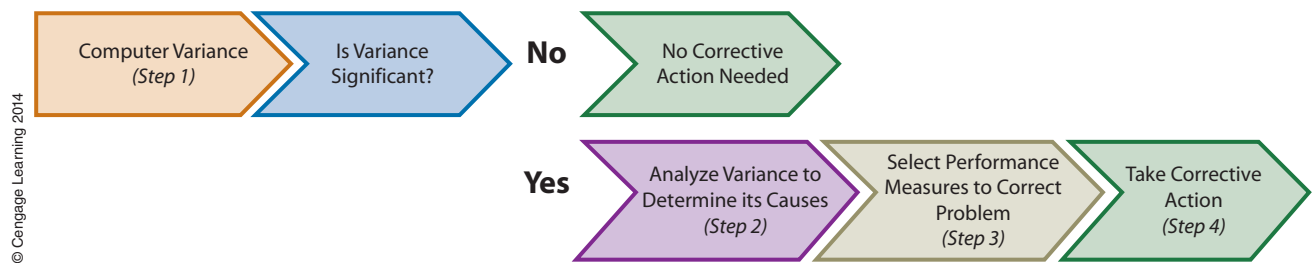
The rest of this chapter will discuss how to explain the variances between actual costs and the flexible budget by using standard costing to analyze specific variances for direct materials, direct labor, variable overhead, and fixed overhead.

## Using Variance Analysis to Control Costs

As Exhibit 3 shows, using variance analysis to control costs is a four-step process:

- **Step 1.** Managers compute the amount of the variance. If the amount is insignificant—actual operating results are close to those anticipated—no corrective action is needed.
- **Step 2.** If the variance is significant, managers analyze the variance to identify its cause.
- **Step 3.** In identifying the cause, they then select performance measures that will enable them to track the activities that need to be monitored, analyze the results, and determine the action needed to correct the problem.
- **Step 4.** The final step is to take the appropriate corrective action.

**Exhibit 3**  
**Variance Analysis: A Four-Step Approach to Controlling Costs**



Although computing the amount of a variance is important, it does nothing to prevent the variance from recurring. To control costs, managers must determine the cause of the variance and select performance measures that will help them track the problem and find the best solution for it.

### APPLY IT!

Using the information that follows, compute the total standard unit cost of a 5-pound bag of sugar.

Direct materials quantity standard	5 pounds per unit
Direct materials price standard	\$0.05 per pound
Direct labor time standard	0.01 hour per unit
Direct labor rate standard	\$10.00 per hour
Variable overhead rate standard	\$0.15 per machine hour
Fixed overhead rate standard	\$0.10 per machine hour
Machine hour standard	0.5 hour per unit

#### SOLUTION

Direct materials cost (\$0.05 × 5 pounds)	\$0.25
Direct labor cost (\$10.00 × 0.01 hour)	0.10
Variable overhead (\$0.15 × 0.5 machine hour)	0.08*
Fixed overhead (\$0.10 × 0.5 machine hour)	0.05
Total standard unit cost	<u>\$0.48</u>

\*Rounded

**TRY IT! SE3, SE4, E2A, E3A, E2B, E3B**

## LO 3 Computing and Analyzing Direct Materials Variances

To control cost center operations, managers compute and analyze variances for whole cost categories, such as total direct materials costs, as well as variances for elements of those categories, such as the price and quantity of each direct material. The more detailed their analysis of direct materials variances, the more effective they will be in controlling costs.

### Computing Total Direct Materials Cost Variance

#### Total Direct Materials Cost Variance

**Performance Measure** The **total direct materials cost variance** measures the difference between what the actual total materials cost and what they should have cost according to the flexible budget for the good units produced. *Good units* are the total units produced less units that are scrapped or need to be reworked—in other words, the salable units.

#### Formula

$$\text{Total Direct Materials Cost Variance} = \text{Standard Cost}^* - \text{Actual Cost}^{**}$$

\*Standard Cost = Standard Price  $\times$  Standard Quantity

\*\*Actual Cost = Actual Price  $\times$  Actual Quantity

**Example** Cambria Company is a manufacturer that makes leather bags to carry the Watch Dog robots. Each bag should use 4 feet of leather (standard quantity), and the standard price of leather is \$6.00 per foot. During August, Cambria purchased 760 feet of leather costing \$5.90 per foot and used the leather to produce 180 bags. The total direct materials cost variance for Cambria is calculated as follows.

$$\text{Standard cost: } \$6.00 \text{ per foot} \times (180 \text{ bags} \times 4 \text{ feet per bag}) = \$4,320$$

$$\text{Actual cost: } \$5.90 \text{ per foot} \times 760 \text{ feet} = \$4,484$$

$$\text{Total direct materials cost variance: } \$4,320 - \$4,484 = \underline{\$164} \text{ (U)}$$

Here, actual cost exceeds standard cost. The situation is unfavorable, as indicated by the U in parentheses after the dollar amount. An F means a favorable situation.

### Computing Total Direct Materials Price Variance

To find the area or people responsible for the variance, the total direct materials cost variance must be broken down into two parts: the direct materials price variance and the direct materials quantity variance.

#### Direct Materials Price Variance

**Performance Measure** The **direct materials price variance** (or *direct materials spending or rate variance*) measures the difference between what the purchased materials actually cost and what they should have cost according to the flexible budget standard.

#### Formula

$$\text{Direct Materials Price Variance} = (\text{Standard Price} - \text{Actual Price}) \times \text{Actual Quantity}$$

**Example** For Cambria, the direct materials price variance is computed as follows.

$$\text{Direct Materials Price Variance} = (\$6.00 - \$5.90) \times 760 \text{ feet} = \underline{\$76} \text{ (F)}$$

Because the price that the company paid for the direct materials was less than the standard price, the variance is favorable.

### Computing Total Direct Materials Quantity Variance

#### Direct Materials Quantity Variance

**Performance Measure** The **direct materials quantity variance** (or *direct materials efficiency or usage variance*) measures the difference between the quantity of materials actually used to make the product and what the design standard called for.

**STUDY NOTE:** It is just as important to identify whether a variance is favorable or unfavorable as it is to compute the variance. This information is necessary for analyzing the variance and taking corrective action.

**Formula**

Direct Materials Quantity Variance = Standard Price × (Standard Quantity – Actual Quantity)

**Example** For Cambria, it is computed as follows.

$$\text{Direct Materials Quantity Variance} = \$6 \times [(180 \text{ bags} \times 4 \text{ feet}) - 760 \text{ feet}] = \underline{\$240 (U)}$$

Because more leather than the standard quantity was used in the production process, the direct materials quantity variance is unfavorable.

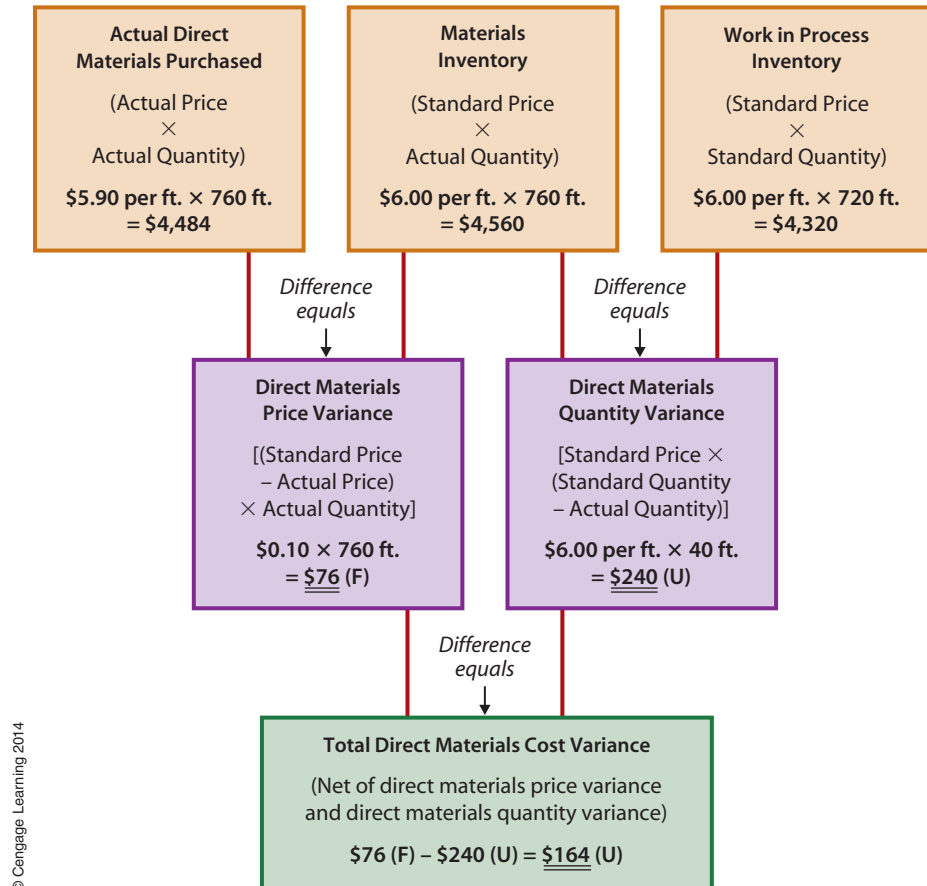
**Summary of Direct Materials Variances**

The net of the direct materials price variance and the direct materials quantity variance should equal the total direct materials cost variance. The following check shows that the variances for Cambria were computed correctly:

Direct materials price variance	\$ 76 (F)
Direct materials quantity variance	<u>240 (U)</u>
Total direct materials cost variance	<u>\$164 (U)</u>

Variance analyses are sometimes easier to interpret in diagram form, as shown for Cambria in Exhibit 4. Notice that although direct materials are purchased at actual cost, they are entered in the Materials Inventory account at standard price. Thus, the direct materials price variance of \$76 (F) is obvious when the costs are recorded. As Exhibit 4 shows, the standard price multiplied by the standard quantity is the amount entered in the Work in Process Inventory account.

**Exhibit 4**  
Diagram of Direct Materials Variance Analysis



## Business Application

Cambria's managers were concerned because the company had been experiencing direct materials price and quantity variances for some time. Moreover, as our analysis shows, the price variances were always favorable and the quantity variances were always unfavorable. By tracking the purchasing activity for three months, the managers discovered that the company's purchasing agent, without any authorization, had been purchasing a lower grade of leather at a reduced price. After careful analysis, the engineering manager determined that the substitute leather was not appropriate and that the company should resume purchasing the grade of leather originally specified. In addition, an analysis of scrap and rework revealed that the inferior quality of the substitute leather was causing the unfavorable quantity variance. By tracking the purchasing activity, Cambria's managers were able to solve the problems.

### APPLY IT!

Using the information that follows, compare the actual and standard cost and usage data for the production of 5-pound bags of sugar, and compute the direct materials price and direct materials quantity variances using formulas or diagram form.

Direct materials quantity standard	5 pounds per unit
Direct materials price standard	\$0.05 per pound
Direct materials purchased and used	55,100 pounds
Price paid for direct materials	\$0.04 per pound
Number of good units produced	11,000 units

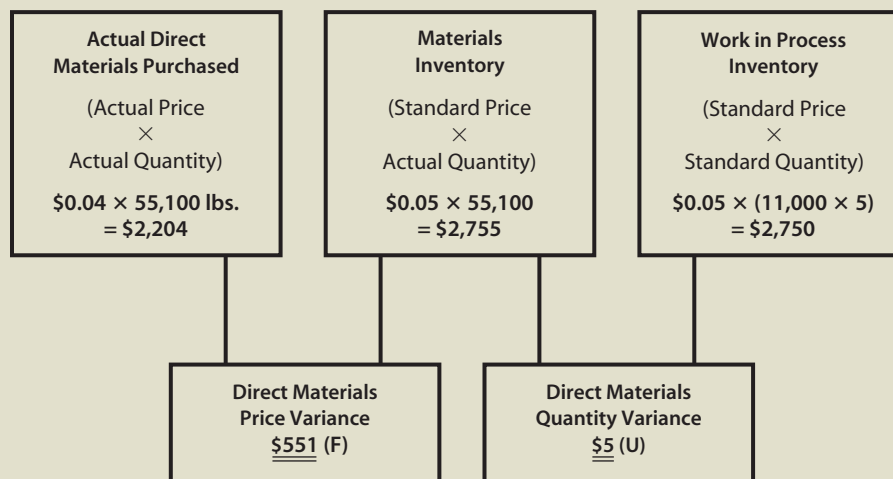
### SOLUTION

Using formulas:

$$\begin{aligned} \text{Direct Materials Price Variance} &= (\text{Standard Price} - \text{Actual Price}) \times \text{Actual Quantity} \\ &= (\$0.05 - \$0.04) \times 55,100 \text{ pounds} \\ &= \underline{\$551} \text{ (F)} \end{aligned}$$

$$\begin{aligned} \text{Direct Materials Quantity Variance} &= \text{Standard Price} \times (\text{Standard Quantity} - \text{Actual Quantity}) \\ &= \$0.05 \times [(11,000 \times 5 \text{ pounds}) - 55,100 \text{ pounds}] \\ &= \underline{\$5} \text{ (U)} \end{aligned}$$

In diagram form:



© Cengage Learning 2014

**TRY IT! SE5, SE6, E4A, E5A, E6A, E4B, E5B, E6B**

## LO 4 Computing and Analyzing Direct Labor Variances

The procedure for computing and analyzing direct labor cost variances parallels the procedure for finding direct materials variances. Again, the more detailed the analysis, the more effective managers will be in controlling costs.

### Computing Total Direct Labor Cost Variance

#### Total Direct Labor Cost Variance

**Performance Measure** The **total direct labor cost variance** measures the difference between what the actual total labor cost and what it should have cost according to the flexible budget for the good units produced.

#### Formula

$$\text{Total Direct Labor Cost Variance} = \text{Standard Cost}^* - \text{Actual Cost}^{**}$$

\*Standard Cost = Standard Price  $\times$  Standard Quantity

\*\*Actual Cost = Actual Price  $\times$  Actual Quantity

**Example** At Cambria, each leather bag requires 2.4 standard direct labor hours, and the standard direct labor rate is \$8.50 per hour. During August, 450 direct labor hours were used to make 180 bags at an average pay rate of \$9.20 per hour. Cambria's total direct labor cost variance is computed as follows.

$$\text{Standard cost: } \$8.50 \text{ per hour} \times (180 \text{ bags} \times 2.4 \text{ hours per bag}) = \$3,672$$

$$\text{Actual cost: } \$9.20 \text{ per hour} \times 450 \text{ hours} = \$4,140$$

$$\text{Total direct labor cost variance: } \$3,672 - \$4,140 = \underline{\$468} \text{ (U)}$$

Both the actual direct labor hours per bag and the actual direct labor rate varied from the standard.

For effective performance evaluation, management must know how much of the total cost arose from different direct labor rates and how much from different numbers of direct labor hours. This information is found by computing the direct labor rate variance and the direct labor efficiency variance.

### Computing Direct Labor Rate Variance

#### Direct Labor Rate Variance

**Performance Measure** The **direct labor rate variance** (or *direct labor spending variance*) measures the difference between what the direct labor actually cost and what it should have cost according to the flexible budget standard.

#### Formula

$$\text{Direct Labor Rate Variance} = (\text{Standard Rate} - \text{Actual Rate}) \times \text{Actual Hours}$$

**Example** For Cambria, it is computed as follows.

$$\text{Direct Labor Rate Variance} = (\$8.50 - \$9.20) \times 450 \text{ hours} = \underline{\$315} \text{ (U)}$$

### Computing Direct Labor Efficiency Variance

#### Direct Labor Efficiency Variance

**Performance Measure** The **direct labor efficiency variance** (or *direct labor quantity or usage variance*) measures the difference between the labor quantity actually used to make the product and what the design standard called for. It is computed as follows.



**Formula**

$$\text{Direct Labor Efficiency Variance} = \text{Standard Rate} \times (\text{Standard Hours Allowed} - \text{Actual Hours})$$

**Example** For Cambria, it is computed this way:

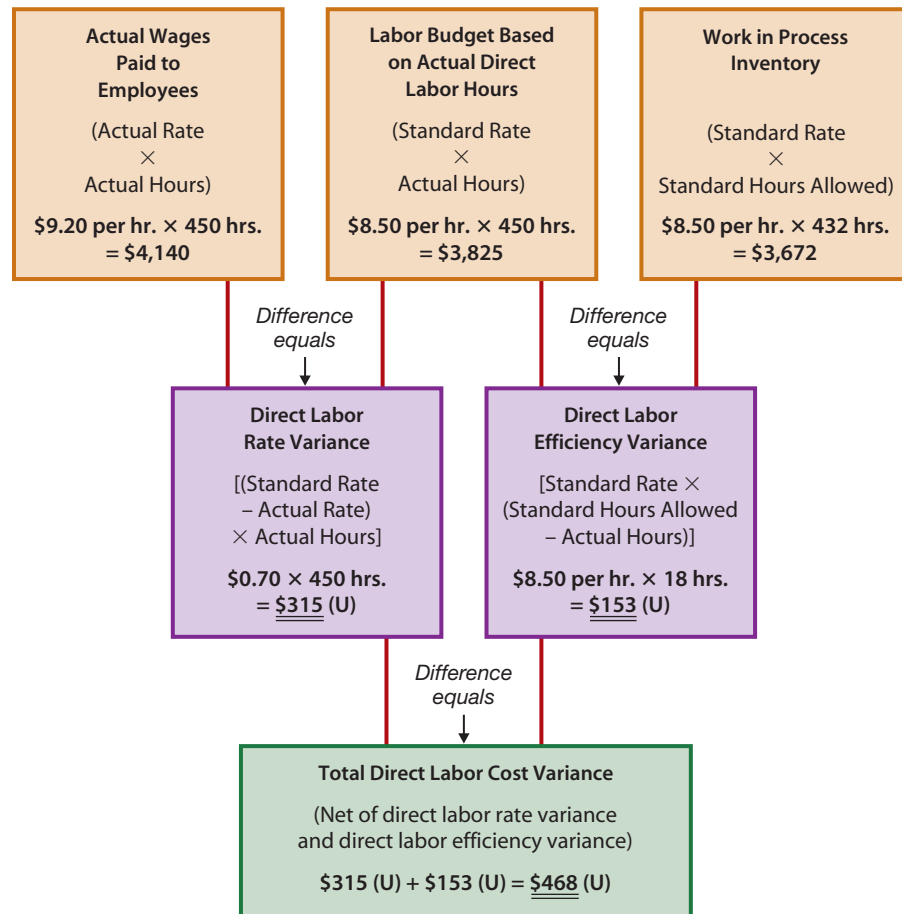
$$\text{Direct Labor Efficiency Variance} = \$8.50 \times [(180 \text{ bags} \times 2.4 \text{ hours}) - 450 \text{ hours}] = \underline{\$153 \text{ (U)}}$$

**Summary of Direct Labor Variances** The net of the direct labor rate variance and the direct labor efficiency variance should equal the total direct labor cost variance. The following check shows that the variances were computed correctly:

Direct labor rate variance	\$315 (U)
Direct labor efficiency variance	153 (U)
Total direct labor cost variance	<u>\$468 (U)</u>

Exhibit 5 summarizes Cambria’s direct labor variances. Unlike direct materials variances, the direct labor rate and efficiency variances are usually computed and recorded at the same time.

**Exhibit 5**  
Diagram of Direct Labor Variance Analysis



© Cengage Learning 2014



## Business Perspective

### What Do You Get When You Cross a Vacuum Cleaner with a Gaming Console?

© Allija / iStockphoto.com

The transfer of technology ideas developed for government purposes to everyday consumer use is common—for example, the Internet and computers. But what about transferring technology from home use to the battlefield? **iRobot Corporation** applied the technology it uses in its Roomba vacuum cleaner to create Small Unmanned Ground Vehicles (SUGVs). These robots, such as the PackBot, have cameras that see both during the day and at night, flexible treads that allow them to climb stairs, and radio links that connect them to an operator at a gaming-like console and to the military command center.

Source: iRobot Corporation website: <http://www.irobot.com>.

## Business Application

Because Cambria's direct labor rate variance and direct labor efficiency variance were unfavorable, its managers investigated the causes of these variances. An analysis of employee time cards revealed that the Bag Assembly Department had replaced an assembly worker who was ill with a machine operator from another department. The machine operator made \$9.20 per hour, whereas the assembly worker earned the standard \$8.50 per hour rate. When questioned about the unfavorable efficiency variance, the assembly supervisor identified two causes. First, the machine operator had to learn assembly skills on the job, so his assembly time was longer than the standard time per bag. Second, the materials handling people were partially responsible because they delivered parts late on five different occasions. Because the machine operator was a temporary replacement, Cambria's managers took no corrective action; but they decided to keep a close eye on the materials handling function by tracking delivery times and the number of delays for the next three months. Once they have collected and analyzed the new data, they will take whatever action is needed to correct the scheduling problem.

## APPLY IT!

Using the information that follows, compare the standard cost and usage data for the production of 5-pound bags of sugar, and compute the direct labor rate and direct labor efficiency variances using formulas or diagram form.

Direct labor time standard	0.01 hour per unit
Direct labor rate standard	\$10.00 per hour
Direct labor hours used (actual)	100 hours
Total cost of direct labor	\$1,010
Number of good units produced	11,000 units

### SOLUTION

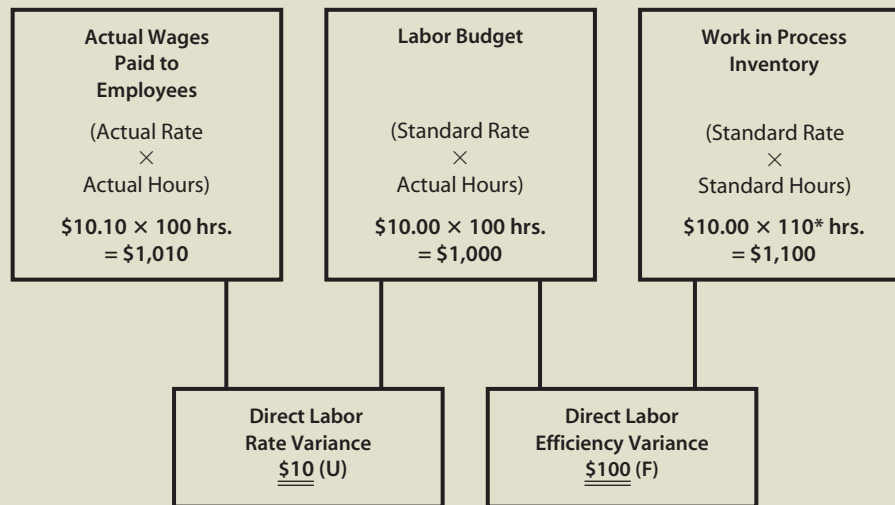
Using formulas:

$$\begin{aligned} \text{Direct Labor Rate Variance} &= (\text{Standard Rate} - \text{Actual Rate}) \times \text{Actual Hours} \\ &= [\$10.00 - (\$1,010 \div 100 \text{ hours})] \times 100 \text{ hours} \\ &= \underline{\underline{\$10}} \text{ (U)} \end{aligned}$$

$$\begin{aligned} \text{Direct Labor Efficiency Variance} &= \text{Standard Rate} \times (\text{Standard Hours Allowed} - \text{Actual Hours}) \\ &= \$10 \times [(11,000 \times 0.01 \text{ hour}) - 100 \text{ hours}] \\ &= \underline{\underline{\$100}} \text{ (F)} \end{aligned}$$

(Continued)

In diagram form:



\*11,000 × 0.01

© Cengage Learning 2014

**TRY IT! SE7, E7A, E8A, E7B, E8B**

## LO 5 Computing and Analyzing Overhead Variances

Controlling variable and fixed overhead costs is more difficult than controlling direct materials and direct labor costs because the responsibility for overhead costs is hard to assign. Fixed overhead costs may be unavoidable past costs, such as depreciation and lease expenses, which are not under the control of any department manager. If variable overhead costs can be related to departments or activities, however, some control is possible.

### Computing Total Overhead Cost Variance

#### Total Overhead Cost Variance

**Performance Measure** Analyses of overhead variances differ in degree of detail. The basic approach is to compute the **total overhead cost variance**, which is the difference between what actual overhead cost and what it should have cost according to the flexible budget for the good units produced.

#### Formula

$$\text{Total Overhead Cost Variance} = \text{Standard Cost}^* - \text{Actual Cost}^{**}$$

\*Standard Cost = Standard Rate × Standard Hours for the Good Units Produced

\*\*Actual cost is given.

**Example** Recall how overhead is applied to production using a standard or predetermined overhead rate. A standard overhead rate has two parts: a variable rate and a fixed rate. For Cambria, these standard overhead rates are as follows.

Variable overhead rate (from the flexible budget)	\$5.75 per direct labor hour
Standard fixed overhead rate [\$1,300 total budgeted fixed overhead ÷ 400 direct labor hours (normal capacity)]	<u>3.25</u> per direct labor hour
Total standard overhead rate	<u>\$9.00</u> per direct labor hour

Cambria’s total overhead cost variance would therefore be computed as follows.

$$\begin{aligned} \text{Standard cost: } & \$9.00 \text{ per hour} \times (180 \text{ bags} \times 2.4 \text{ hours per bag}) = \$3,888 \\ \text{Actual cost (given): } & \text{Variable } \$2,500 + \text{Fixed } \$1,600 = \$4,100 \\ \text{Total direct materials cost variance: } & \$3,888 - \$4,100 = \underline{\$212 \text{ (U)}} \end{aligned}$$

This amount can be divided into a variable overhead variance and a fixed overhead variance.

### Variable Overhead Variances

#### Total Variable Overhead Cost Variance

**Performance Measure** The **total variable overhead cost variance** measures the difference between what the actual variable overhead cost and what it should have cost according to the flexible budget for the good units produced.

#### Formula

$$\text{Total Variable Overhead Cost Variance} = \text{Overhead Applied}^* - \text{Actual Overhead}$$

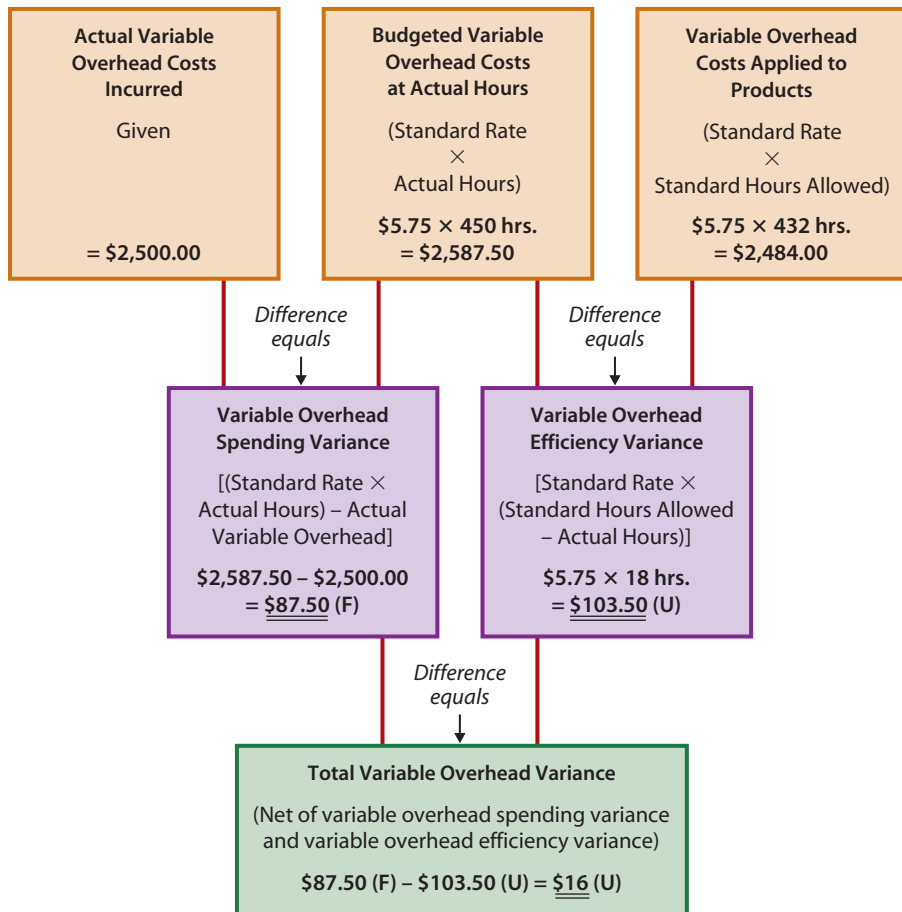
\*Overhead Applied = Standard Rate × Standard Hours for the Good Units Produced

**Example** At Cambria, each leather bag requires 2.4 standard direct labor hours, and the standard variable overhead rate is \$5.75 per direct labor hour. For the month, the company incurred \$2,500 of actual variable overhead costs. The total variable overhead cost variance is computed as follows.

$$\begin{aligned} \text{Overhead applied: } & \$5.75 \text{ per hour} \times (180 \text{ bags} \times 2.4 \text{ hours per bag}) = \$2,484 \\ \text{Total variable overhead cost variance: } & \$2,484 - \$2,500 = \underline{\$16 \text{ (U)}} \end{aligned}$$

Exhibit 6 shows an analysis of Cambria’s variable overhead variances.

**Exhibit 6**  
Diagram of Variable Overhead Variance Analysis



© Cengage Learning 2014

For effective performance evaluation, managers must know how much of the total cost arose from variable overhead spending deviations and how much from variable overhead application deviations (i.e., applied and actual direct labor hours). This information is found by computing the variable overhead spending variance and the variable overhead efficiency variance.

### Computing Variable Overhead Spending Variance

#### Variable Overhead Spending Variance

**Performance Measure** The **variable overhead spending variance** (or *variable overhead rate variance*) measures the difference between what variable overhead actually cost and what it should have cost according to the flexible budget standard.

#### Formula

$$\text{Variable Overhead Spending Variance} = (\text{Standard Rate} \times \text{Actual Hours}) - \text{Actual Variable Overhead Cost}$$

**Example** For Cambria, it is computed as follows:

$$\begin{aligned} \text{Variable Overhead Spending Variance} &= (\$5.75 \times 450 \text{ hours}) - \$2,500 \\ &= \underline{\$87.50} \text{ (F)} \end{aligned}$$

### Computing Variable Overhead Efficiency Variance

#### Variable Overhead Efficiency Variance

**Performance Measure** The **variable overhead efficiency variance** measures the difference between the labor hours actually worked to make the product and the labor hours that should have been worked to produce the number of products made.

#### Formula

$$\text{Variable Overhead Efficiency Variance} = \text{Standard Rate} \times (\text{Standard Hours Allowed} - \text{Actual Hours})$$

**Example** For Cambria, it is computed as follows.

$$\begin{aligned} \text{Variable Overhead Efficiency Variance} &= \$5.75 \times [(180 \text{ bags} \times 2.4 \text{ hours}) - 450 \text{ hours}] \\ &= \underline{\$103.50} \text{ (U)} \end{aligned}$$

**Summary of Variable Overhead Variances** The net of the variable overhead spending variance and the variable overhead efficiency variance should equal the total variable overhead variance. The following check shows that these variances have been computed correctly:

Variable overhead spending variance	\$ 87.50 (F)
Variable overhead efficiency variance	103.50 (U)
Total variable overhead cost variance	<u>\$ 16.00 (U)</u>

### Fixed Overhead Variances

#### Total Fixed Overhead Cost Variance

**Performance Measure** The **total fixed overhead cost variance** measures the difference between what the actual fixed overhead cost and what was applied according to the flexible budget for the good units produced.

**Formula**

$$\text{Total Fixed Overhead Cost Variance} = \text{Fixed Overhead Applied}^* - \text{Actual Fixed Overhead}$$

\*Fixed Overhead Applied = Standard Rate × Standard Hours for the Good Units Produced

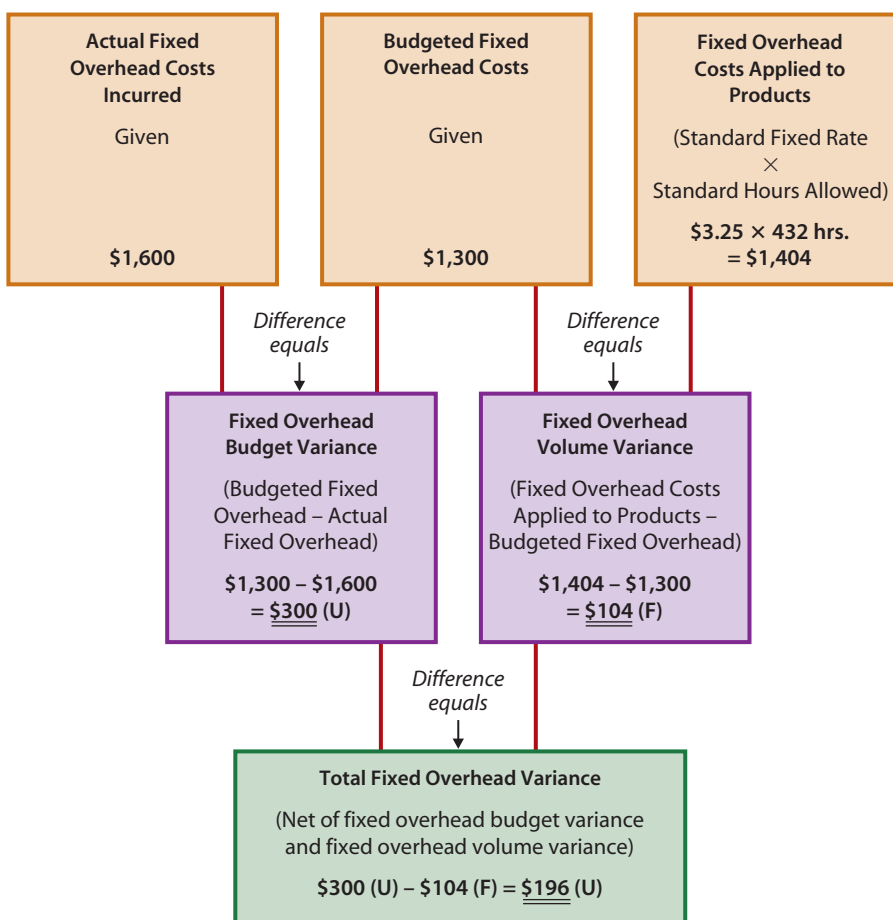
**STUDY NOTE:** The procedure for finding the total fixed overhead cost variance differs from the procedure used for finding direct materials, direct labor, and variable overhead variances.

**Example** At Cambria, each bag requires 2.4 standard direct labor hours, and the standard fixed overhead rate is \$3.25 per direct labor hour. As we noted earlier, the standard fixed overhead rate is found by dividing budgeted fixed overhead (\$1,300) by normal capacity, which was set by the master budget at the beginning of the period. In this case, because normal capacity is 400 direct labor hours, the fixed overhead rate is \$3.25 per direct labor hour ( $\$1,300 \div 400$  hours). For the month, Cambria incurred \$1,600 of actual fixed overhead costs. The total fixed overhead variance is computed as follows.

$$\begin{aligned} \text{Fixed overhead applied: } & \$3.25 \text{ per hour} \times (180 \text{ bags} \times 2.4 \text{ hours per bag}) = \$1,404 \\ \text{Total fixed overhead variance: } & \$1,404 - \$1,600 = \underline{\$196 (U)} \end{aligned}$$

Exhibit 7 shows an analysis of Cambria’s fixed overhead variances.

**Exhibit 7**  
Diagram of Fixed Overhead Variance Analysis



© Cengage Learning 2014

For effective performance evaluation, managers break down the total fixed overhead cost variance into two additional variances: the fixed overhead budget variance and the fixed overhead volume variance.

## Computing Fixed Overhead Budget Variance

### Fixed Overhead Budget Variance

**Performance Measure** The **fixed overhead budget variance** (or *budgeted fixed overhead variance*) measures the difference between what fixed overhead actually cost and what was budgeted.

#### Formula

$$\text{Fixed Overhead Budget Variance} = \text{Budgeted Fixed Overhead} - \text{Actual Fixed Overhead}$$

**Example** For Cambria, it is computed as follows.

$$\text{Fixed Overhead Budget Variance} = \$1,300 - \$1,600 = \underline{\underline{\$300}} \text{ (U)}$$

## Computing Fixed Overhead Volume Variance

### Fixed Overhead Volume Variance

**Performance Measure** The **fixed overhead volume variance** measures the difference between budgeted fixed overhead costs and the fixed overhead costs applied to products based on the standard fixed rate and standard hours allowed.

#### Formula

$$\text{Fixed Overhead Volume Variance} = (\text{Standard Fixed Rate} \times \text{Standard Hours Allowed}) - \text{Budgeted Fixed Overhead}$$

**Example** For Cambria, the fixed overhead volume variance is computed as follows.

$$\begin{aligned} \text{Fixed Overhead Volume Variance} &= [\$3.25 \times (180 \text{ bags} \times 2.4 \text{ hours})] - \$1,300 \\ &= \underline{\underline{\$104}} \text{ (F)} \end{aligned}$$

Because the fixed overhead volume variance measures the use of existing facilities and capacity, a volume variance will occur if more or less than normal capacity is used. At Cambria, 400 direct labor hours are considered normal use of facilities. Because fixed overhead costs are applied on the basis of standard hours allowed, Cambria's overhead was applied on the basis of 432 hours, even though the fixed overhead rate was computed using 400 hours. Thus, more fixed costs would be applied to products than were budgeted.

- When capacity exceeds the expected amount, the result is a favorable overhead volume variance because fixed overhead was overapplied.
- When a company operates at a level below the normal capacity in units, the result is an unfavorable volume variance. Not all of the fixed overhead costs will be applied to units produced. In other words, fixed overhead is underapplied, and the cost of goods produced does not include the full budgeted cost of fixed overhead.

**Summary of Variable and Fixed Overhead Variances** The net of the variable and fixed overhead variances should equal the total overhead cost variance. Checking the computations, we find that the variable and fixed overhead variances do equal the total overhead cost variance:

Variable overhead spending variance	\$ 87.50 (F)
Variable overhead efficiency variance	103.50 (U)
Fixed overhead budget variance	300.00 (U)
Fixed overhead volume variance	104.00 (F)
Total overhead cost variance	<u><u>\$212.00</u></u> (U)



Exhibits 6 and 7 summarize the analysis of overhead variances. The total overhead cost variance is also the amount of overapplied or underapplied overhead. Recall that actual variable and fixed overhead costs are recorded as they occur, that variable and fixed overhead are applied to products as they are produced, and that the overapplied or underapplied overhead is computed and reconciled at the end of each period. By breaking down the total overhead cost variance into its variable and fixed components, managers can more accurately control costs and reconcile their causes. An analysis of these two overhead variances will help explain why the amount of overhead applied to units produced is different from the actual overhead costs incurred.

## Business Application

In analyzing the unfavorable total overhead cost variance of \$212, the manager of Cambria's Bag Assembly Department found the following causes for the variances that contributed to it.

- Although the variable overhead spending variance was favorable (\$87.50 less than expected because of savings on purchases), the inefficiency of the machine operator who substituted for an assembly worker created unfavorable variances for both direct labor efficiency and variable overhead efficiency. As a result, the manager is going to consider the feasibility of implementing a program for cross-training employees.
- After reviewing the fixed overhead costs, the Bag Assembly Department's manager concluded that higher-than-anticipated factory insurance premiums were the reason for the unfavorable fixed overhead budget variance and were the result of an increase in the number of insurance claims filed by employees. To obtain more specific information, the manager will study the insurance claims filed over a three-month period.
- Finally, since the 432 standard hours were well above the normal capacity of 400 direct labor hours, fixed overhead was overapplied, and it resulted in a \$104 (F) volume variance. The overutilization of capacity was traced to high demand that pressed the company to use almost all its capacity. Management decided not to do anything about the fixed overhead volume variance because it fell within an anticipated seasonal range.

## APPLY IT!

Sutherland Products uses standard costing. The following information about overhead was generated during August:

Standard variable overhead rate	\$2 per machine hour
Standard fixed overhead rate	\$3 per machine hour
Actual variable overhead costs	\$443,200
Actual fixed overhead costs	\$698,800
Budgeted fixed overhead costs	\$700,000
Standard machine hours per unit produced	12
Good units produced	18,940
Actual machine hours	228,400

Compute the variable overhead spending and efficiency variances and the fixed overhead budget and volume variances using formulas or diagram form.

*(Continued)*

**SOLUTION**

Using formulas:

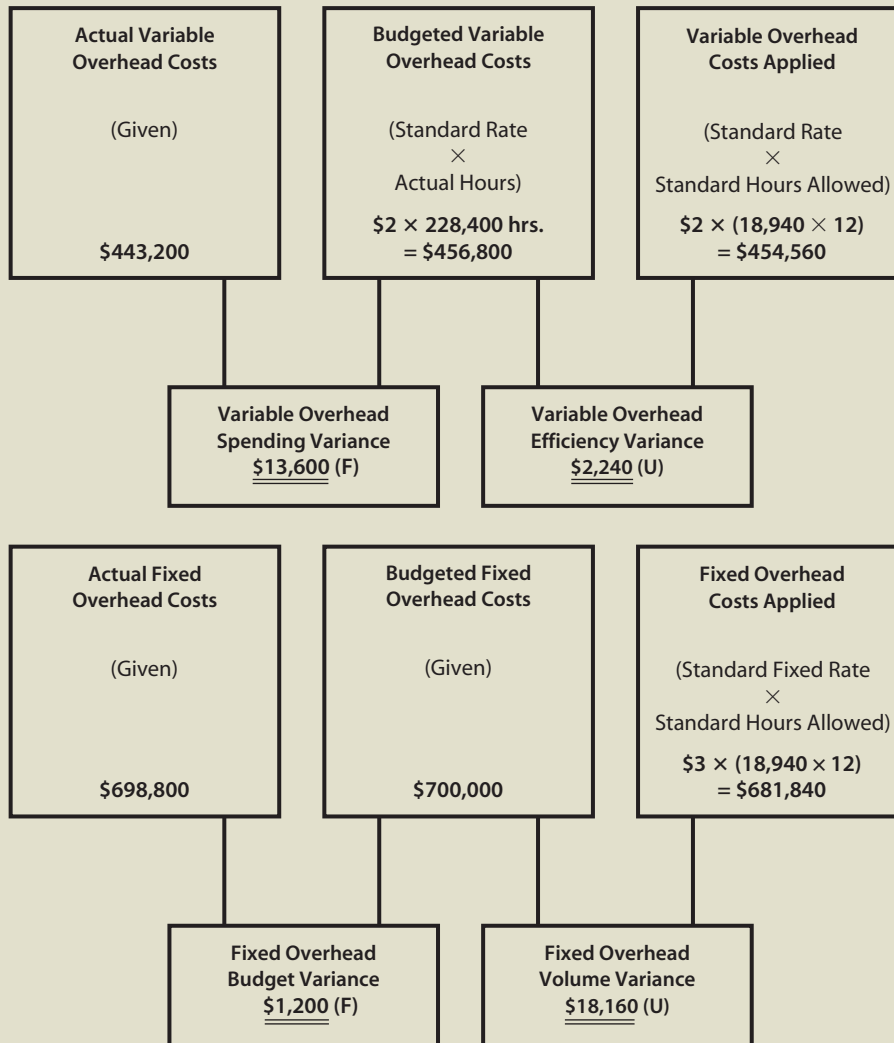
$$\begin{aligned} \text{Variable Overhead Spending Variance} &= (\text{Standard Rate} \times \text{Actual Hours}) - \text{Actual Variable Overhead Cost} \\ &= (\$2 \times 228,400 \text{ hours}) - \$443,200 \\ &= \underline{\$13,600} \text{ (F)} \end{aligned}$$

$$\begin{aligned} \text{Variable Overhead Efficiency Variance} &= \text{Standard Rate} \times (\text{Standard Hours Allowed} - \text{Actual Hours}) \\ &= \$2 \times [(18,940 \times 12) - 228,400 \text{ hours}] \\ &= \underline{\$2,240} \text{ (U)} \end{aligned}$$

$$\begin{aligned} \text{Fixed Overhead Budget Variance} &= \text{Budgeted Fixed Overhead} - \text{Actual Fixed Overhead} \\ &= \$700,000 - \$698,800 \\ &= \underline{\$1,200} \text{ (F)} \end{aligned}$$

$$\begin{aligned} \text{Fixed Overhead Volume Variance} &= (\text{Standard Rate} \times \text{Standard Hours Allowed}) - \text{Budgeted Fixed Overhead} \\ &= [\$3 \times (18,940 \times 12)] - \$700,000 \\ &= \underline{\$18,160} \text{ (U)} \end{aligned}$$

In diagram form:



© Cengage Learning 2014

**TRY IT! SE8, SE9, E9A, E10A, E11A, E12A, E13A, E14A, E9B, E10B, E11B, E12B, E13B, E14B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

**LO 6** Explain how variances are used to evaluate a business's performance.

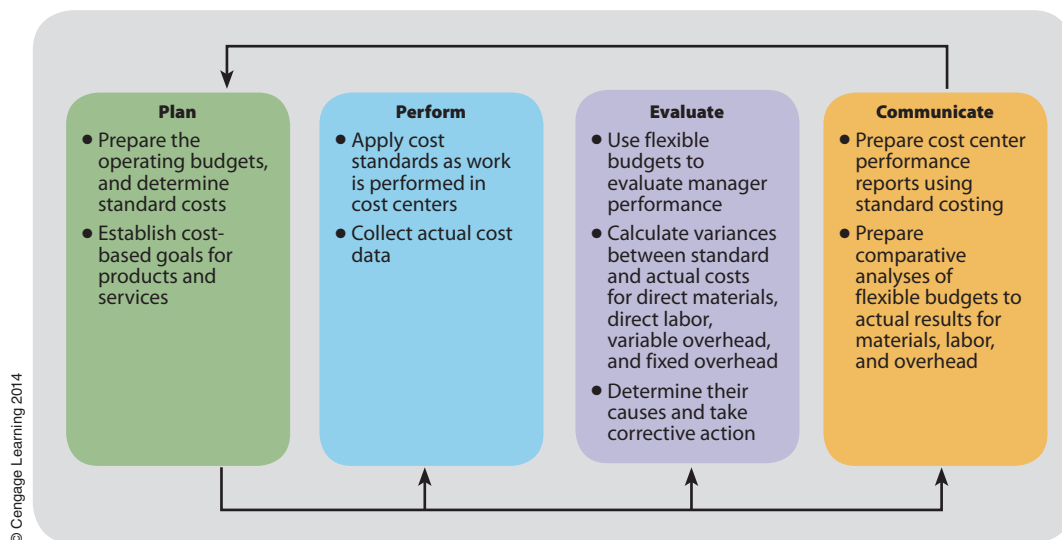
## LO 6 Using Cost Variances to Evaluate Managers' Performance

To ensure that the evaluation of a business's performance is effective and fair, a company's policies should be based on input from managers and employees and should specify the procedures that managers are to use when doing the following:

- Preparing operational plans
- Assigning responsibility for carrying out the operational plans
- Communicating the operational plans to key personnel
- Evaluating performance in each area of responsibility
- Identifying the causes of significant variances from the operational plan
- Taking corrective action to eliminate problems

Exhibit 8 frames these manager responsibilities for standard costing and variance analysis within the management process of planning, performing, evaluating and reporting on cost center operations.

### Exhibit 8 Variance Analysis and The Management Process



Variance analysis is usually more effective at pinpointing efficient and inefficient operating areas than are basic comparisons of budgeted and actual data. A managerial performance report based on standard costs and related variances should identify the causes of each significant variance, the personnel involved, and the corrective actions taken. It should be tailored to the cost center manager's specific areas of responsibility and explain clearly how the manager's department met or did not meet operating expectations. Managers should be held accountable only for the cost areas under their control.

Exhibit 9 shows a performance report for the manager of Cambria's Bag Assembly Department. The report summarizes all cost data and variances for direct materials, direct labor, and overhead. In addition, it identifies the causes of the variances and the corrective actions taken.

**Exhibit 9****Managerial Performance  
Report Using Variance Analysis**

**Cambria Company**  
**Managerial Performance Report—Bag Assembly Department**  
**For the Month Ended August 31**

**Productivity Summary:**

Normal capacity in units	167 bags
Normal capacity in direct labor hours (DLH)	400* DLH
Good units produced (actual)	180 bags
Performance level (standard hours allowed for good units produced)	432 DLH

\*Rounded

**Cost and Variance Analysis:**

	Standard Costs	Actual Costs	Total Variance	Variance Breakdown	
				Amount	Type
Direct materials	\$ 4,320	\$ 4,484	\$164 (U)	\$ 76.00 (F)	Direct materials price variance
				240.00 (U)	Direct materials quantity variance
Direct labor	3,672	4,140	468 (U)	315.00 (U)	Direct labor rate variance
				153.00 (U)	Direct labor efficiency variance
Variable overhead	2,484	2,500	16 (U)	87.50 (F)	Variable overhead spending variance
				103.50 (U)	Variable overhead efficiency variance
Fixed overhead	1,404	1,600	196 (U)	300.00 (U)	Fixed overhead budget variance
				104.00 (F)	Fixed overhead volume variance
<b>Totals</b>	<u>\$11,880</u>	<u>\$12,724</u>	<u>\$844 (U)</u>	<u>\$844.00 (U)</u>	

**Causes of Variances****Actions Taken****Direct materials price variance:**

New direct materials purchased at reduced price

New direct materials deemed inappropriate; resumed purchasing materials originally specified

**Direct materials quantity variance:**

Poor quality of new direct materials

New direct materials deemed inappropriate; resumed using direct materials originally specified

**Direct labor rate variance:**

Machine operator who had to learn assembly

Temporary replacement; no action taken on the job skills

**Direct labor efficiency variance:**Machine operator who had to learn assembly  
Late delivery of parts to assembly floorTemporary replacement; no action taken on the job skills  
Material delivery times and number of delays being tracked**Variable overhead spending variance:**

Cost savings on purchases

No action necessary

**Variable overhead efficiency variance:**

Machine operator who had to learn assembly

A cross-training program for employees is under consideration

**Fixed overhead budget variance:**

Large number of factory insurance claims

Study of insurance claims being conducted

**Fixed overhead volume variance:**

High number of orders caused by demand

No action necessary

Remember that the mere occurrence of a variance does not indicate that a manager of a cost center has performed poorly. However, if a variance occurs consistently, and no cause is identified and no corrective action is taken, it may well indicate poor managerial performance. Exhibit 9 shows that the causes of the variances have been identified and corrective actions are being taken, indicating that the manager of Cambria's Bag Assembly Department has the operation under control.

## APPLY IT!

Jayson Dunn, the production manager at Sample Industries, recently received his performance report from the company's controller. The report contained the following information:

	Actual Cost	Standard Cost	Variance
Direct materials	\$38,200	\$36,600	\$1,600 (U)
Direct labor	19,450	19,000	450 (U)
Variable overhead	62,890	60,000	2,890 (U)

The controller asked Dunn to respond to his performance report. Help Dunn prepare his response by deciding whether the following statements are true or false. If false, make the statement true.

- Dunn is responsible for all the variances listed on his performance report.
- Before Dunn can answer the controller's query, the total variances given to him need to be broken down into their component parts. Then, and only then, will Dunn find out how well or poorly he performed.

### SOLUTION

- False  
Dunn is responsible only for the direct materials quantity variance, the direct labor efficiency variance, and the variable overhead efficiency variance listed on his performance report.
- True

**TRY IT! SE10, E15A, E15B**

## TriLevel Problem



ICU, Inc.

AP Photo/Ed Bailey

The beginning of this chapter focused on ICU, Inc., the manufacturer of a home surveillance robot called Watch Dog. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*Why is standard costing and variance analysis useful?*

### Section 2: Accounting Applications

*How can ICU's managers evaluate the performance of its cost centers?*

Suppose ICU has begun producing carrier bags for the Watch Dog, and these high-quality, heavy-duty bags are made in a single cost center using a standard costing system. The standard variable costs for one bag (a unit) are as follows.

Direct materials (3 sq. meters @ \$12.50 per sq. meter)	\$37.50
Direct labor (1.2 hours @ \$9.00 per hour)	10.80
Variable overhead (1.2 hours @ \$5.00 per direct labor hour)	6.00
Total standard variable cost per unit	<u>\$54.30</u>

The center's master budget was based on its normal capacity of 15,000 direct labor hours. Its budgeted fixed overhead costs for the year were \$54,000. During the year, the

company produced and sold 12,200 bags, and it purchased and used 37,500 square meters of direct materials; the purchase cost was \$12.40 per square meter. The average labor rate was \$9.20 per hour, and 15,250 direct labor hours were worked. The center's actual variable overhead costs for the year were \$73,200, and its fixed overhead costs were \$55,000.

Using the data given, compute the following using formulas or diagram form:

1. Standard hours allowed for good output
2. Standard fixed overhead rate
3. Direct materials cost variances:
  - (a) Direct materials price variance
  - (b) Direct materials quantity variance
  - (c) Total direct materials cost variance
4. Direct labor cost variances:
  - (a) Direct labor rate variance
  - (b) Direct labor efficiency variance
  - (c) Total direct labor cost variance
5. Variable overhead cost variances:
  - (a) Variable overhead spending variance
  - (b) Variable overhead efficiency variance
  - (c) Total variable overhead cost variance
6. Fixed overhead cost variances:
  - (a) Fixed overhead budget variance
  - (b) Fixed overhead volume variance
  - (c) Total fixed overhead cost variance

### Section 3: Business Applications

*Why does the setting of performance standards help managers control costs and improve performance? To answer this question, match this chapter's manager responsibilities with when they occur within the management process.*

- |                |  |
|----------------|--|
| a. Plan        | 1. Prepare operating budgets                                       |
| b. Perform     | 2. Apply cost standards as work is performed in cost centers       |
| c. Evaluate    | 3. Establish product and service cost goals                        |
| d. Communicate | 4. Collect actual cost data  |
|                | 5. Determine standard costs  |
|                | 6. Calculate variances   |
|                | 7. Use flexible budgets to evaluate performance                    |
|                | 8. Prepare comparative reports using flexible budgets              |
|                | 9. Determine cause of variances and take corrective action         |
|                | 10. Prepare cost center performance reports using standard costing |

## SOLUTION

### Section 1: Concepts

Managers find standard costing and variance analysis useful because they enhance *comparability* and *understandability*. When evaluating cost centers, managers use standard costs to prepare a flexible budget, which will improve the accuracy of their cost comparisons and variance analysis. This comparison of actual costs and a budget based on the same amount of output can provide managers with understandable objective data that they can use to assess the center's performance in terms of its key success factor—cost. By analyzing variances between standard and actual costs, they gain insight into the causes of those differences. Once they understand the operating problem that is causing a cost variance, they can devise a solution that results in better control of costs.





## 4. Direct Labor Cost Variances:

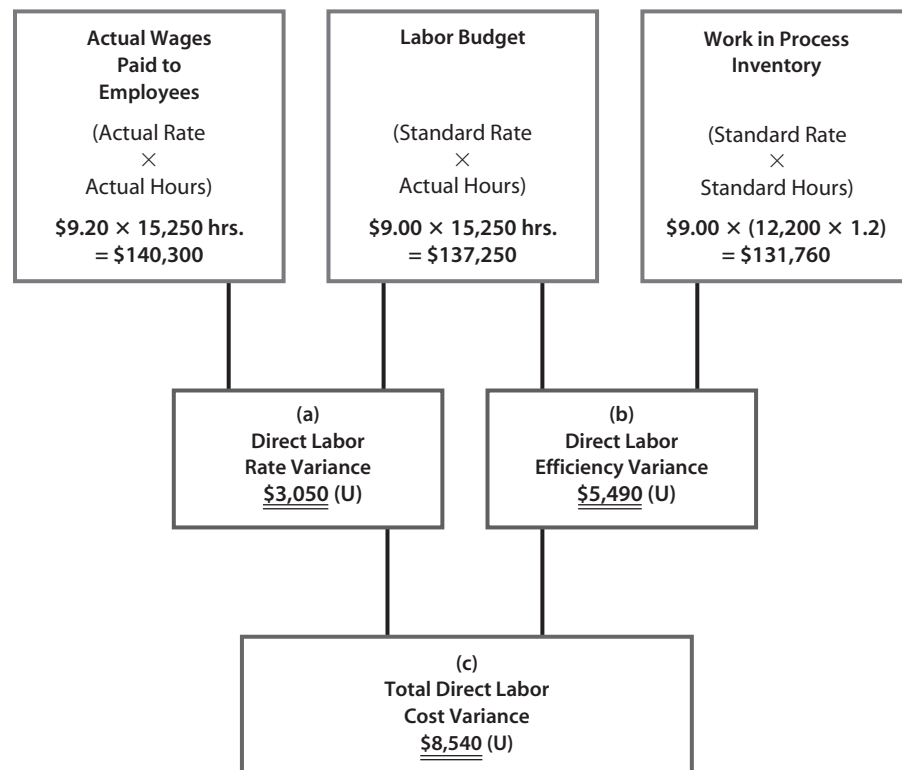
Using formulas:

$$\begin{aligned} \text{(a) Direct Labor Rate} &= (\text{Standard Rate} - \text{Actual Rate}) \times \text{Actual Hours} \\ \text{Variance} &= (\$9.00 - \$9.20) \times 15,250 \text{ hours} \\ &= \underline{\$3,050} \text{ (U)} \end{aligned}$$

$$\begin{aligned} \text{(b) Direct Labor} &= \text{Standard Rate} \times (\text{Standard Hours Allowed} - \text{Actual Hours}) \\ \text{Efficiency Variance} &= \$9.00 \times [(12,200 \text{ units produced} \times 1.2 \text{ hours}) - 15,250] \\ &= \underline{\$5,490} \text{ (U)} \end{aligned}$$

$$\begin{aligned} \text{(c) Total Direct Labor} &= \text{Direct Labor Rate} + \text{Direct Labor Efficiency} \\ \text{Cost Variance} &= \text{Variance} + \text{Variance} \\ &= \$3,050 \text{ (U)} + \$5,490 \text{ (U)} \\ &= \underline{\$8,540} \text{ (U)} \end{aligned}$$

In diagram form:





## 6. Fixed Overhead Cost Variances:

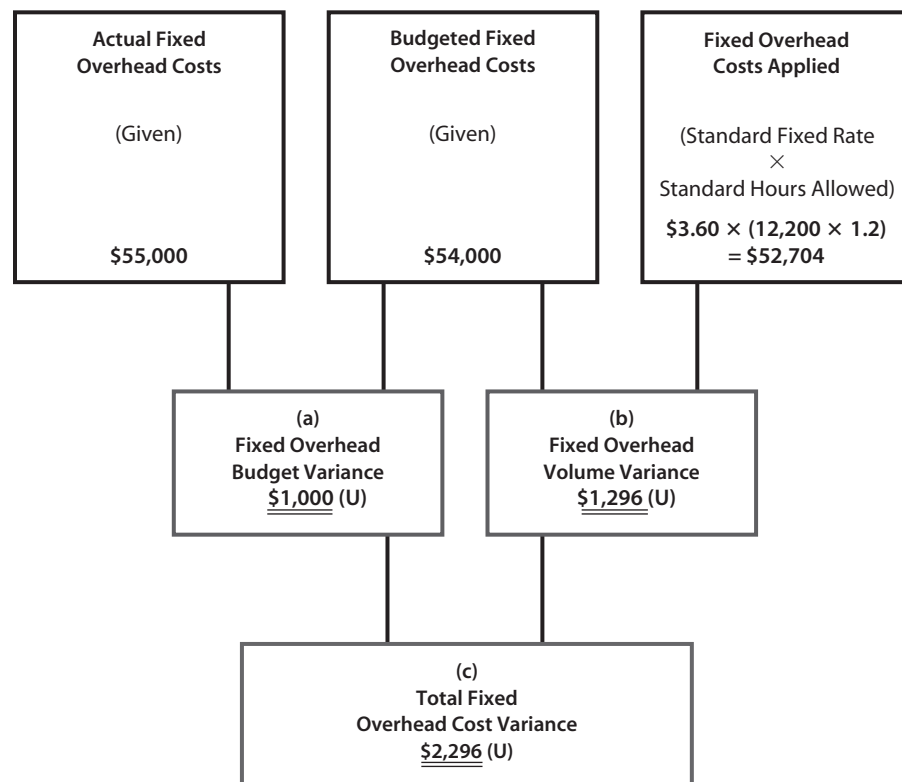
Using formulas:

$$\begin{aligned} \text{(a) Fixed Overhead Budget Variance} &= \text{Budgeted Fixed Overhead} - \text{Actual Fixed Overhead} \\ &= \$54,000 - \$55,000 \\ &= \underline{\$1,000 \text{ (U)}} \end{aligned}$$

$$\begin{aligned} \text{(b) Fixed Overhead Volume Variance} &= (\text{Standard Rate} \times \text{Standard Hours Allowed}) - \text{Budgeted Fixed Overhead} \\ &= [\$3.60 \times (12,200 \text{ units produced} \times 1.2)] - \$54,000 \\ &= \underline{\$1,296 \text{ (U)}} \end{aligned}$$

$$\begin{aligned} \text{(c) Total Fixed Overhead Cost Variance} &= \text{Fixed Overhead Budget Variance} + \text{Fixed Overhead Volume Variance} \\ &= \$1,000 \text{ (U)} + \$1,296 \text{ (U)} \\ &= \underline{\$2,296 \text{ (U)}} \end{aligned}$$

In diagram form:



© Cengage Learning 2014

**Section 3: Business Applications**

- |      |       |
|------|-------|
| 1. a | 6. c  |
| 2. b | 7. c  |
| 3. a | 8. d  |
| 4. b | 9. c  |
| 5. a | 10. d |

## Chapter Review

**Define standard costs, and explain why standard costing is useful.** **Lo 1**

Standard costs are realistic estimates of costs based on analyses of both past and projected operating costs and conditions. They provide an understandable standard, or predetermined, performance level for use in standard costing, which includes a comparison measure of the variance between standard and actual performance.

**Compute standard unit costs, and describe the role of flexible budgets in variance analysis to control costs.** **Lo 2**

A standard unit cost has six elements. A total standard unit cost is computed by adding the following costs: direct materials costs (direct materials price standard times direct materials quantity standard), direct labor costs (direct labor rate standard times direct labor time standard), and overhead costs (standard variable and standard fixed overhead rates times standard direct labor hours allowed per unit). Standard unit costs are used to develop a flexible budget. A flexible budget is a summary of anticipated costs for a range of activity levels. It provides forecasted cost data that can be adjusted for changes in level of output. The variable cost per unit and total fixed costs presented in a flexible budget are components of the flexible budget formula, which determines the budgeted cost for any level of output. A flexible budget improves the accuracy of variance analysis, which is a four-step approach to controlling costs. First, managers compute the amount of the variance. If the amount is significant, managers then analyze the variance to identify its cause. They then select performance measures that will enable them to track those activities, analyze the results, and determine the action needed to correct the problem. Their final step is to take the appropriate corrective action.

**Compute and analyze direct materials variances.** **Lo 3**

The direct materials price variance is computed by finding the difference between the standard price and the actual price per unit and multiplying it by the actual quantity purchased. The direct materials quantity variance is the difference between the standard quantity that should have been used and the actual quantity used, multiplied by the standard price. An analysis of these variances enables managers to identify what is causing them and to formulate plans for correcting related operating problems.

**Compute and analyze direct labor variances.** **Lo 4**

The direct labor rate variance is computed by determining the difference between the standard direct labor rate and the actual rate and multiplying it by the actual direct labor hours worked. The direct labor efficiency variance is the difference between the standard hours allowed for the number of good units produced and the actual hours worked multiplied by the standard direct labor rate. Managers analyze these variances to find the causes of differences between standard direct labor costs and actual direct labor costs.

**Compute and analyze overhead variances.** **Lo 5**

The total overhead variance is equal to the amount of under- or overapplied overhead costs for an accounting period. An analysis of the variable and fixed overhead variances will help explain why the amount of overhead applied to units produced differs from the actual overhead costs incurred. The total overhead cost variance can be broken down into a variable overhead spending variance, a variable overhead efficiency variance, a fixed overhead budget variance, and a fixed overhead volume variance.

**Explain how variances are used to evaluate a business's performance.** **Lo 6**

To ensure that performance evaluation is effective and fair, a company's evaluation policies should be based on input from managers and employees and should be specific about the procedures that managers are to follow. The evaluation process becomes more accurate when performance reports for cost centers include variances from standard costs. A performance report based on standard costs and related variances should identify the causes of each significant variance, along with the personnel involved and the corrective actions taken. It should be tailored to the cost center manager's specific areas of responsibility.

## Key Terms

<b>direct labor efficiency variance</b> 1057 (LO4)	<b>fixed overhead volume variance</b> 1064 (LO5)	<b>total direct materials cost variance</b> 1054 (LO3)
<b>direct labor rate standard</b> 1050 (LO2)	<b>standard costing</b> 1048 (LO1)	<b>total fixed overhead cost variance</b> 1062 (LO5)
<b>direct labor rate variance</b> 1057 (LO4)	<b>standard costs</b> 1048 (LO1)	<b>total overhead cost variance</b> 1060 (LO5)
<b>direct labor time standard</b> 1050 (LO2)	<b>standard direct labor cost</b> 1050 (LO2)	<b>total variable overhead cost variance</b> 1061 (LO5)
<b>direct materials price standard</b> 1049 (LO2)	<b>standard direct materials cost</b> 1049 (LO2)	<b>variable overhead efficiency variance</b> 1062 (LO5)
<b>direct materials price variance</b> 1054 (LO3)	<b>standard fixed overhead rate</b> 1050 (LO2)	<b>variable overhead spending variance</b> 1062 (LO5)
<b>direct materials quantity standard</b> 1049 (LO2)	<b>standard overhead cost</b> 1050 (LO2)	<b>variance</b> 1048 (LO1)
<b>direct materials quantity variance</b> 1054 (LO3)	<b>standard variable overhead rate</b> 1050 (LO2)	<b>variance analysis</b> 1049 (LO2)
<b>fixed overhead budget variance</b> 1064 (LO5)	<b>total direct labor cost variance</b> 1057 (LO4)	

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1, 2 **DQ1. CONCEPT** ► Describe how the six elements of a standard unit cost increase cost comparability and understandability.
- LO 2 **DQ2.** What role do flexible budgets play in improving the understanding of variance analysis?
- LO 2, 3, 4, 5 **DQ3.** Why does the four-step process of variance analysis enhance a cost center's ability to control costs?
- LO 6 **DQ4. CONCEPT** ► **BUSINESS APPLICATION** ► What should be included in a management report to further understandability and comparability when evaluating a cost center?
- LO 6 **DQ5. CONCEPT** ► **BUSINESS APPLICATION** ► Why does the use of standard costing and variance analysis in the management process reinforce the concepts of comparability and understandability to better business performance?

### SHORT EXERCISES

- LO 1 **Standard Costing Concepts**
- SE1. CONCEPT** ► Columbus Corporation is considering adopting the standard costing method to enhance the understandability and comparability of accounting information. Prepare several reasons in support of why understandability and comparability will be enhanced.
- LO 1 **Purposes of Standard Costs**
- SE2. ACCOUNTING CONNECTION** ► Suppose you are a management consultant and a client asks you the advantages and disadvantages of using standard costs in cost accounting systems. Prepare your response, listing the advantages and disadvantages of using standard costs.

**LO 2 Computing a Standard Unit Cost**

**SE3.** Using the information that follows, compute the total standard unit cost of Product WW+.

Direct materials quantity standard	1 pound per unit
Direct materials price standard	\$10.00 per pound
Direct labor time standard	0.5 hour per unit
Direct labor rate standard	\$12.00 per hour
Variable overhead rate standard	\$6.00 per machine hour
Fixed overhead rate standard	\$11.00 per machine hour
Machine hour standard	4 hours per unit

**LO 2 Analyzing Cost Variances**

**SE4. ACCOUNTING CONNECTION** ▶ Dancing Waters produces fountains. The company analyzes only variances that differ by more than 5 percent from the standard cost. The controller computed the following direct labor efficiency variances for May:

	<b>Direct Labor Efficiency Variance</b>	<b>Standard Direct Labor Cost</b>
Product 4	\$1,200 (U)	\$24,000
Product 6	3,200 (F)	42,800
Product 7	2,000 (U)	42,000
Product 9	1,600 (F)	34,000
Product 12	2,800 (U)	50,000

For each product, determine the variance as a percentage of the standard cost (round to one decimal place). Then identify the products for which variances should be analyzed and suggest possible causes for the variances.

**LO 3 Direct Materials Variances**

**SE5.** Clean Plate Company produces placemats. Each placemat calls for 0.2 meters of vinyl material; the material should cost \$1 per meter. In June, the company manufactured and sold 100,000 placemats. During the month, it used 20,200 meters of vinyl material. The total cost of the material was \$19,796. Compute the direct materials price and direct materials quantity variances for June.

**LO 3 Direct Materials Variances**

**SE6.** Using the standard unit costs that you computed in **SE3** and the actual cost and usage data that follow, compute the direct materials price and direct materials quantity variances.

Direct materials purchased and used (pounds)	21,800
Price paid for direct materials	\$10.10 per pound
Number of good units produced	21,000 units

**LO 4 Direct Labor Variances**

**SE7.** Using the standard unit costs that you computed in **SE3** and the actual cost and usage data that follow, compute the direct labor rate and direct labor efficiency variances.

Direct labor hours used	11,000 hours
Total cost of direct labor	\$134,200
Number of good units produced	21,000 units

**LO 5 Overhead Variances**

**SE8.** Meanwhile Products uses standard costing. The following information about overhead was generated during August:

Standard variable overhead rate	\$2.50 per machine hour
Standard fixed overhead rate	\$3.00 per machine hour
Actual variable overhead costs	\$60,100
Actual fixed overhead costs	\$68,800
Budgeted fixed overhead costs	\$70,000
Standard machine hours per unit produced	2.8
Good units produced	8,000
Actual machine hours	24,200

Compute the variable overhead spending and efficiency variances and the fixed overhead budget and volume variances.

**LO 5 Fixed Overhead Rate and Variances**

**SE9.** Point Manufacturing Company uses the standard costing method. The company's main product is a fine-quality pen that normally takes 5.1 hours to produce. Normal annual capacity is 20,000 direct labor hours, and budgeted fixed overhead costs for the year were \$10,000. During the year, the company produced and sold 4,000 units. Actual fixed overhead costs were \$10,200. Compute the fixed overhead rate per direct labor hour, and determine the fixed overhead budget and volume variances.

**LO 6 Evaluating Managerial Performance**

**SE10. BUSINESS APPLICATION** ► ZMT Products' controller gave the production manager a report containing the following information:

	Actual Cost	Standard Cost	Variance
Direct materials	\$50,000	\$48,200	\$1,800 (U)
Direct labor	7,550	7,000	550 (U)
Variable overhead	52,000	50,000	2,000 (U)

The controller asked for a response. How would you respond? What additional information might you need to prepare your response?

**EXERCISES: SET A****LO 1 Uses of Standard Costs**

**E1A. ACCOUNTING CONNECTION** ► Asa Wentz, the new controller at Market Research Company, is concerned that the company's methods of cost control do not accurately track the operations of the business. She plans to suggest to Tyson Getz, the company's president, that the company start using standard costing for budgeting and cost control. The new method could be incorporated into the existing accounting system. The anticipated cost of adopting it and training managers is around \$80,000. Prepare a memo from Wentz to Getz that defines standard costing and outlines its uses and benefits.

**LO 2 Computing Standard Costs**

**E2A.** Flossmoor Corporation uses standard costing and is in the process of updating its direct materials and direct labor standards for Product 2B. The following data have been accumulated:

**Direct materials:** In the previous period, 20,000 units were produced, and 32,000 square yards of direct materials at a cost of \$128,000 were used to produce them.



**Direct labor:** In the previous period, 20,000 units were produced and 58,000 direct labor hours were worked—34,000 hours on machine H and 24,000 hours on machine K. Machine H operators earned \$10 per hour, and machine K operators earned \$9 per hour last period. A new labor union contract calls for a 10 percent increase in labor rates for the coming period.

Using this information as the basis for the new standards, compute the direct materials quantity and price standards and the direct labor time and rate standards for each machine for the coming accounting period.

**LO 2 Computing a Total Standard Unit Cost**

**E3A.** Weather Balloons, Inc., makes reusable weather-detecting balloons. Because of a recent recession, management has ordered that standard costs be recomputed. New direct materials price standards are \$600 per set for electronic components and \$13 per square meter for heavy-duty canvas. Direct materials quantity standards include one set of electronic components and 100 square meters of heavy-duty canvas per balloon. Direct labor time standards are 26 hours per balloon for the Electronics Department and 21 hours per balloon for the Assembly Department. Direct labor rate standards are \$20 per hour for the Electronics Department and \$15 per hour for the Assembly Department. Standard overhead rates are \$18 per direct labor hour for the standard variable overhead rate and \$10 per direct labor hour for the standard fixed overhead rate. Compute the total standard unit cost of one weather balloon.

**LO 3 Direct Materials Price and Quantity Variances**

**E4A.** Natural Company produces organic twig brooms. Each broom calls for 1 pound of wood; the wood should cost \$0.25 per pound. In July, the division manufactured and sold 500,000 brooms. During the month, it used 495,000 pounds of wood, and the total cost of the material was \$128,700. Normal monthly capacity was set at 580,000 brooms. Calculate Natural's material price and quantity variances for wood for the month.

**LO 3 Direct Materials Price and Quantity Variances**

**E5A.** LIFT Elevator Company manufactures small hydroelectric elevators. One of the direct materials used is heavy-duty carpeting for the floor of the elevator. The direct materials quantity standard for May was 6 square yards per elevator. During May, the purchasing agent purchased this carpeting at \$20 per square yard; the standard price for the period was \$22. Fifty elevators were completed and sold during the month; the Production Department used an average of 6.5 square yards of carpet per elevator. Calculate the company's direct materials price and quantity variances for carpeting for May.

**LO 3 Direct Materials Variances**

**E6A.** Creative Productions manufactured and sold 800 products at \$10,000 each during the past year. At the beginning of the year, production had been set at 1,000 products, and direct materials standards had been set at 10 pounds of direct materials at \$12 per pound for each product produced. During the year, the company purchased and used 7,900 pounds of direct materials with a cost of \$12.02 per pound. Calculate the company's direct materials price and quantity variances for the year.

**LO 4 Direct Labor Variances**

**E7A.** At the beginning of last year, Creative Productions set direct labor standards of 2 hours at \$25 per hour for each product produced. During the year, 1,700 direct labor hours were actually worked at an average cost of \$26 per hour. Using this information and the applicable information in **E6A**, calculate the company's direct labor rate and efficiency variances for the year.

**LO 4 Direct Labor Rate and Efficiency Variances**

**E8A.** For the past two years, NE Company's best-selling product has been a titanium engine block. Standard direct labor hours per block are 2.0 hours. All direct labor employees are paid \$24 per hour. During July, NE produced 16,000 blocks. Actual direct labor hours and costs for the month were 31,000 hours and \$775,000, respectively.

1. Compute the direct labor rate variance for blocks during July.
2. Using the same data, compute the direct labor efficiency variance for engine blocks during July. Check your answer, assuming that the total direct labor cost variance is \$7,000 (U).

**LO 5 Variable Overhead Variances**

**E9A.** At the beginning of last year, Creative Productions set variable overhead standards of 5 machine hours at a rate of \$15 per hour for each product produced. During the year, 4,800 machine hours were used at a cost of \$15.10 per hour. Using this information and the applicable information in **E6A**, calculate the company's variable overhead spending and efficiency variances for the year.

**LO 5 Fixed Overhead Variances**

**E10A.** At the beginning of last year, Creative Productions set budgeted fixed overhead costs at \$46,000 and budgeted production at 1,000 products. During the year, actual fixed overhead costs were \$50,000. Using this information and the applicable information in **E6A**, calculate the company's fixed overhead budget and volume variances for the year. Assume that fixed overhead is applied based on units of product.

**LO 5 Variable Overhead Variances for a Service Business**

**E11A.** MUF Architects, LLP, billed clients for 6,000 hours of design work for the month. Actual variable overhead costs for the month were \$910,000, and 6,050 hours were worked. At the beginning of the year, a variable overhead standard of \$150 per design hour had been developed based on a budget of 5,000 design hours each month. Calculate the company's variable overhead spending and efficiency variances for the month.

**LO 5 Fixed Overhead Variances for a Service Business**

**E12A.** Engineering Associates billed clients for 10,000 hours of engineering work for the month. Actual fixed overhead costs for the month were \$1,450,000. At the beginning of the year, a fixed overhead standard of \$140 per engineering hour had been developed based on a budget of 10,500 engineering hours each month. Calculate the company's fixed overhead budget and volume variances for the month.

**LO 5 Overhead Variances**

**E13A.** Quay Company produces handmade scallop buckets and sells them to distributors along Florida's Gulf Coast. The company incurred \$10,500 of actual overhead costs (\$9,500 variable; \$1,000 fixed) in March. Budgeted standard overhead costs for March were \$1 of variable overhead costs per direct labor hour and \$1,200 of fixed overhead costs. Normal capacity was set at 10,000 direct labor hours per month. In March, the company produced 8,100 clamming buckets by working 9,000 direct labor hours. The time standard is 0.9 direct labor hour per bucket. Compute (a) the variable overhead spending and efficiency variances and (b) the fixed overhead budget and volume variances for March. (Round to the nearest dollar.)

**LO 5 Overhead Variances**

**E14A.** Goldencoast Industries uses standard costing and a flexible budget for cost planning and control. Its monthly budget for overhead costs is \$100,000 of fixed costs plus \$5 per machine hour. Monthly normal capacity of 100,000 machine hours is used to compute the standard fixed overhead rate. During the month, 104,000 machine hours were used. Only 102,500 standard machine hours were allowed for good units produced

during the month. Actual overhead costs incurred during the month totaled \$511,000 of variable costs and \$94,500 of fixed costs. Compute (a) the under- or overapplied overhead for the month and (b) the variable overhead spending and efficiency variances and the fixed overhead budget and volume variances.

### LO 6 Evaluating Managerial Performance

**E15A. BUSINESS APPLICATION** ► Layton Davis oversees projects for Pace Construction Company. Recently, the company's controller sent him a performance report regarding the construction of the Highlands Bank, a project that Davis supervised. Included in the report was an unfavorable direct labor efficiency variance of \$900 for roof structures. What types of information does Davis need to analyze before he can respond to this report?

## EXERCISES: SET B

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

## PROBLEMS

### LO 2 Computing and Using Standard Costs

#### SPREADSHEET

✓ 2: Total standard unit cost per entrance last year: \$9,542

**P1.** Modular houses are Homes, Inc.'s specialty. The company's best-selling model is a three-bedroom, 1,400-square-foot house with an impressive front entrance. Last year, the standard costs for the six basic direct materials used in manufacturing the entrance were as follows: wood framing materials, \$2,140; deluxe front door, \$480; door hardware, \$260; exterior siding, \$710; electrical materials, \$580; and interior finishing materials, \$1,520. Three types of direct labor are used to build the entrance: carpenter, 30 hours at \$36 per hour; door specialist, 4 hours at \$24 per hour; and electrician, 8 hours at \$50 per hour. Last year, the company used an overhead rate of 40 percent of total direct materials cost.

This year, the cost of wood framing materials is expected to increase by 20 percent, and a deluxe front door will cost \$496. The cost of the door hardware will increase by 10 percent, and the cost of electrical materials will increase by 20 percent. Exterior siding cost should decrease by \$15 per unit. The cost of interior finishing materials is expected to remain the same. The carpenter's wages will increase by \$1 per hour, and the door specialist's wages should remain the same. The electrician's wages will increase by \$0.50 per hour. Finally, the overhead rate will decrease to 30 percent of total direct materials cost.

#### REQUIRED

1. Compute the total standard cost of direct materials per entrance for last year.
2. Using your answer to requirement 1, compute the total standard unit cost per entrance for last year.
3. Compute the total standard unit cost per entrance for this year. (Round to the nearest dollar.)

### LO 3, 4

#### Direct Materials and Direct Labor Variances

- ✓ 1: Direct materials price variance, \$1,204 (F)
- ✓ 1: Direct materials quantity variance, \$6 (U)
- ✓ 2: Direct labor rate variance, \$1,000 (U)
- ✓ 2: Direct labor efficiency variance, \$108 (F)

**P2.** Party Balloons Company produces mylar balloons. The company's direct materials standards for its deluxe balloon include 3 ounces of mylar. Standard prices for the year were \$0.030 per ounce. Direct labor standards for the deluxe balloon specify 0.01 hour of direct labor at a standard direct labor rate of \$18 per hour.

During January, the company made 200,600 deluxe balloons. Actual production data follow.

Direct materials	602,000 ounces @ \$0.028 per ounce
Direct labor	2,000 hours @ \$18.50 per hour

#### REQUIRED

1. Compute the direct materials price and quantity variances.
2. Compute the direct labor rate and efficiency variances.

## LO 3, 4

- ✓ 1: Wood: Direct materials price variance, \$4,932 (U)
- ✓ 1: Wood: Direct materials quantity variance, \$180 (U)
- ✓ 2: Molding: Direct labor rate variance, \$680 (F)
- ✓ 2: Molding: Direct labor efficiency variance, \$2,400 (U)

**Direct Materials and Direct Labor Variances**

**P3.** Winners Trophy Company produces trophies. The company's direct materials standards for its deluxe trophy include 1 pound of metal and 10 ounces of wood for the base. Standard prices for the year were \$3 per pound of metal and \$0.45 per ounce of wood. Direct labor standards for the deluxe trophy specify 0.2 hour of direct labor in the Molding Department and 0.4 hour in the Trimming/Finishing Department. Standard direct labor rates are \$20 per hour in the Molding Department and \$18.00 per hour in the Trimming/Finishing Department.

During January, the company made 16,400 deluxe trophies. Actual production data follow.

Direct materials:	
Metal	16,640 pounds @ \$2.95 per pound
Wood	164,400 ounces @ \$0.48 per ounce
Direct labor:	
Molding	3,400 hours @ \$19.80 per hour
Trimming/Finishing	6,540 hours @ \$18.10 per hour

**REQUIRED**

1. Compute the direct materials price and quantity variances for metal and wood.
2. Compute the direct labor rate and efficiency variances for the Molding and Trimming/Finishing Departments.

## LO 5

- ✓ b: Variable overhead efficiency variance, \$1,000 (F)
- ✓ d: Normal capacity in machine hours, 17,000 hours
- ✓ f: Fixed overhead applied, \$157,500

**Overhead Variances**

**P4.** Copa Corporation's accountant left for vacation before completing the monthly cost variance report. The corporation's president has asked you to complete the report. The following data are available (capacities are expressed in machine hours):

Actual machine hours	17,100
Standard machine hours allowed	17,500
Actual variable overhead	(a)
Standard variable overhead rate	\$2.50
Variable overhead spending variance	\$750 (F)
Variable overhead efficiency variance	(b)
Actual fixed overhead	(c)
Budgeted fixed overhead	\$153,000
Fixed overhead budget variance	\$1,300 (U)
Fixed overhead volume variance	\$4,500 (F)
Normal capacity in machine hours	(d)
Standard fixed overhead rate	(e)
Fixed overhead applied	(f)

**REQUIRED**

Analyze the data and fill in the missing amounts. [*Hint:* Use the structure of Exhibits 6 and 7 to guide your analysis. Solve for (f) before solving for (e) and (d).]

**Computing Variances and Evaluating Performance**

**P5.** Clean Sweep Company produces all-vinyl mats. Each doormat calls for 0.5 meter of vinyl material; the material should cost \$3 per meter. Standard direct labor hours and labor cost per doormat are 0.3 hour and \$6 (0.3 hour × \$20 per hour), respectively. Currently, the division's standard variable overhead rate is \$1.50 per direct labor hour, and its standard fixed overhead rate is \$0.80 per direct labor hour.

## LO 3, 4, 5, 6

## SPREADSHEET

- ✓ 1a: Direct materials price variance, \$2,520 (F)
- ✓ 1d: Direct labor efficiency variance, \$84,000 (F)
- ✓ 1e: Variable overhead spending variance, \$2,000 (U)
- ✓ 1f: Variable overhead efficiency variance, \$6,300 (F)
- ✓ 1g: Fixed overhead budget variance, \$720 (U)
- ✓ 1h: Fixed overhead volume variance, \$2,720 (F)

In August, the division manufactured and sold 50,000 doormats. During the month, it used 25,200 meters of vinyl material; the total cost of the material was \$73,080. The total actual overhead costs for August were \$28,200, of which \$18,200 was variable. The total number of direct labor hours worked was 10,800, and the factory payroll for direct labor for the month was \$214,920. Budgeted fixed overhead for August was \$9,280. Normal monthly capacity for the year was set at 58,000 doormats.

**REQUIRED**

1. Compute for August the (a) direct materials price variance, (b) direct materials quantity variance, (c) direct labor rate variance, (d) direct labor efficiency variance, (e) variable overhead spending variance, (f) variable overhead efficiency variance, (g) fixed overhead budget variance, and (h) fixed overhead volume variance.
2. **BUSINESS APPLICATION** ► Prepare a performance report based on your variance analysis, and suggest possible causes for each variance.

**ALTERNATE PROBLEMS****LO 2****Computing Standard Costs for Direct Materials****SPREADSHEET**

✓ 1: Total standard direct materials cost per unit for next year: \$167.52

**P6. BUSINESS APPLICATION** ► Old Hands, Ltd., assembles clock movements for grandfather clocks. Each movement has four components: the clock facing, the clock hands, the time movement, and the spring assembly. For the current year, the company used the following standard costs: clock facing, \$15.90; clock hands, \$12.70; time movement, \$66.10; and spring assembly, \$52.50.

Prices of materials are expected to change next year. Old Hands will purchase 60 percent of the facings from Company A at \$18.50 each and the other 40 percent from Company B at \$18.80 each. The clock hands are purchased from Hardware, Inc. and will cost \$15.50 per set next year. Old Hands will purchase 30 percent of the time movements from Company Q at \$68.50 each, 20 percent from Company R at \$69.50 each, and 50 percent from Company S at \$71.90 each. The manufacturer that supplies Old Hands with spring assemblies has announced that it will increase its prices by 20 percent.

**REQUIRED**

1. Determine the total standard direct materials cost per unit for next year.
2. Suppose that because Old Hands has guaranteed Hardware that it will purchase 2,500 sets of clock hands next year, the cost of a set of clock hands has been reduced by 20 percent. Find the total standard direct materials cost per clock.
3. Suppose that to avoid the increase in the cost of spring assemblies, Old Hands purchased substandard ones from a different manufacturer at \$50 each; 20 percent of them turned out to be unusable and could not be returned. Assuming that all other data remain the same, compute the total standard direct materials unit cost. Spread the cost of the defective materials over the good units produced.

**LO 3, 4****Direct Materials and Direct Labor Variances**

- ✓ 1: Direct materials price variance, \$500.10 (U)
- ✓ 1: Direct materials quantity variance, \$1.10 (U)
- ✓ 2: Direct labor rate variance, \$1,995 (U)
- ✓ 2: Direct labor efficiency variance, \$200 (F)

**P7.** Flat Cups Company produces collapsible beverage containers. The company's direct materials standards for its 16-ounce beverage bottle include 5 ounces of biodegradable plastic. Standard prices for the year were \$0.011 per ounce. Direct labor standards for the beverage bottle specify 0.04 hours of direct labor at a standard direct labor rate of \$20 per hour.

During January, the company made 100,000 16-ounce beverage bottles. Actual production data follow.

Direct materials	500,100 ounces @ \$0.012 per ounce
Direct labor	3,990 hours @ \$20.50 per hour

(Continued)



**REQUIRED**

1. Compute the direct materials price and quantity variances.
2. Compute the direct labor rate and efficiency variances.

**LO 3, 4**

- ✓ 1: Material G: Direct materials price variance, \$386 (F)
- ✓ 1: Material G: Direct materials quantity variance, \$30 (U)
- ✓ 2: Molding: Direct labor rate variance, \$96 (F)
- ✓ 2: Molding: Direct labor efficiency variance, \$0

**Direct Materials and Direct Labor Variances**

**P8.** Green Packaging Company makes plant-based baskets for food wholesalers. Each basket requires 0.8 gram of material G and 0.6 gram of an additive that includes color and hardening agents. The standard prices are \$0.15 per gram of material G and \$0.09 per gram of additive. Two kinds of direct labor—molding and trimming/packing—are required to make the baskets. The direct labor time and rate standards for a batch of 100 baskets are as follows: molding, 1.0 hour per batch at an hourly rate of \$12; and trimming/packing, 1.2 hours per batch at \$10 per hour.

During the year, the company produced 48,000 baskets. It used 38,600 grams of material G at a total cost of \$5,404 and 28,950 grams of additive at \$2,895. Actual direct labor included 480 hours for molding at a total cost of \$5,664 and 560 hours for trimming/packing at \$5,656.

**REQUIRED**

1. Compute the direct materials price and quantity variances for both material G and the additive.
2. Compute the direct labor rate and efficiency variances for the molding and trimming/packing processes.

**LO 5**

- ✓ b: Variable overhead efficiency variance, \$800 (F)
- ✓ d: Normal capacity in machine hours, 20,400 hours
- ✓ f: Fixed overhead applied, \$153,750

**Overhead Variances**

**P9.** Exact Corporation's accountant left for vacation before completing the monthly cost variance report. The corporation's president has asked you to complete the report. The following data are available (capacities are expressed in machine hours):

Actual machine hours	20,100
Standard machine hours allowed	20,500
Actual variable overhead	(a)
Standard variable overhead rate	\$2.00
Variable overhead spending variance	\$250 (F)
Variable overhead efficiency variance	(b)
Actual fixed overhead	(c)
Budgeted fixed overhead	\$153,000
Fixed overhead budget variance	\$500 (U)
Fixed overhead volume variance	\$750 (F)
Normal capacity in machine hours	(d)
Standard fixed overhead rate	(e)
Fixed overhead applied	(f)

**REQUIRED**

Analyze the data and fill in the missing amounts. [*Hint:* Use the structure of Exhibits 6 and 7 to guide your analysis. Solve for (f) before solving for (e) and (d).]

**LO 3, 4, 5, 6****SPREADSHEET**

- ✓ 1a: Chemicals direct materials price variance, \$12,200 (F)
- ✓ 1d: Direct labor efficiency variance, \$3,500 (U)
- ✓ 1e: Variable overhead spending variance, \$100 (U)
- ✓ 1f: Variable overhead efficiency variance, \$1,000 (U)
- ✓ 1g: Fixed overhead budget variance, \$2,000 (U)
- ✓ 1h: Fixed overhead volume variance, \$16,000 (F)

**Computing Variances and Evaluating Performance**

**P10.** Last year, Panacea Laboratories, Inc., researched and perfected a cure for the common cold. Called Cold-Gone, the product sells for \$28.00 per package, each of which contains five tablets. Standard unit costs for this product were developed late last year for use this year. Per package, the standard unit costs were as follows: chemical ingredients, 6 ounces at \$1.00 per ounce; packaging, \$1.20; direct labor, 0.8 hour at \$14.00 per hour; standard variable overhead, \$4.00 per direct labor hour; and standard fixed overhead, \$6.40 per direct labor hour. Normal capacity is 46,875 units per week.

In the first quarter of this year, demand for the new product rose well beyond the expectations of management. During those three months, the peak season for colds, the company produced and sold over 500,000 packages of Cold-Gone. During the first week in April, it produced 50,000 packages but used materials for 50,200 packages costing \$60,240. It also used 305,000 ounces of chemical ingredients costing \$292,800. The total cost of direct labor for the week was \$579,600; direct labor hours totaled 40,250. Total variable overhead was \$161,100, and total fixed overhead was \$242,000. Budgeted fixed overhead for the week was \$240,000.

### REQUIRED

1. Compute for the first week of April (a) all direct materials price variances, (b) all direct materials quantity variances, (c) the direct labor rate variance, (d) the direct labor efficiency variance, (e) the variable overhead spending variance, (f) the variable overhead efficiency variance, (g) the fixed overhead budget variance, and (h) the fixed overhead volume variance.
2. **BUSINESS APPLICATION** ► Prepare a performance report based on your variance analysis, and suggest possible causes for each significant variance.

## CASES

### LO 2 Ethical Dilemma: An Ethical Question Involving Standard Costs

**C1.** Lopez Industries, Inc., develops standard costs for all its direct materials, direct labor, and overhead costs. It uses these costs to price products, cost inventories, and evaluate the performance of purchasing and production managers. It updates the standard costs whenever costs, prices, or rates change by 3 percent or more. It also reviews and updates all standard costs each December; this practice provides current standards that are appropriate for use in valuing year-end inventories on the company's financial statements.

Jaye Elgar is in charge of standard costing at Lopez. On November 30, she received a memo from the chief financial officer informing her that Lopez was considering purchasing another company and that she and her staff were to postpone adjusting standard costs until late February; they were instead to concentrate on analyzing the proposed purchase.

In the third week of November, prices on more than 20 of Lopez's direct materials had been reduced by 10 percent or more, and a new labor union contract had reduced several categories of labor rates. A revision of standard costs in December would have resulted in lower valuations of inventories, higher cost of goods sold because of inventory write-downs, and lower net income for the year. Elgar believed that the company was facing an operating loss and that the assignment to evaluate the proposed purchase was designed primarily to keep her staff from revising and lowering standard costs. She questioned the chief financial officer about the assignment and reiterated the need for updating the standard costs, but she was again told to ignore the update and concentrate on the proposed purchase. Elgar and her staff were relieved of the evaluation assignment in early February. The purchase never materialized.

Assess Elgar's actions in this situation. Did she follow all ethical paths to solving the problem? What are the consequences of failing to adjust the standard costs?

### LO 1, 2 Group Activity: Standard Costs and Variance Analysis

**C2. Domino's Pizza** is a major purveyor of home-delivered pizzas. Although customers can pick up their orders at the shops where Domino's makes its pizzas, employees deliver most orders to customers' homes, and they use their own cars to do it.

Specify what standard costing for a Domino's pizza shop would entail. Where would you obtain the information for determining the cost standards? In what ways would the standards help in managing a pizza shop? If necessary to gain a better understanding of the operation, visit a pizzeria (it does not have to be a Domino's).

*(Continued)*



Your instructor will divide the class into groups to discuss the case. Summarize your group's discussion, and select one person from your group to report the group's findings to the class.

LO 2, 4, 5, 6

### Business Communication: Preparing Performance Reports

**C3. BUSINESS APPLICATION** ▶ Terry Correy, Pine Valley Spa's president, is concerned about the spa's operating performance during March. He budgeted his costs carefully so that he could reduce the annual membership fees. He now needs to evaluate those costs to make sure that the spa's profits are at the level he expected.

He has asked you, the spa's controller, to prepare a performance report on labor and overhead costs for March. He also wants you to analyze the report and suggest possible causes for any problems that you find. He wants to attend to any problems quickly, so he has asked you to submit your report as soon as possible. The following information for the month is available:

	Budgeted Costs	Actual Costs
Variable costs:		
Operating labor	\$10,880	\$12,150
Utilities	2,880	3,360
Repairs and maintenance	5,760	7,140
Fixed overhead costs:		
Depreciation, equipment	2,600	2,680
Rent	3,280	3,280
Other	1,704	1,860
Totals	<u>\$27,104</u>	<u>\$30,470</u>

Correy's budget allows for eight employees to work 160 hours each per month. During March, nine employees worked an average of 150 hours each.

- Answer the following questions:
  - Why are you preparing this performance report?
  - Who will use the report?
  - What information do you need to develop the report? How will you obtain that information?
  - When are the performance report and the analysis needed?
- With the limited information available to you, compute the labor rate variance, the labor efficiency variance, and the variable and fixed overhead variances.
- Prepare a performance report for the spa for March. Analyze the report, and suggest causes for any problems that you find.

LO 2, 5, 6

### Decision Analysis: Developing a Flexible Budget and Analyzing Overhead Variances

**C4. BUSINESS APPLICATION** ▶ The controller at FT Industries has asked you, her new assistant, to analyze the following data related to projected and actual overhead costs for October:

Variable Overhead Costs	Standard Variable Costs per Machine Hour (MH)	Actual Variable Costs in October
Indirect materials and supplies	\$1.10	\$ 2,380
Indirect machine setup labor	2.50	5,090
Materials handling	1.40	3,950
Maintenance and repairs	1.50	2,980
Utilities	0.80	1,490
Miscellaneous	0.10	200
Totals	<u>\$7.40</u>	<u>\$16,090</u>

Fixed Overhead Costs	Budgeted Fixed Overhead	Actual Fixed Overhead in October
Supervisory salaries	\$ 3,630	\$ 3,630
Machine depreciation	8,360	8,580
Other	1,210	1,220
Totals	<u>\$13,200</u>	<u>\$13,430</u>

For October, the number of good units produced was used to compute the 2,100 standard machine hours allowed.

1. Prepare a monthly flexible budget for operating activity at 2,000 machine hours, 2,200 machine hours, and 2,500 machine hours.
2. Develop a flexible budget formula.
3. The company's normal operating capacity is 2,200 machine hours per month. Compute the fixed overhead rate at this level of activity. Then break the rate down into rates for each element of fixed overhead.
4. Prepare a detailed comparative cost analysis for October. Include all variable and fixed overhead costs. Format your analysis by using columns for the following five elements: cost category, cost per machine hour, costs applied, actual costs incurred, and variance.
5. Develop an overhead variance analysis for October that identifies the variable overhead spending and efficiency variances and the fixed overhead budget and volume variances.
6. Prepare an analysis of the variances. Could a manager control some of the fixed costs? Defend your answer.

LO 4, 5

### Conceptual Understanding: Standard Costing in a Service Company

**C5.** AAA Life Insurance Company's (ALIC) most popular life insurance policy is P20A—a permanent, 20-year life annuity policy. This policy sells in \$10,000 increments depending on the policyholder's needs and age. ALIC devotes an entire department to supporting and marketing the P20A policy. Because both the support staff and the salespersons contribute to each P20A policy, ALIC categorizes them as direct labor for purposes of variance analysis, cost control, and performance evaluation. For unit costing, each \$10,000 increment is considered one unit; thus, a \$90,000 policy is counted as nine units. Standard unit cost information for January is as follows.

Direct labor:	
Policy support staff (3 hours at \$12.00 per hour)	\$ 36.00
Policy salespersons (8.5 hours at \$14.20 per hour)	120.70
Operating overhead:	
Variable operating overhead (11.5 hours at \$26.00 per hour)	299.00
Fixed operating overhead (11.5 hours at \$18.00 per hour)	<u>207.00</u>
Standard unit cost	<u>\$662.70</u>

Actual costs incurred for the 265 units sold during January were as follows.

Direct labor:	
Policy support staff (848 hours at \$12.50 per hour)	\$10,600
Policy salespersons (2,252.5 hours at \$14.00 per hour)	31,535
Operating overhead:	
Variable operating overhead	78,440
Fixed operating overhead	53,400

Normal monthly capacity is 260 units, and the budgeted fixed operating overhead for January was \$53,820.

1. Compute the standard hours allowed in January for policy support staff and policy salespersons.
2. What should the total standard costs for January have been? What were the total actual costs that the company incurred in January? Compute the total cost variance for the month.

(Continued)

3. Compute the direct labor rate and efficiency variances for policy support staff and policy salespersons.
4. Compute the variable and fixed operating overhead variances for January.
5. Identify possible causes for each variance and suggest possible solutions.

### Continuing Case: Cookie Company

**C6.** In this segment of our continuing case, assume that you have been using standard costing to plan and control costs at your cookie store. In a meeting with your budget team, which includes managers and employees from the Purchasing, Product Design, and Production departments, you ask all team members to describe any operating problems they encountered in the last quarter. You explain that you will use this information to analyze the causes of significant cost variances that occurred during the quarter.

For each of the following situations, identify the direct materials and/or direct labor variance(s) that could be affected, and indicate whether the variances are favorable or unfavorable.

1. The production department uses highly skilled, highly paid workers.
2. Machines were improperly adjusted.
3. Direct labor personnel worked more carefully than they had in the past to manufacture the product.
4. The Product Design Department replaced a direct material with one that was less expensive and of lower quality.
5. The Purchasing Department bought higher-quality materials at a higher price.
6. A major supplier used a less-expensive mode of transportation to deliver the raw materials.
7. Work was halted for 2 hours because of a power failure.

# CHAPTER 25

## Short-Run Decision Analysis and Capital Budgeting

### BUSINESS INSIGHT

#### Home State Bank

Home State Bank is a local institution that caters to individuals and small businesses. It has received many awards for its services and initiatives in preventing online fraud and identity theft. The bank's managers believe the trend to online commerce is good for business, and as customers gain confidence in dealing with their finances online, they plan to offer more online products and services. In looking for safe and innovative ways to meet customers' needs, the managers will make short-run and long-run decisions that will affect the bank's profits, resources, and opportunities.

- 1. CONCEPT** ► *Why is the concept of cost-benefit important when making short-run and capital budgeting decisions?*
- 2. ACCOUNTING APPLICATION** ► *How do incremental analysis and capital budgeting ensure a wise allocation of resources and minimize the risks involved in short-run and long-run decisions?*
- 3. BUSINESS APPLICATION** ► *Why is incremental and capital investment analysis critical to the business performance of a company like Home State Bank?*

### LEARNING OBJECTIVES

- LO 1** Describe how the concept of cost-benefit is useful when making short-run and capital budgeting decisions.
- LO 2** Perform incremental analysis for outsourcing decisions.
- LO 3** Perform incremental analysis for special order decisions.
- LO 4** Perform incremental analysis for segment profitability decisions.
- LO 5** Perform incremental analysis for sales mix decisions involving constrained resources.
- LO 6** Perform incremental analysis for sell-or-process-further decisions.
- LO 7** Analyze capital budgeting proposals using the net present value method, the payback period method, and the accounting rate-of-return method.
- LO 8** Describe why short-run and capital investment decisions are critical for business success.

## SECTION 1

## CONCEPTS

## CONCEPT

■ Cost-benefit

RELEVANT  
LEARNING OBJECTIVE

**Lo 1** Describe how the concept of cost-benefit is useful when making short-run and capital budgeting decisions.

## Lo 1 Concepts Underlying Decision Analysis

The concept of *cost-benefit* holds that the benefits to be gained from a course of action or alternative should be greater than the costs of implementing it. Cost-benefit is an accounting convention or rule of thumb that supports both short-run and long-run decision making. It considers both quantitative and qualitative cost and benefit measures to facilitate cost-benefit comparisons between alternatives for sound business decisions. Managers frequently take the following actions when applying the cost-benefit concept:

- **Step 1.** Discover a problem or need.
- **Step 2.** Identify all reasonable courses of action that can solve the problem or meet the need.
- **Step 3.** Prepare a thorough analysis of each possible solution, identifying its total costs, savings, benefits, other financial effects, and any qualitative factors.
- **Step 4.** Select the best course of action.

Later, each decision is reviewed to determine whether it produced the forecasted results by examining how each decision was carried out and how its actual costs and benefits affected the organization. If results fell short, managers identify and prescribe corrective action. This post-decision audit supplies feedback about the results of the decision. If the solution is not completely satisfactory or if the problem remains, the process of evaluating costs and benefits of alternatives begins again.

**Short-run decision analysis** is the systematic examination of any decision whose effects will be felt over the course of the next year or less. In making such decisions, managers analyze not only quantitative cost and benefit factors relating to profitability and liquidity; but they also analyze qualitative factors. In the course of a year, managers may make many short-run decisions that involve the evaluation of the costs and benefits of short-term actions, such as whether to make a product or service or buy it from an outside supplier, whether to accept a special order, whether to keep or drop an unprofitable segment, and whether to sell a product as is or process it further. If resources are limited, they may also have to decide on the most appropriate product mix.

**Capital investment analysis** (or *capital budgeting*) involves the evaluation of alternative proposals for large capital investments, including considerations for financing the projects. Capital investment analyses affect both short-term and long-term planning. Capital facilities and projects may include new machinery, systems, or processes; new buildings or additions; renovations to existing buildings; entire new divisions or product lines; and new distribution and software systems.

## Concepts Underlying Incremental Analysis

Once managers have determined that a problem or need is worthy of consideration and have identified alternative courses of action, they must evaluate the costs and benefits of each alternative. The method of comparing alternatives by focusing on the differences in their projected revenues and costs is called **incremental analysis**. Incremental analysis can be used for capital investment or short-run decisions. In this section, the *costs and benefits* of capital investment alternatives are compared using incremental analysis. In the next section, incremental analysis for different types of short-run decisions is discussed. If incremental analysis excludes revenues or costs that stay the same or that do not change between the alternatives, it is called *differential analysis*.

**Irrelevant Costs and Revenues** A cost that changes between alternatives is known as a **differential cost** (or *incremental cost*). For example, suppose that Home State Bank’s managers are deciding which of two ATM machines—C or W—to buy. The ATMs have the same purchase price but different revenue and cost characteristics. The company currently owns ATM B, which it bought three years ago for \$15,000 and which has accumulated depreciation of \$9,000, and carries a book value of \$6,000. ATM B is now obsolete as a result of advances in technology and cannot be sold or traded in.

A manager has prepared the following comparison of the annual revenue and operating cost estimates for the two new machines:

	ATM C	ATM W
Increase in revenue	\$16,200	\$19,800
Increase in annual operating costs:		
Direct materials	4,800	4,800
Direct labor	2,200	4,100
Variable overhead	2,100	3,050
Fixed overhead (depreciation included)	5,000	5,000

**STUDY NOTE:** Sunk costs cannot be recovered and are irrelevant in short-run decision making.

**Incremental Analysis** The first step in the incremental analysis is to eliminate any irrelevant revenues and costs. *Irrelevant revenues* are those that will not differ between the alternatives. *Irrelevant costs* include costs that will not differ between the alternatives and sunk costs. A **sunk cost** is a cost that was incurred because of a previous decision and cannot be recovered through the current decision. For Home State Bank, the costs of direct materials and fixed overhead (depreciation included) are irrelevant costs because they are the same under both alternatives. In addition, ATM B’s book value is a sunk cost because it represents money that was spent in the past and so does not affect the decision about whether to replace ATM B with a new one. ATM B would be of interest only if it could be sold or traded in, and if the amount received for it would be different, depending on which new ATM was chosen. In that case, the amount of the sale or trade-in value would be relevant to the decision because it would affect the future cash flows of the alternatives.

Once the irrelevant revenues and costs have been identified, the incremental analysis can be prepared using only the differential revenues and costs that will change between the alternative ATMs, as shown in Exhibit 1. The analysis shows that ATM W would produce \$750 more in operating income than ATM C. Because the costs of buying the two ATMs are the same, this report would favor the purchase of ATM W.

**Exhibit 1**  
Incremental Analysis

Home State Bank Incremental Analysis			Difference in Favor of ATM W
	ATM C	ATM W	
Increase in revenue	\$16,200	\$19,800	\$ 3,600
Increase in annual operating costs that differ between alternatives:			
Direct labor	\$ 2,200	\$ 4,100	\$(1,900)
Variable overhead	2,100	3,050	(950)
Total increase in operating costs	\$ 4,300	\$ 7,150	\$(2,850)
Resulting change in operating income	\$11,900	\$12,650	\$ 750

© Cengage Learning 2014





Operating Central Park in New York City involves maintenance, employee, and equipment costs. Yet the largest cost is actually the opportunity cost of the tens of billions of dollars the city could get by leasing the land to real estate developers.

**Opportunity Costs** Because incremental analysis focuses on only the quantitative differences among the alternatives, it simplifies management's evaluation of a decision and reduces the time needed to choose the best course of action. However, incremental analysis is only one input to the final decision. Management needs to consider qualitative issues. For instance, the manufacturer of ATM C might have a reputation for better quality or service than the manufacturer of ATM W.

**Opportunity costs** are the benefits that are forfeited or lost when one alternative is chosen over another. In other words, opportunity costs arise when the choice of one course of action eliminates the possibility of another course of action. Opportunity costs often come into play when a company is operating at or near capacity and must choose which products or services to offer. For example, suppose that Home State Bank, which currently services 20,000 debit cards, has the option of offering 15,000 premium debit cards, which is a higher-priced product, but it cannot do both. The amount of income from the 20,000 debit cards is an opportunity cost of the premium debit cards.

## APPLY IT!

Credit Bank has assembled the following monthly information related to the purchase of a new automated teller machine:

	Machine A	Machine B
Increase in revenue	\$4,200	\$5,100
Increase in annual operating costs:		
Direct materials	1,200	1,200
Direct labor	1,200	1,600
Variable overhead	2,500	2,900
Fixed overhead (including depreciation)	1,400	1,400

Use incremental analysis to determine the cost benefit difference in favor of the Machine B.

### SOLUTION

	Credit Bank Incremental Analysis		Difference in Favor of Machine B
	Machine A	Machine B	
Increase in revenue	<u>\$4,200</u>	<u>\$5,100</u>	<u>\$ 900</u>
Increase in operating costs that differ between alternatives:			
Direct labor	\$1,200	\$1,600	\$(400)
Variable overhead	<u>2,500</u>	<u>2,900</u>	<u>(400)</u>
Total increase in operating costs	<u>\$3,700</u>	<u>\$4,500</u>	<u>\$(800)</u>
Resulting change in operating income	<u>\$ 500</u>	<u>\$ 600</u>	<u>\$ 100</u>

### TRY IT! SE1, SE2, E1A, E1B



## SECTION 2

## ACCOUNTING APPLICATIONS

## ACCOUNTING APPLICATIONS

- Perform incremental analysis for
  - Outsourcing decisions
  - Special order decisions
  - Segment profitability decisions
  - Sales mix decisions
  - Sell-or-process-further decisions
- Analyze capital investment proposals using
  - net present value method
  - payback period method
  - accounting rate-of-return method

## RELEVANT LEARNING OBJECTIVES

**LO 2** Perform incremental analysis for outsourcing decisions.

**LO 3** Perform incremental analysis for special order decisions.

**LO 4** Perform incremental analysis for segment profitability decisions.

**LO 5** Perform incremental analysis for sales mix decisions involving constrained resources.

**LO 6** Perform incremental analysis for sell-or-process-further decisions.

**LO 7** Analyze capital budgeting proposals using the net present value method, the payback period method, and the accounting rate-of-return method.

## LO 2 Incremental Analysis for Outsourcing Decisions

**Outsourcing** is the use of suppliers outside the organization to perform services or produce goods that could be performed or produced internally. **Make-or-buy decisions**, which are decisions about whether to make a part internally or buy it from an external supplier, may lead to outsourcing. A company may decide to outsource entire operating activities, such as warehousing or human resources, that have traditionally been performed in-house. Outsourcing can reduce a company's investment in physical assets and human resources, which can improve cash flow. It can also help a company reduce its operating costs and improve operating income. For example, because **Amazon.com** outsources the distribution of most of its products, it has been able to reduce its storage and distribution costs enough to offer product discounts of up to 40 percent off the list price.

### Outsourcing Analysis

In manufacturing companies, a common decision facing managers is whether to make or to buy some or all of the parts used in product assembly. The goal is to select the more profitable choice by identifying the costs of each alternative and their effects on revenues and existing costs. Managers need the following information for this analysis:

#### Information About Making

- Variable costs of making the item
- Need for additional machinery
- Incremental fixed costs

#### Information About Buying

- Purchase price of item
- Rent or cash flow to be generated from vacated space in the factory
- Salvage value of unused machinery

For example, for the past five years, Box Company has purchased packing cartons from Pappé, Inc., an outside supplier, at a cost of \$1.25 per carton. Effective immediately, Pappé is raising the price 20 percent, to \$1.50 per carton. Box has space and idle machinery that could be adjusted to produce the cartons. Annual production and usage would be 20,000 cartons. Box estimates the cost of direct materials at \$0.84 per carton. Workers, who will be paid \$8 per hour, can process 20 cartons per hour (\$0.40 per carton). The cost of variable overhead will be \$4 per direct labor hour, and 1,000 direct labor hours will be required. Fixed overhead includes \$4,000 of depreciation per year and \$6,000 of other fixed costs. The idle machines will continue to be idle if the cartons are purchased. Should Box continue to outsource the cartons?

Exhibit 2 presents an incremental analysis of the two alternatives. All relevant costs are listed. Because the machinery has already been purchased and neither the machinery

**Exhibit 2**  
Incremental Analysis: Outsourcing Decision

	Box Company Outsourcing Decision Incremental Analysis		Difference in Favor of Make
	Make	Outsource	
Direct materials (20,000 × \$0.84)	\$16,800	\$ —	\$(16,800)
Direct labor (20,000 × \$0.40)	8,000	—	(8,000)
Variable overhead (1,000 hours × \$4)	4,000	—	(4,000)
Purchase price (20,000 × \$1.50)	—	30,000	30,000
Totals	<u>\$28,800</u>	<u>\$30,000</u>	<u>\$ 1,200</u>

© Cengage Learning 2014

**STUDY NOTE:** Remember to exclude irrelevant information (such as depreciation and other fixed costs). Only costs that change between the alternatives should be used in incremental analysis.

nor the required factory space has any other use, the depreciation costs and other fixed overhead costs are the same for both alternatives. Therefore, they are not relevant to the decision. The cost of making the needed cartons is \$28,800. The cost of buying 20,000 cartons at the increased purchase price will be \$30,000. Since the company would save \$1,200 by making the cartons, management should decide to make the cartons.

## APPLY IT!

Office Associates, Inc., is currently operating at less than capacity. The company thinks it could cut costs by outsourcing office cleaning to an independent cleaning service for \$75 a week. Currently, a general office worker is employed for \$10 an hour to do light cleaning and other general office duties. Cleaning the office usually takes one hour a day to perform and consumes \$10 of supplies, \$2 of variable overhead, and \$18 of fixed overhead each week. Should Office Associates continue to perform office cleanings, or should it outsource them?

### SOLUTION

Costs per Cleaning	Continue to Perform Cleanings	Outsource Cleanings	Difference in Favor of Continuing to Perform Cleanings
Employee labor	\$50	\$—	\$(50)
Supplies	10	—	(10)
Variable overhead	2	—	(2)
Outside cleaning service	—	75	75
Totals	<u>\$62</u>	<u>\$75</u>	<u>\$ 13</u>

Office Associates should continue to perform office cleanings itself.

**TRY IT! SE3, E2A, E2B**

## LO 3 Incremental Analysis for Special Order Decisions

Managers are often faced with **special order decisions**, which are decisions about whether to accept or reject special orders at prices below the normal market prices. Special order decisions must be consistent with the company's strategic plan and tactical objectives and must take into account not only costs and revenues but also relevant qualitative factors such as the impact of the special order on regular customers, the potential of the special order to lead into new sales areas, and the customer's ability to maintain an ongoing relationship that includes good ordering and paying practices.

Before a company accepts a special product order, it must be sure that excess capacity exists to complete the order and that the order will not reduce unit sales from its full-priced regular product line. In addition, a special order should be accepted only if it maximizes operating income. In many situations, sales commission expenses are excluded from a special order decision analysis because the customer approached the company directly. In addition, the fixed costs of existing facilities usually do not change if a company accepts a special order, and therefore these costs are usually irrelevant to the decision. If additional fixed costs must be incurred to fill the special order, they would be relevant to the decision. Examples of relevant fixed costs are the purchase of additional machinery, an increase in supervisory help, and an increase in insurance premiums required by a specific order.

## Special Order Analysis: Price and Relevant Cost Comparison

One approach to a special order decision is to compare the price of the special order with the relevant costs of producing, packaging, and shipping the order. The relevant costs include the variable costs, variable selling costs (if any), and other costs directly associated with the special order (e.g., freight, insurance, and packaging and labeling the product). For example, suppose Home State Bank has been approved to provide and service four ATMs at a special event. The event sponsors want the fee reduced to \$0.50 per ATM transaction. At past special events, ATM use has averaged 2,000 transactions per machine. Home State Bank has four idle ATMs and determined the following additional information:

### ATM Cost Data for Annual Use of One Machine (400,000 Transactions)

Direct materials	\$0.10
Direct labor	0.05
Variable overhead	0.20
Fixed overhead (\$100,000 ÷ 400,000)	0.25
Advertising (\$60,000 ÷ 400,000)	0.15
Other fixed selling and administrative expenses (\$120,000 ÷ 400,000)	<u>0.30</u>
Cost per transaction	<u>\$1.05</u>
Regular fee per transaction	<u>\$1.50</u>

Should Home State Bank accept the special event offer?

An incremental analysis of the decision appears in Exhibit 3. The report shows the contribution margin for Home State Bank’s operations both with and without the special order for the four machines. Fixed costs are not included because the only costs affected by the order are direct materials, direct labor, and variable overhead. The net result of accepting the special order is a \$1,200 increase in contribution margin (and, correspondingly, in operating income). The analysis reveals that Home State Bank should accept the special order. The \$1,200 increase is verified by the following contribution margin calculation:

Special order sales [(2,000 transactions × 4 machines) × \$0.50]	\$4,000
Less variable costs:	
Direct materials (8,000 transactions × \$0.10)	\$ 800
Direct labor (8,000 transactions × \$0.05)	400
Variable overhead (8,000 transactions × \$0.20)	<u>1,600</u>
Total variable costs	<u>2,800</u>
Special order contribution margin	<u>\$1,200</u>

**Exhibit 3**  
Incremental Analysis:  
Special Order Decision

Home State Bank Special Order Decision Incremental Analysis			
	Without Order	With Order	Difference in Favor of Accepting Order
Sales	\$2,400,000	\$2,404,000	\$ 4,000
Less variable costs:			
Direct materials	\$ 160,000	\$ 160,800	\$ (800)
Direct labor	80,000	80,400	(400)
Variable overhead	<u>320,000</u>	<u>321,600</u>	<u>(1,600)</u>
Total variable costs	<u>\$ 560,000</u>	<u>\$ 562,800</u>	<u>\$(2,800)</u>
Contribution margin	<u>\$1,840,000</u>	<u>\$1,841,200</u>	<u>\$ 1,200</u>

© Cengage Learning 2014

## Special Order Analysis: Minimum Bid Price for Special Order

Another approach to this kind of decision is to prepare a special order bid price by calculating a minimum selling price for the special order. The bid price must cover the relevant costs and an estimated profit. For example, assume that the event sponsor asks Home State Bank what its minimum special order price is. If the incremental costs for the special order are \$2,800, the relevant cost per transaction is \$0.35 ( $\$2,800 \div 8,000$ ). The special order price should cover this cost and generate a profit. If Home State Bank would like to earn \$800 from the special order, the special order price should be \$0.45 [ $\$0.35$  cost per transaction plus  $\$0.10$  profit per transaction ( $\$800 \div 8,000$  transactions)].

### APPLY IT!

Sample Company has received an order for Product EZ at a special selling price of \$26 per unit (suggested retail price is \$30). This order is over and above normal production, and budgeted production and sales targets for the year have already been exceeded. Capacity exists to satisfy the special order. No selling costs will be incurred in connection with this order. Unit costs to manufacture and sell Product EZ are as follows: direct materials, \$7.00; direct labor, \$10.00; variable overhead, \$8.00; fixed manufacturing costs, \$5.00; variable selling costs, \$3.00; and fixed general and administrative costs, \$9.00. Should Sample accept the order?

#### SOLUTION

Variable costs to produce Product EZ:

Direct materials	\$ 7.00
Direct labor	10.00
Variable overhead	<u>8.00</u>
Total variable costs	<u>\$25.00</u>

Sample should accept the special order because the offered price of \$26 exceeds the variable manufacturing costs of \$25.

**TRY IT! SE4, E3A, E3B**

## Lo 4 Incremental Analysis for Segment Profitability Decisions

Another type of operating decision that management must make is whether to keep or drop unprofitable segments, such as product lines, services, sales territories, divisions, departments, stores, or outlets. Management must select the alternative that maximizes operating income. The objective of the decision analysis is to identify the segments that have a negative segment margin so that managers can drop them or take corrective action.

A **segment margin** is a segment's sales revenue minus its direct costs (direct variable costs and direct fixed costs traceable to the segment). Such costs are assumed to be **avoidable costs**. An avoidable cost could be eliminated if management were to drop the segment.

- ▲ If a segment has a positive segment margin—that is, the segment's revenue is greater than its direct costs—it is able to cover its own direct costs and contribute a portion of its revenue to cover common costs and add to operating income. In that case, management should keep the segment.
- ▼ If a segment has a negative segment margin—that is, the segment's revenue is less than its direct costs—management should eliminate the segment.

However, certain common costs will be incurred regardless of the decision. Those are unavoidable costs, and the remaining segments must have sufficient contribution margin to cover their own direct costs and the common costs.

### Segment Profitability Analysis

An analysis of segment profitability includes the preparation of a segmented income statement using variable costing to identify variable and fixed costs. The fixed costs that are traceable to the segments are called *direct fixed costs*. The remaining fixed costs are *common costs* and are not assigned to segments.



## Business Perspective

### Why Banks Prefer e-Banking

After performing segment analysis of online banking and face-to-face banking, bank managers worldwide are encouraging customers to do their banking over the Internet. Banks have found that linking global Internet access with customer relationship management (CRM), customer-friendly financial software, and online bill payment in a secure banking environment can reduce costs, increase service and product availability, and boost earnings.<sup>1</sup>

© Allija / Stockphoto.com

Suppose Home State Bank wants to determine if it should eliminate its Safe Deposit Division. Managers prepare a segmented income statement, separating variable and fixed costs to calculate the contribution margin. They separate the total fixed costs of \$84,000 further by directly tracing \$55,500 to Bank Operations and \$16,500 to the Safe Deposit Division. The remaining \$12,000 are common fixed costs. Exhibit 4 shows the segment margins for Bank Operations and the Safe Deposit Division and the operating income for the total company.

#### Exhibit 4 Segmented Income Statement

<b>Home State Bank</b>			
<b>Segmented Income Statement</b>			
<b>For the Year Ended December 31, 2014</b>			
	<b>Bank Operations</b>	<b>Safe Deposit Division</b>	<b>Total Company</b>
Sales	\$135,000	\$15,000	\$150,000
Less variable costs	<u>52,500</u>	<u>7,500</u>	<u>60,000</u>
Contribution margin	\$ 82,500	\$ 7,500	\$ 90,000
Less direct fixed costs	<u>55,500</u>	<u>16,500</u>	<u>72,000</u>
Segment margin	<u>\$ 27,000</u>	<u>\$ (9,000)</u>	\$ 18,000
Less common fixed costs			<u>12,000</u>
Operating income			<u>\$ 6,000</u>

© Cengage Learning 2014

**Situation 1** Exhibit 5 demonstrates that dropping the Safe Deposit Division will increase operating income by \$9,000. Unless the bank can increase the division's segment margin by increasing sales revenue or by reducing direct costs, management should drop the segment. The incremental approach to analyzing this decision isolates the segment and focuses on its segment margin, as shown in the last column of Exhibit 5. The decision to drop a segment also requires a careful review of the other segments to see whether they will be affected.

**Situation 2** Exhibit 6 assumes that the Bank Operations' sales volume and variable costs will decrease 20 percent if management eliminates the Safe Deposit Division. The reduction in sales volume stems from the loss of customers who purchase products from both divisions. The analysis shows that dropping the division would reduce both the segment margin and the bank's operating income by \$7,500. In this situation, Home State Bank would want to keep the Safe Deposit Division.

**Exhibit 5**  
Incremental Analysis:  
Segment Profitability  
Decision (Situation 1)

Home State Bank Segment Profitability Decision Incremental Analysis—Situation 1			
	Keep Safe Deposit Division	Drop Safe Deposit Division	Difference in Favor of Dropping Safe Deposit Division
Sales	\$150,000	\$135,000	\$(15,000)
Less variable costs	60,000	52,500	7,500
Contribution margin	\$ 90,000	\$ 82,500	\$( 7,500)
Less direct fixed costs	72,000	55,500	16,500
Segment margin	\$ 18,000	\$ 27,000	\$ 9,000
Less common fixed costs	12,000	12,000	0
Operating income	\$ 6,000	\$ 15,000	\$ 9,000

© Cengage Learning 2014

**Exhibit 6**  
Incremental Analysis:  
Segment Profitability  
Decision (Situation 2)

Home State Bank Segment Profitability Decision Incremental Analysis—Situation 2			
	Keep Safe Deposit Division	Drop Safe Deposit Division	Difference in Favor of Keeping Safe Deposit Division
Sales	\$150,000	\$108,000	\$(42,000)
Less variable costs	60,000	42,000	18,000
Contribution margin	\$ 90,000	\$ 66,000	\$(24,000)
Less direct fixed costs	72,000	55,500	16,500
Segment margin	\$ 18,000	\$ 10,500	\$( 7,500)
Less common fixed costs	12,000	12,000	0
Operating income	\$ 6,000	\$ (1,500)	\$( 7,500)

© Cengage Learning 2014

## APPLY IT!

Sample Company is evaluating its two divisions, East Division and West Division. Data for East Division include sales of \$500,000, variable costs of \$250,000, and fixed costs of \$400,000, 50 percent of which are traceable to the division. West Division's data for the same period include sales of \$600,000, variable costs of \$350,000, and fixed costs of \$450,000, 60 percent of which are traceable to the division. Should either division be considered for elimination?

### SOLUTION

	East Division	West Division	Total Company
Sales	\$500,000	\$600,000	\$1,100,000
Less variable costs	250,000	350,000	600,000
Contribution margin	\$250,000	\$250,000	\$ 500,000
Less direct fixed costs	200,000	270,000	470,000
Divisional income	\$ 50,000	\$( 20,000)	\$ 30,000
Less common fixed costs			380,000
Operating income (loss)			\$( 350,000)

The company should keep East Division because it is profitable. West Division does not seem to be profitable and should be considered for elimination. The home office and its very heavy overhead costs are causing the company's loss.

### TRY IT! E4A, E4B

## LO 5 Incremental Analysis for Sales Mix Decisions

Limits on resources like machine time or available labor may restrict the types or quantities of products or services that a company can provide. The question is, which products or services contribute the most to profitability in relation to the amount of capital assets or other constrained resources needed to offer those items? To satisfy customers' demands and maximize operating income, management will make a **sales mix decision** to offer the most profitable combination of products and services. To decide on the optimal sales mix of products or



services, managers calculate the contribution margin per constrained resource (such as labor hours or machine hours) for each product or service.

## Sales Mix Analysis

The objective of a sales mix decision is to select the alternative that maximizes the contribution margin per constrained resource. The decision analysis, which uses incremental analysis to identify the relevant costs and revenues, consists of two steps.

- **Step 1.** Calculate the contribution margin per unit for each product or service affected by the constrained resource as follows.

$$\text{Contribution Margin per Unit} = \text{Selling Price per Unit} - \text{Variable Costs per Unit}$$

- **Step 2.** Calculate the contribution margin per unit of the constrained resource as follows.

$$\text{Contribution Margin per Unit of Constrained Resources} = \frac{\text{Contribution Margin per Unit}}{\text{Quantity of the Constrained Resource Required per Unit}}$$

Suppose Home State Bank offers three types of loans: commercial loans, auto loans, and home loans. The product line data are as follows.

	Commercial Loans	Auto Loans	Home Loans
Current loan application demand	20,000	30,000	18,000
Processing hours per loan application	2.0	1.0	2.5
Loan origination fee	\$24.00	\$18.00	\$32.00
Variable processing costs	\$12.50	\$10.00	\$18.75
Variable selling costs	\$6.50	\$5.00	\$6.25

The current loan application capacity is 100,000 processing hours.

**Ranking the Order** Which loan type should be advertised and promoted first because it is the most profitable for the bank? Which should be second? Which last? It indicates that the auto loans should be promoted first because they provide the highest contribution margin per processing hour. Home loans should be second, and commercial loans should be last.

**Number of Units** How many of each type of loan should the bank sell to maximize its contribution margin based on the current loan application capacity of 100,000 processing hours? What is the total contribution margin for that combination? Exhibit 8 shows the sales mix analysis. To begin the analysis, compare the current loan application capacity with the total capacity required to meet the current loan demand. The company needs 115,000 processing hours to meet the current loan demand, calculated as follows.

Processing hours for commercial loans (20,000 loans × 2 processing hours per loan)	40,000
Processing hours for auto loans (30,000 loans × 1 processing hour per loan)	30,000
Processing hours for home loans (18,000 × 2.5 processing hours per loan)	45,000
Total processing hours	<u>115,000</u>

Because the 115,000 processing hours needed exceeds the current capacity of 100,000 processing hours, management must determine the sales mix that maximizes the company's contribution margin, which will also maximize its operating income.

The calculations in Exhibit 8 show that Home State Bank should sell 30,000 auto loans, 18,000 home loans, and 12,500 commercial loans. The total contribution margin is as follows.

Auto loans (30,000 loans × \$3.00 per loan)	\$ 90,000
Home loans (18,000 loans × \$7.00 per loan)	126,000
Commercial loans (12,500 loans × \$5.00 per loan)	62,500
Total contribution margin	<u>\$278,500</u>

**STUDY NOTE:** When resources like direct materials, direct labor, or time are scarce, the goal is to maximize the contribution margin per unit of scarce resource.



**Exhibit 7**  
Incremental Analysis:  
Sales Mix Decision  
Involving Constrained  
Resources  
(Ranking the Order)

<b>Home State Bank</b>			
<b>Sales Mix Decision: Ranking the Order of Loans</b>			
<b>Incremental Analysis</b>			
	<b>Commercial Loans</b>	<b>Auto Loans</b>	<b>Home Loans</b>
Loan origination fee per loan	\$24.00	\$18.00	\$32.00
Less variable costs:			
Processing	\$12.50	\$10.00	\$18.75
Selling	6.50	5.00	6.25
Total variable costs	\$19.00	\$15.00	\$25.00
Contribution margin per loan	\$ 5.00	\$ 3.00	\$ 7.00
Processing hours per loan	÷ 2.0	÷ 1.0	÷ 2.5
Contribution margin per processing hour	\$ 2.50	\$ 3.00	\$ 2.80

© Cengage Learning 2014

**Exhibit 8**  
Incremental Analysis:  
Sales Mix Decision  
Involving Constrained  
Resources  
(Number of Units)

<b>Home State Bank</b>		
<b>Sales Mix Decision: Number of Units to Make</b>		
<b>Incremental Analysis</b>		<b>Processing Hours</b>
Total processing hours available		100,000
Less processing hours to produce auto loans (30,000 loans × 1 processing hour per loan)		<u>30,000</u>
Balance of processing hours available		70,000
Less processing hours to produce home loans (18,000 loans × 2.5 processing hours per loan)		<u>45,000</u>
Balance of processing hours available		25,000
Less processing hours to produce commercial loans (12,500 loans × 2 processing hours per loan)		<u>25,000</u>
Balance of processing hours available		<u>0</u>

© Cengage Learning 2014

## APPLY IT!

Surf, Inc., makes three kinds of surfboards, but it has a limited number of machine hours available to make them. Product line data follow. In what order should the surfboard product lines be produced?

	<b>Fiberglass</b>	<b>Plastic</b>	<b>Graphite</b>
Machine hours per unit	4	1	2
Selling price per unit	\$1,500	\$800	\$1,300
Variable manufacturing cost per unit	500	200	800
Variable selling costs per unit	200	350	200

### SOLUTION

	<b>Fiberglass</b>	<b>Plastic</b>	<b>Graphite</b>
Selling price per unit	<u>\$1,500</u>	<u>\$800</u>	<u>\$1,300</u>
Less variable costs:			
Manufacturing	\$ 500	\$200	\$ 800
Selling	200	350	200
Total unit variable costs	<u>\$ 700</u>	<u>\$550</u>	<u>\$1,000</u>
Contribution margin per unit	\$ 800	\$250	\$ 300
Machine hours per unit	÷ 4	÷ 1	÷ 2
Contribution margin per machine hour	<u>\$ 200</u>	<u>\$250</u>	<u>\$ 150</u>

Surf should produce plastic first, then fiberglass, and finally graphite surfboards.

### TRY IT! SE5, E5A, E6A, E5B, E6B

## LO 6 Incremental Analysis for Sell-or-Process-Further Decisions

**STUDY NOTE:** Products are made by combining materials or by dividing materials, as in oil refining or ore extraction.

Some companies offer products or services that can either be sold in a basic form or be processed further and sold as a more refined product or service to a different market. A **sell-or-process-further decision** is a decision about whether to sell a joint product at the split-off point or sell it after further processing. **Joint products** are two or more products made from a common material or process that cannot be identified as separate products or services during some or all of the processing. Only at a specific point, called the **split-off point**, do joint products or services become separate and identifiable. At that point, a company may choose to sell the product or service as is or to process it into another form for sale to a different market.

### Sell-or-Process-Further Analysis

The objective of a sell-or-process-further decision is to select the alternative that maximizes operating income. The decision analysis entails calculating the **incremental revenue** as follows.

$$\text{Incremental Revenue} = \text{Total Revenue if Product/Service Is Sold at Split-Off Point} - \text{Total Revenue if Product/Service Is Sold after Further Processing}$$

- ▲ If the incremental *revenue* is greater than the incremental costs of processing further, a decision to process the product or service further would be justified.
- ▲ If the incremental *costs* are greater than the incremental revenue, a decision to sell the product or service at the split-off point would be in order.

**STUDY NOTE:** Joint costs are irrelevant in a sell-or-process-further decision.

The common costs shared by two or more products before they are split off are called **joint costs** (or *common costs*). Although accountants assign joint costs to products or services when valuing inventories and calculating cost of goods sold, joint costs are not relevant to a sell-or-process-further decision because they are incurred *before* the split-off point and do not change if further processing occurs.

For example, as part of the company's strategic plan, Home State Bank's management is looking for new markets for banking services, and management is considering whether it would be profitable to bundle banking services. The bank is considering adding two levels of service beyond its current Basic Checking account services: Premier Checking and Personal Banker. The three levels have the following bundled features:

- **Basic Checking:** Online checking account, debit card, and online bill payment with a required minimum average balance of \$500
- **Premier Checking:** Paper and online checking, a debit card, a credit card, and a small life insurance policy equal to the maximum credit limit on the credit card for customers who maintain a minimum average balance of \$1,000
- **Personal Banker:** All of the features of Premier Checking plus a safe deposit box, a \$5,000 personal line of credit at the prime interest rate, financial investment advice, and a toaster upon opening the account for customers who maintain a minimum average balance of \$5,000

Assume that the bank can earn sales revenue of 5 percent on its checking account balances and that the total cost of offering basic checking services is currently \$50,000. The bank's accountant provided these data for each level of service:

Product	Sales Revenue	Additional Costs
Basic Checking	\$ 25	\$ 0
Premier Checking	50	30
Personal Banker	250	200

Should the bank offer any additional services? The decision analysis in Exhibit 9 indicates that the bank should offer Personal Banker services in addition to Basic Checking accounts. Notice that the \$50,000 joint costs of Basic Checking were ignored because they are sunk costs that will not influence the decision.

**Exhibit 9**  
Incremental Analysis:  
Sell-or-Process-Further  
Decision

<b>Home State Bank</b>		
<b>Sell-or-Process-Further Decision</b>		
<b>Incremental Analysis</b>		
	<b>Premier Checking</b>	<b>Personal Banker</b>
Incremental revenue per account if processed further:		
Process further	\$50	\$250
Split-off—Basic Checking	<u>25</u>	<u>25</u>
Incremental revenue	\$25	\$225
Less incremental costs	<u>30</u>	<u>200</u>
Operating income (loss) from processing further	<u>\$ (5)</u>	<u>\$ 25</u>

© Cengage Learning 2014

## APPLY IT!

In an attempt to provide superb customer service, Anytime Movie Access is considering expanding its product offerings from single movie or game pay-per-view to complete movie or game evenings. Each evening would include unlimited online access to movies or games and a coupon for candy, popcorn, and drinks. The company's accountant has compiled the information that follows. Determine which products Anytime Movie Access should offer.

Product	Sales Revenue if No Additional Services	Sales Revenue if Processed Further into Unlimited Evening	Additional Processing Costs
Movie	\$2	\$10	\$5
Game	1	6	5

### SOLUTION

	Movie Evening	Game Evening
Incremental revenue if processed further:		
Process further	\$10	\$6
Split-off	<u>2</u>	<u>1</u>
Incremental revenue	\$ 8	\$5
Less incremental costs	<u>5</u>	<u>5</u>
Operating income from further processing	<u>\$ 3</u>	<u>\$0</u>

Anytime Movie Access should promote movie evenings first, then movies, and finally games or game evenings. There is no difference in profitability between the sale of games and the sale of game evenings.

**TRY IT! E7A, E8A, E7B, E8B**

## LO 7 Analyzing Capital Investments

**Capital investment decisions** are decisions about when and how much to spend on capital facilities and other long-term projects. For example, Home State Bank will make decisions about installing new equipment, replacing old equipment, expanding service by renovating or adding to existing equipment, buying a building, or acquiring another company.

## Capital Budgeting Process

Each decision made about a capital investment is vitally important because it involves a large amount of money and commits a company to a course of action for years to come. *Capital investment analysis* (or *capital budgeting*) is the process of identifying the need for a capital investment, analyzing courses of action to meet that need, preparing reports for managers, choosing the best alternative, and allocating funds among competing needs. The capital investment process involves the evaluation of alternative proposals for large capital investments, including considerations for financing the projects. For example, Home State Bank must make capital investment decisions that fit into its strategic plans.

A series of poor decisions about capital investments can cause a company to fail. To ensure high-quality capital investment decisions, managers follow six key steps.

**Step 1. Identify Capital Investment Needs** Managers identify capital investment opportunities from past sales experience, changes in sources and quality of materials, employees' suggestions, bottlenecks caused by obsolete equipment, new production or distribution methods, or customer complaints. In addition, capital investment needs are identified through proposals to add new products to the product line, expand capacity in existing product lines, reduce production costs of existing products without altering operating levels, or automate existing production processes.

**Step 2. Prepare Formal Requests for Capital Investments** Each request includes a complete description of the investment under review; the reasons a new investment is needed; the alternative means of satisfying the need, the timing, estimated costs, and related cost savings of each alternative; and the investment's engineering specifications, if necessary.

**Step 3. Conduct a Preliminary Screening** Organizations that have a highly developed system for capital investment analysis require that all proposals go through preliminary screening. The purpose of preliminary screening is to ensure that the only proposals to receive serious review are those that both meet company strategic goals and produce the minimum rate of return set by management.

**Step 4. Establish the Acceptance-Rejection Standard** An acceptance-rejection standard may be expressed as a minimum rate of return or a minimum cash flow payback period. If the number of acceptable requests exceeds the funds available for capital investments, the proposals must be ranked according to their rates of return. Acceptance-rejection standards are used to identify projects that are expected to yield inadequate or marginal returns. They also identify proposed projects for which high product demand and high financial returns are expected.

**Step 5. Evaluate Proposals** Proposals are evaluated by verifying decision variables and applying established proposal evaluation methods. The key decision variables are expected life, estimated cash flow, and investment cost. Three commonly used methods of evaluating proposed capital investments are net present value method, payback period method, and accounting rate-of-return method. Using one or more evaluation methods and the minimum acceptance-rejection standard, management evaluates all proposals. Management will also consider qualitative factors, such as availability and training of employees, competition, anticipated future technological improvements, and the proposal's impact on other company operations.

**Step 6. Make Capital Investment Decisions** The proposals that meet the standards of the evaluation process are given to the appropriate manager for final review. When deciding which requests to implement, the manager must consider the funds available. The acceptable proposals are ranked and the highest-ranking proposals are funded first. Often there will not be enough money to fund all proposals. The final capital investment budget is then prepared by allocating funds to the selected proposals.

## The Minimum Rate of Return on Investment

Most companies set a **minimum rate of return** to guard their profitability, and any capital expenditure proposal that fails to produce that rate of return is automatically refused. The minimum rate of return is often referred to as a *hurdle rate* because it is the rate that must be exceeded, or hurdled. If the return from a capital investment falls below the minimum rate of return, the funds can be used more profitably in another part of the organization. Projects that produce poor returns will ultimately have a negative effect on an organization's profitability.

**Ranking Capital Investment Proposals** Even after management evaluates and selects proposals under the minimum acceptance-rejection standard, there are often too many proposals to fund adequately. At that point, managers must rank the proposals according to their rates of return, or profitability, and begin a second selection process.

Suppose that Home State Bank has \$4,500,000 to spend this year for capital improvements and that five acceptable proposals are competing for those funds. The company's current minimum rate of return is 18 percent, and it is considering the following proposals:

Project	Rate of Return	Capital Investment	Cumulative Investment
A	32%	\$1,460,000	\$1,460,000
B	30%	1,890,000	3,350,000
C	28%	460,000	3,810,000
D	24%	840,000	4,650,000
E	22%	580,000	5,230,000
Total		<u>\$5,230,000</u>	

The proposals are listed in the order of their rates of return. As you can see, Projects A, B, and C have the highest rates of return and together will cost a total of \$3,810,000. That leaves \$690,000 in capital funds for other projects. Project D should be examined first to see if it could be implemented for \$150,000 less. If not, then Project E should be selected. The selection of Projects A, B, C, and E means that \$110,000 in capital funds will be uncommitted for the year.

## Capital Budgeting Analysis Measures and Methods

When evaluating a proposed capital investment, managers must predict how the new asset will perform and how it will benefit the company. Some of these methods involve the time value of money. To learn more about the time value of money, including present value, see Appendix B.

### CASH FLOW

**The Net Present Value Method** The **net present value method** evaluates a capital investment by discounting its future cash flows to their present values and subtracting the amount of the initial investment from their sum.

$$\text{Net Present Value} = \text{Present Value of Future Net Cash Inflows} - \text{Cost of Investment}$$

All proposed capital investments are evaluated in the same way, and the projects with the highest net present value—the amount that exceeds the initial investment—are selected for implementation.

**Advantages of the Net Present Value Method** A significant advantage of the net present value method is that it incorporates the time value of money into the analysis of proposed capital investments. Future cash inflows and outflows are discounted by the company's minimum rate of return to determine their present values. The minimum rate of return should at least equal the company's average cost of capital.

**STUDY NOTE:** Because it is based on cash flow, the net present value method is widely used not only in business but also by individuals.

When dealing with the time value of money, use discounting to find the present value of an amount to be received in the future. To determine the present values of future amounts of money, use Tables 1 and 2 in Appendix B. Remember that Table 1 deals with a single payment or amount and Table 2 is used for a series of equal periodic amounts. Tables 1 and 2 are used to discount each future cash inflow and cash outflow over the life of the asset to the present.

- If the net present value is positive (the total of the discounted net cash inflows exceeds the cash investment at the beginning), the rate of return on the investment will exceed the company’s minimum rate of return, or hurdle rate, and the project can be accepted.
- If the net present value is negative (the cash investment at the beginning exceeds the discounted net cash inflows), the return on the investment is less than the minimum rate of return and the project should be rejected.
- If the net present value is zero (if discounted cash inflows equal discounted cash outflows), the project meets the minimum rate of return and can be accepted.

**STUDY NOTE:** If the net present value is zero, the investment will earn the minimum rate of return.

**The Net Present Value Method Illustrated** Suppose that Home State Bank is considering the purchase of a new ATM unit. The company’s minimum rate of return is 16 percent. Management must decide between two models.

- Model M costs \$17,500 and will have an estimated residual value of \$2,000 after five years. It is projected to produce cash inflows of \$6,000, \$5,500, \$5,000, \$4,500, and \$4,000 during its five-year life.
- Model N costs \$21,000 and will have an estimated residual value of \$2,000. It is projected to produce cash inflows of \$6,000 per year for five years.

**STUDY NOTE:** When using the net present value method, remember to consider the present value of the residual or disposal value.

**Model M Analysis** Because Model M is expected to produce unequal cash inflows, Table 1 in Appendix B is used to determine the present value of each cash inflow from each year of the machine’s life. The net present value of Model M is determined as follows.

<b>Model M</b>				
<b>Year</b>	<b>Net Cash Inflows</b>	<b>16% Factor</b>	<b>Present Value</b>	
1	\$6,000	0.862	\$ 5,172.00	
2	5,500	0.743	4,086.50	
3	5,000	0.641	3,205.00	
4	4,500	0.552	2,484.00	
5	4,000	0.476	1,904.00	
Residual value	2,000	0.476	952.00	
Total present value of cash inflows			\$17,803.50	
Less purchase price of Model M			17,500.00	
Net present value			<u>\$ 303.50</u>	

All the factors for this analysis can be found in the column for 16 percent in Table 1. The factors are used to discount the individual cash flows, including the expected residual value, to the present. The amount of the investment in Model M is deducted from the total present value of the cash inflows to arrive at the net present value of \$303.50. Since the entire investment of \$17,500 in Model M is a cash outflow at the beginning—that is, at time zero—no discounting of the \$17,500 purchase price is necessary. Because the net present value is positive, the proposed investment in Model M will achieve at least the minimum rate of return.

**Model N Analysis** Because Model N is expected to produce equal cash receipts in each year of its useful life, Table 2 in Appendix B is used to determine the combined





## Business Perspective

### What Is Total Cost of Ownership, and Why Is It Important?

© Allija / iStockphoto.com

The concept of total cost of ownership (TCO) was developed to determine the total lifetime costs of owning an information technology (IT) asset, such as a computer system. TCO includes both the direct and indirect costs associated with the acquisition, deployment, operation, support, and retirement of the asset. Today, TCO is the industry standard for evaluating and comparing the costs associated with long-lived asset acquisitions. For example, if you buy a printer, TCO includes the direct costs of buying the printer, the annual supplies costs of ink and paper, and the indirect costs of maintaining it. Thus, the decision about which printer to buy is not based solely on the cost of the printer, but on all costs related to it over its useful lifetime.

present value of those future cash inflows. However, Table 1 is used to determine the present value of the machine's residual value because it represents a single payment, not an annuity. The net present value of Model N is calculated as follows.

Model N			
Year	Net Cash Inflows	16% Factor	Present Value
1–5	\$6,000	3.274	\$19,644.00
Residual value	2,000	0.476	952.00
Total present value of cash inflows			\$20,596.00
Less purchase price of Model N			21,000.00
Net present value			\$ (404.00)

Table 2 is used to determine the factor of 3.274 (found in the column for 16 percent and the row for five periods). Because the residual value is a single inflow in the fifth year, the factor of 0.476 must be taken from Table 1 (the column for 16 percent and the row for five periods). The result is a net present value of (\$404). Because the net present value is negative, the proposed investment in Model N will not achieve the minimum rate of return and should be rejected.

**Analysis Recap** The two analyses show that Model M should be chosen because it has a positive net present value and would exceed the company's minimum rate of return. Model M is the better choice because it is expected to produce cash inflows sooner and will thus produce a proportionately greater present value.

## Other Methods of Capital Investment Analysis

The net present value method is the best method for capital investment analysis. However, two other commonly used methods are the payback period method and the accounting rate-of-return method.

**The Payback Period Method** Because cash is an essential measure of a business's health, many managers estimate the cash flow that an investment will generate. Their goal is to determine the minimum time it will take to recover the initial investment. If two investment alternatives are being studied, management should choose the investment that pays back its initial cost in the shorter time. That period of time is known as the *payback period*, and the method of evaluation is called the **payback period method**. The payback period method is simple to use, but it does not consider the time value of money.

**Payback Calculation** The payback period is computed as follows.

$$\text{Payback Period} = \frac{\text{Cost of Investment}}{\text{Annual Net Cash Inflows}}$$

**STUDY NOTE:** Payback period is expressed in time, net present value is expressed in money, and accounting rate of return is expressed as a percentage.

CASH FLOW

**STUDY NOTE:** The payback period method measures the estimated length of time necessary to recover in cash the cost of an investment.



Suppose that Home State Bank is interested in purchasing a new server that costs \$51,000 and has a residual value of \$3,000. Assume that estimates for the proposal include revenue increases of \$17,900 a year and operating cost increases of \$11,696 a year (including depreciation and taxes). To evaluate this proposed capital investment, use the following steps.

**Step 1.** Determine the cost of the investment. For Home State Bank, it is \$51,000.

**Step 2.** Determine the annual net cash inflows, which are the annual cash revenues minus the cash expenses. Eliminate the effects of all noncash revenue and expense items included in the analysis of net income to determine cash revenues and cash expenses. In this case, the only noncash expense or revenue is machine depreciation. To eliminate it from operating expenses, you must first calculate depreciation expense. To calculate this amount, you must know the asset's life and the depreciation method. Suppose Home State Bank uses the straight-line method of depreciation, and the new server will have a ten-year service life. The annual depreciation is computed as follows.

$$\begin{aligned}\text{Annual Depreciation} &= \frac{\text{Cost} - \text{Residual Value}}{\text{Years}} \\ &= \frac{\$51,000 - \$3,000}{10 \text{ Years}} \\ &= \underline{\$4,800} \text{ per year}\end{aligned}$$

Thus, cash expenses are equal to the operating cost of \$11,696 reduced by the depreciation expense of \$4,800, or \$6,896. The annual net cash inflows are \$11,004, or cash revenue increases of \$17,900 less cash expenses of \$6,896.

**Step 3.** Compute the payback period.

$$\begin{aligned}\text{Payback Period} &= \frac{\text{Cost of Machine}}{\text{Cash Revenue} - \text{Cash Expenses}} \\ &= \frac{\$51,000}{\$17,900 - (\$11,696 - \$4,800)} \\ &= \frac{\$51,000}{\$11,004} \\ &= \underline{4.6} \text{ years}^*\end{aligned}$$

\*Rounded

If the company's desired payback period is five years or less, this proposal would be approved.

**Unequal Annual Net Cash Inflows** If a proposed capital investment has unequal annual net cash inflows, the payback period is determined as follows.

$$\text{Payback Period} = \text{Cost of Investment} - \text{Unequal Annual Net Cash Inflows}^*$$

\*In chronological order until a zero balance is reached.

When a zero balance is reached, the payback period has been determined. This will often occur in the middle of a year. The portion of the final year is computed by dividing the amount needed to reach zero (the unrecovered portion of the investment) by the entire year's estimated cash inflow.

**STUDY NOTE:** In computing the payback period, depreciation is omitted because it is a noncash expense.

**Advantages and Disadvantages** The payback period method is especially useful in areas in which technology changes rapidly, such as in Internet companies, and when risk is high, such as when investing in emerging countries. However, this approach has several disadvantages:

- The payback period method does not measure profitability
- It ignores differences in the present values of cash flows from different periods; thus, it does not adjust cash flows for the time value of money.
- The payback period method emphasizes the time it takes to recover the investment rather than the long-term return on the investment.
- It ignores all future cash flows after the payback period is reached.

**The Accounting Rate-of-Return Method** The **accounting rate-of-return method** is an imprecise but easy way to measure the estimated performance of a capital investment, since it uses financial statement information. This method does not use an investment's cash flows but considers the financial reporting effects of the investment instead. The accounting rate-of-return method measures expected performance using two variables: the estimated annual net income from the project and average investment cost.

**Accounting Rate-of-Return Calculation** The basic equation follows.

$$\text{Accounting Rate of Return} = \frac{\text{Average Annual Net Income}}{\text{Average Investment Cost}}$$

*Step 1.* Compute the average annual net income. Use the cost and revenue data prepared for evaluating the project—that is, revenues minus operating expenses (including depreciation and taxes).

*Step 2.* Compute the average investment cost in a proposed capital facility as follows.

$$\text{Average Investment Cost} = \left( \frac{\text{Total Investment} - \text{Residual Value}}{2} \right) + \text{Residual Value}$$

*Step 3.* Compute the accounting rate of return. For example, assume the same facts as before for Home State Bank's interest in purchasing a server. Also assume that the company's management will consider only projects that promise to yield more than a 16 percent return. To determine if the company should invest in the machine, compute the accounting rate of return as follows.

$$\begin{aligned} \text{Accounting Rate of Return} &= \frac{\$17,900 - \$11,696}{\left( \frac{\$51,000 - \$3,000}{2} \right) + \$3,000} \\ &= \underline{\underline{23\%}} \end{aligned}$$

The projected rate of return is higher than the 16 percent minimum, so management should think seriously about making the investment.

**Advantages and Disadvantages** The accounting rate-of-return method is easy to understand and apply. However, it has several disadvantages:

- Because net income is averaged over the life of the investment, it is not a reliable figure, as actual net income may vary considerably from the estimates.
- It ignores cash flows.
- It does not consider the time value of money; thus, future and present dollars are treated as equal.

**APPLY IT!**

Sample One, Inc., is considering purchasing a new piece of data transmission equipment. Estimated annual net cash inflows for the new equipment are \$575,000. The equipment costs \$2 million and will have no residual value at the end of its five-year life.

1. The company's minimum rate of return is 12 percent. Compute the net present value of the equipment. Should the company purchase it?
2. Compute the payback period for the equipment. Does this method yield a positive or negative response to the proposal to buy the equipment, assuming that the company has set a maximum payback period of four years?

Sample Two, Inc., is considering whether to purchase a delivery truck that will cost \$26,000, last six years, and have an estimated residual value of \$6,000. Average annual net income from the delivery truck is estimated at \$4,000. The company's owners want to earn an accounting rate of return of 20 percent.

3. Compute the average investment cost and the accounting rate of return. Should the company make the investment?

**SOLUTION**

$$\begin{aligned}
 1. \text{ Net Present Value} &= \text{Present Value of Future Net Cash Inflows} - \text{Cost of Equipment} \\
 &= (\$575,000 \times 3.605^*) - \$2,000,000 \\
 &= \$2,072,875 - \$2,000,000 \\
 &= \underline{\underline{\$72,875}}
 \end{aligned}$$

\*From Table 1 in Appendix B.

The solution is positive, so the company should purchase the equipment. A positive answer means that the investment will yield more than the minimum 12 percent return required by the company.

$$\begin{aligned}
 2. \text{ Payback Period} &= \text{Cost of Investment} \div \text{Annual Net Cash Inflows} \\
 &= \$2,000,000 \div \$575,000 \\
 &= \underline{\underline{3.5 \text{ years}^*}}
 \end{aligned}$$

\*Rounded

The piece of equipment should be purchased because its payback period is less than the company's maximum payback period of 4 years.

$$\begin{aligned}
 3. \text{ Average Investment Cost} &= \left( \frac{\text{Total Investment} - \text{Residual Value}}{2} \right) + \text{Residual Value} \\
 &= \left( \frac{\$26,000 - \$6,000}{2} \right) + \$6,000 \\
 &= \$16,000
 \end{aligned}$$

$$\begin{aligned}
 \text{Accounting Rate of Return} &= \frac{\text{Average Annual Net Income}}{\text{Average Investment Cost}} \\
 &= \frac{\$4,000}{\$16,000} \\
 &= 0.25 = \underline{\underline{25\%}}
 \end{aligned}$$

The project will exceed the desired return of 20% and should be undertaken.

**TRY IT! SE6, SE7, SE8, SE9, SE10, E9A, E10A, E11A, E12A, E13A, E14A, E9B, E10B, E11B, E12B, E13B, E14B**

## SECTION 3

## BUSINESS APPLICATIONS

## BUSINESS APPLICATIONS

- Planning
- Performing
- Evaluating
- Communicating

## RELEVANT LEARNING OBJECTIVE

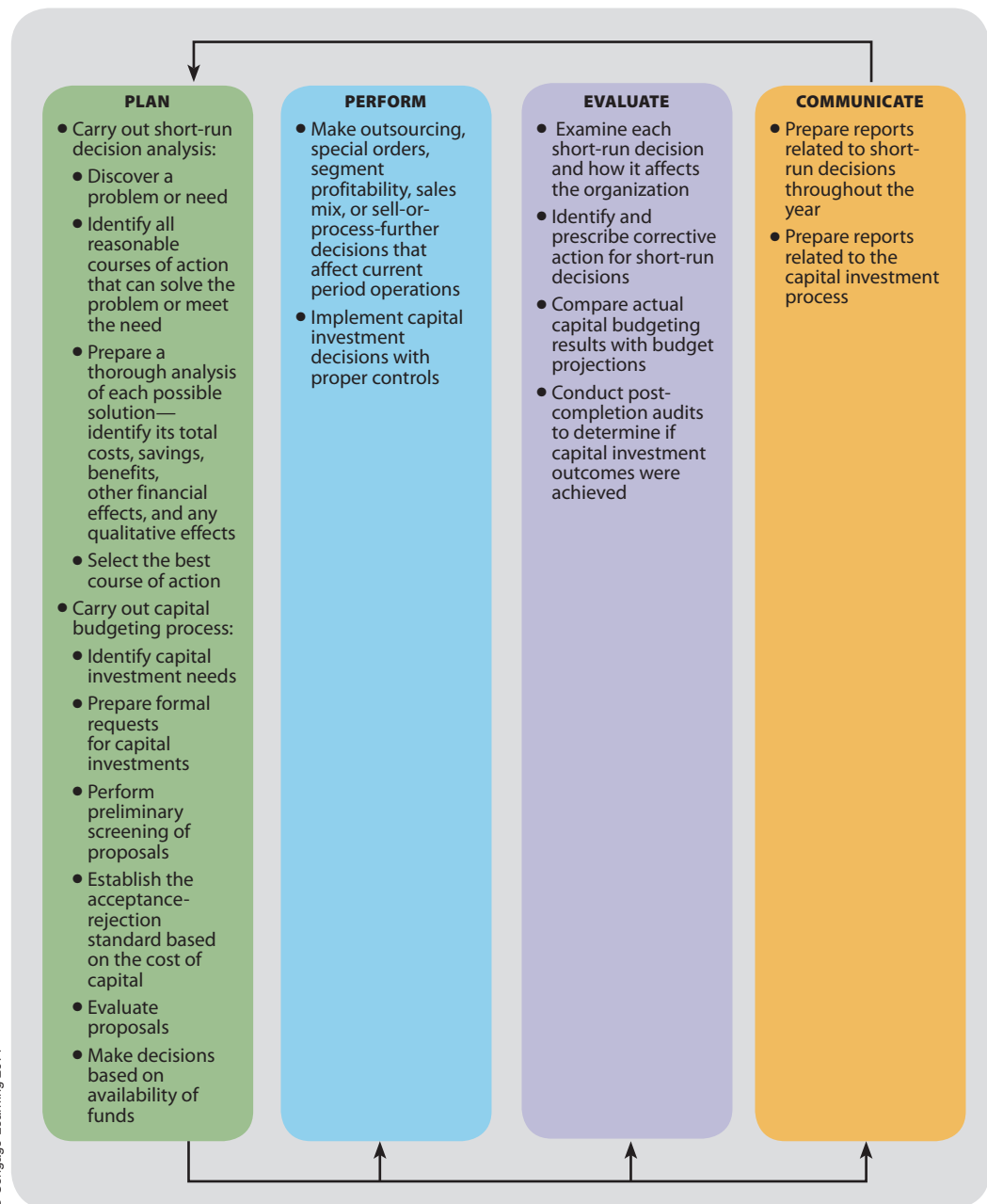
**LO 8** Describe why short-run and capital investment decisions are critical for business success.

## LO 8 The Management Process

Managers use both financial and nonfinancial quantitative and qualitative information to analyze the effects of past and potential business actions on their organization's resources and profits. Although many business problems are unique and cannot be solved by following strict rules, managers often use a suite of short-run and long-run decision-making methods and tools. Those decision methods and tools were the focus of this chapter. Exhibit 10 summarizes the tools and methods managers use to ensure a wise allocation of resources, to make sound, ethical decisions that will enhance customers' and other stakeholders' value, to earn a profit and to minimize business risks.

### Exhibit 10

#### Short-Run Decisions and Capital Budgeting and the Management Process



## APPLY IT!

When managers make short-run and capital investment decisions that are critical to their business, they ask questions. From the list that follows, select the questions a manager might ask.

1. When should products and services be outsourced?
2. Which capital budget proposal should be accepted?
3. When is a business segment profitable?
4. When resource constraints exist, what is the best sales mix?
5. When should products or services be sold as is or processed further into different products or services?
6. When should a special order for service or products be accepted?

### SOLUTION

All are examples of questions managers might ask when making short-term and capital investment decisions that are critical to their business's success.

## TriLevel Problem



JGJ/Jamie Grill/Blend Images/Corbis

The beginning of this chapter focused on Home State Bank. Complete the following requirements in order to answer the questions posed at the beginning of the chapter.

### Section 1: Concepts

*Why is the concept of cost-benefit important when making short-run and capital budgeting decisions?*

### Section 2: Accounting Applications

*How do incremental analysis and capital budgeting ensure a wise allocation of resources and minimize the risks involved in short-run and long-run decisions?*

Suppose that Home State Bank is considering building a new communications tower and has gathered the following information:

Purchase price	\$600,000
Residual value	\$100,000
Desired payback period	3 years
Minimum rate of return	15%

The cash flow estimates follow.

Year	Cash Inflows	Cash Outflows	Net Cash Inflows	Projected Net Income
1	\$ 500,000	\$260,000	\$240,000	\$115,000
2	450,000	240,000	210,000	85,000
3	400,000	220,000	180,000	55,000
4	350,000	200,000	150,000	25,000
Totals	<u>\$1,700,000</u>	<u>\$920,000</u>	<u>\$780,000</u>	<u>\$280,000</u>

1. Analyze the company's investment in the new tower. In your analysis, use (a) the net present value method, (b) the payback period method, and (c) the accounting rate-of-return method.
2. Summarize your findings from requirement 1, and recommend a course of action.







of action are considered relevant decision information. Examples of relevant information are projected sales or estimated costs, such as the costs of direct materials or direct labor, that differ for each alternative. The manager analyzes relevant information to determine which alternative contributes the most to profits or incurs the lowest costs. Only data that differ for each alternative are considered. Differential or incremental costs are costs that vary among alternatives and thus are relevant to the decision. Sunk costs are past costs that cannot be recovered. They are irrelevant to the decision process. Opportunity costs are revenue or income forgone as a result of choosing an alternative.

**Perform incremental analysis for outsourcing decisions.** **Lo 2**

Outsourcing (including make-or-buy) decision analysis helps managers decide whether to use suppliers from outside the organization to perform services or provide goods that could be performed or produced internally. An incremental analysis of the expected costs and revenues for each alternative is used to identify the best alternative.

**Perform incremental analysis for special order decisions.** **Lo 3**

A special order decision is a decision about whether to accept or reject a special order at a price below the normal market price. One approach is to compare the special order price with the relevant costs to see if a profit can be generated. Another approach is to prepare a special order bid price by calculating a minimum selling price for the special order. Generally, fixed costs are irrelevant to a special order decision because such costs are covered by regular sales activity and do not differ among alternatives.

**Perform incremental analysis for segment profitability decisions.** **Lo 4**

Segment profitability decisions involve the review of product lines, services, sales territories, divisions, or departments. Managers often must decide whether to add or drop a segment. A segment with a negative segment margin may be dropped. A segment margin is a segment's sales revenue minus its direct costs, which include variable costs and avoidable fixed costs. Avoidable costs are traceable to a specific segment. If the segment is eliminated, the avoidable costs will also be eliminated.

**Perform incremental analysis for sales mix decisions involving constrained resources.** **Lo 5**

Sales mix decisions require the selection of the most profitable combination of sales items when a company makes more than one product or service using a common constrained resource. The product or service generating the highest contribution margin per constrained resource is offered and sold first.

**Perform incremental analysis for sell-or-process-further decisions.** **Lo 6**

Sell-or-process-further decisions require managers to choose between selling a joint product at its split-off point or processing it into a more refined product. Managers compare the incremental revenues and costs of the two alternatives. Joint processing costs are irrelevant to the decision because they are identical for both alternatives. A product should be processed further only if the incremental revenues generated exceed the incremental costs incurred.

**Analyze capital budgeting proposals using the net present value method, the payback period method, and the accounting rate-of-return method.** **Lo 7**

Capital investment analysis, or capital budgeting, consists of identifying the need for a capital investment, analyzing courses of action to meet that need, preparing reports for management, choosing the best alternative, and dividing funds among competing resource needs. The minimum rate of return, or hurdle rate, is used as a screening mechanism to eliminate from further consideration capital investment requests with anticipated inadequate returns. When considering long-term decisions about when and how much to spend on capital facilities and other long-term projects, one method requires measures of net income, while other methods evaluate net cash inflows or cost savings.

The net present value method incorporates the time value of money into the analysis of a proposed capital investment. A minimum required rate of return is used to discount an investment's expected future cash flows to their present values. The present values are added together, and the amount of the initial investment is subtracted from their total. If the resulting amount, called the net present value, is positive, the rate of return on the investment will exceed the required rate of return, and the investment should be accepted. If the net present value is negative, the return on the investment will be less than the minimum rate of return, and the investment should be rejected.

The payback period method of evaluating a capital investment focuses on the minimum length of time needed to get the amount of the initial investment back in cash.

The accounting rate-of-return method requires measures of net income. With the accounting rate-of-return method, managers evaluate two or more capital investment proposals and then select the alternative that yields the highest ratio of average annual net income to average cost of investment. Both the payback and accounting rate-of-return methods are very rough measures that do not consider the time value of money. As a result, the net present value method is preferred.

**Describe why short-run and capital investment decisions are critical for business success.**

LO 8

As managers make short-term decisions, they ask a number of questions, including the following: When should products and services be outsourced? When should a special order for service or products be accepted? When is a business segment profitable? When resource constraints exist, what is the best sales mix? When should products or services be sold as is or processed further into different products or services? To answer such questions and determine the costs and benefits under alternative courses of action, the managers need pertinent information that they can use in incremental analysis. On that basis, they can make sound, ethical decisions that will enhance customers' and other stakeholders' value, use organization resources effectively and responsibly, and earn a profit.

When deciding when and how much to spend on long-term projects, such as the construction of a new building or the installation of a new communication tower, managers apply capital budgeting or capital investment analysis to ensure these decisions will have a positive effect on a company for many years, generate an adequate return, wisely allocate resources, and, at the same time, minimize the risks involved in the capital investment decision.

## Key Terms

**accounting rate-of-return method** 1108 (LO7)  
**avoidable costs** 1096 (LO4)  
**capital investment analysis** 1090 (LO1)  
**capital investment decisions** 1102 (LO7)  
**differential cost** 1091 (LO1)  
**incremental analysis** 1090 (LO1)

**incremental revenue** 1101 (LO6)  
**joint costs** 1101 (LO6)  
**joint products** 1101 (LO6)  
**make-or-buy decisions** 1093 (LO2)  
**minimum rate of return** 1104 (LO7)  
**net present value method** 1104 (LO7)  
**opportunity costs** 1092 (LO1)  
**outsourcing** 1093 (LO2)  
**payback period method** 1106 (LO7)

**sales mix decision** 1098 (LO5)  
**segment margin** 1096 (LO4)  
**sell-or-process-further decision** 1101 (LO6)  
**short-run decision analysis** 1090 (LO1)  
**special order decisions** 1094 (LO3)  
**split-off point** 1101 (LO6)  
**sunk cost** 1091 (LO1)

## Chapter Assignments

### DISCUSSION QUESTIONS

- LO 1, 8 **DQ1. CONCEPT ► BUSINESS APPLICATION ►** How do managers use the concept of cost-benefit during the planning phase of the management process?
- LO 1, 8 **DQ2. CONCEPT ► BUSINESS APPLICATION ►** How do managers use the concept of cost-benefit during the performing phase of the management process?
- LO 1, 8 **DQ3. CONCEPT ► BUSINESS APPLICATION ►** How do managers use the concept of cost-benefit during the evaluating phase of the management process?
- LO 1, 8 **DQ4. CONCEPT ► BUSINESS APPLICATION ►** How do managers use the concept of cost-benefit during the communicating phase of the management process?

## SHORT EXERCISES

### LO 1 Qualitative and Quantitative Information in Short-Run Decision Analysis

**SE1.** The owner of a Mexican restaurant is deciding whether to take fish tacos off the menu. State whether each item of decision information that follows is qualitative or quantitative. If the information is quantitative, specify whether it is financial or nonfinancial.

1. The time needed to prepare the fish
2. The daily number of customers who order the tacos
3. Whether competing Mexican restaurants have this entrée on the menu
4. The labor cost of the chef who prepares the fish tacos
5. The fact that the president of a nearby company who brings ten guests with him each week always orders fish tacos

### LO 1 Using Incremental Analysis

**SE2.** Fortress Hill Corporation has assembled the following information related to the purchase of a new cable car:

	<b>Peaks Machine</b>	<b>Valley Machine</b>
Increase in revenue	\$44,200	\$49,300
Increase in annual operating costs:		
Direct materials	12,200	12,200
Direct labor	10,200	10,600
Variable overhead	24,500	26,900
Fixed overhead (including depreciation)	12,400	12,400

Using incremental analysis and only relevant information, compute the difference in favor of the Valley machine.

### LO 2 Outsourcing Decision

**SE3.** Will Company assembles products from a group of interconnecting parts. The company produces some of the parts and buys some from outside vendors. The vendor for Part X has just increased its price by 35 percent, to \$10 per unit for the first 5,000 units and \$9 per additional unit ordered each year. The company uses 7,500 units of Part X each year. Unit costs if the company makes the part are as follows.

Direct materials	\$3.50
Direct labor	2.00
Variable overhead	4.00
Variable selling costs for the assembled product	3.75

Should Will Company continue to purchase Part X or begin making it?

### LO 3 Special Order Decision

**SE4.** Wong Accounting Services is considering a special order that it received from one of its corporate clients. The special order calls for Wong to prepare the individual tax returns of the corporation's four largest shareholders. The company has idle capacity that could be used to complete the special order. The following data have been gathered about the preparation of individual tax returns:

Materials cost per page	\$1
Average hourly labor rate	\$60
Standard hours per return	4
Standard pages per return	10
Variable overhead cost per page	\$0.50
Fixed overhead cost per page	\$0.50

Wong would be satisfied with a \$40 gross profit per return. Compute the minimum bid price for the entire order.

LO 5 **Sales Mix Decision**

**SE5.** Blizzard, Inc., makes three kinds of snowboards, but it has a limited number of machine hours available to make them. Product line data follow.

	Wood	Plastic	Graphite
Machine hours per unit	1.25	1.0	1.5
Selling price per unit	\$100	\$120	\$200
Variable manufacturing cost per unit	\$45	\$50	\$100
Variable selling costs per unit	\$15	\$26	\$37

In what order should the snowboard product lines be produced?

LO 7 **Capital Investment Analysis and Revenue Measures**

**SE6. ACCOUNTING CONNECTION** ► Admiralty Corporation is analyzing a proposal to switch its factory over to a lights-out operation. To do so, it must acquire a fully automated machine. The machine will be able to produce an entire product line in a single operation. Projected annual net cash inflows from the machine are \$180,000, and projected net income is \$120,000. Why is the projected net income lower than the projected net cash inflows? Identify possible causes for the \$60,000 difference.

LO 7 **Net Present Value Method**

**SE7. ACCOUNTING CONNECTION** ► Sandcastles, Inc.'s management has recently been looking at a proposal to purchase a new brick molding machine. With the new machine, the company would not have to buy bricks. The estimated useful life of the machine is 15 years, and the purchase price, including all setup charges, is \$400,000. The residual value is estimated to be \$40,000. The net addition to the company's cash inflow as a result of the savings from making the bricks is estimated to be \$70,000 a year. Sandcastle's management has decided on a minimum rate of return of 14 percent. Using the net present value method to evaluate this capital investment, determine whether the company should purchase the machine. Support your answer. (*Hint:* Use Tables 1 and 2 in Appendix B.)

LO 7 **Capital Investment Decision: Payback Period Method**

**SE8. ACCOUNTING CONNECTION** ► Territories Cable, Inc., is considering the purchase of new data transmission equipment. Estimated annual cash revenues for the new equipment are \$1 million, and operating costs (including depreciation of \$400,000) are \$825,000. The equipment costs \$2 million, it has a five-year life, and it will have no residual value at the end of the five years. Compute the payback period for the piece of equipment. (Round to one decimal place.) Does this method yield a positive or a negative response to the proposal to buy the equipment if the company has set a maximum payback period of four years? Explain your answer.

LO 7 **Capital Investment Decision: Accounting Rate-of-Return Method**

**SE9.** Doorstep Cleaners is considering whether to purchase a delivery truck that will cost \$50,000, last six years, and have an estimated residual value of \$5,000. Average annual net income from the delivery service is estimated to be \$4,000. Doorstep Cleaners' owners seek to earn an accounting rate of return of 10 percent. Compute the average investment cost and the accounting rate of return. (Round percentages to one decimal place.) Should the investment be made?

LO 7 **Time Value of Money**

**SE10. ACCOUNTING CONNECTION** ► Sherry Rudd recently inherited a trust fund from a distant relative. On January 2, the bank managing the trust fund notified Rudd that she has the option of receiving a lump-sum check for \$200,000 or leaving the money in the trust fund and receiving an annual year-end check for \$20,000 for each of the next 20 years. Rudd likes to earn at least a 5 percent return on her investments. What should she do?

## EXERCISES: SET A

### LO 1 Incremental Analysis

**E1A.** Coffee Culture Company's managers must decide which of two coffee grinders—Y or Z—to buy. The grinders have the same purchase price but different revenue and cost characteristics. The company currently owns Grinder X, which it bought three years ago for \$10,000 and which has accumulated depreciation of \$9,000 and a book value of \$1,000. Grinder X is now obsolete as a result of advances in technology and cannot be sold or traded in.

The accountant has collected the following annual revenue and operating cost estimates for the two new machines:

	Grinder Y	Grinder Z
Increase in revenue	\$15,000	\$18,000
Increase in annual operating costs:		
Direct materials	4,500	4,500
Direct labor	3,000	4,000
Variable overhead	2,000	3,000
Fixed overhead (depreciation included)	4,000	4,000

1. Identify the relevant data in this problem.
2. Prepare an incremental analysis to aid the managers in their decision.
3. **ACCOUNTING CONNECTION** ► Should the company purchase Grinder Y or Grinder Z? Explain your answer.

### LO 2 Outsourcing Decision

**E2A. ACCOUNTING CONNECTION** ► Cyber Queen Services' manager must decide whether to hire a new employee or to outsource some of the web design work to Kai Yu, a freelance graphic designer. If she hires a new employee, she will pay \$30 per design hour for the employee to work 500 hours and incur service overhead costs of \$2 per design hour. She will also redirect the use of a computer and server to generate \$4,000 in additional revenue from web page maintenance work. If she outsources the work to Kai Yu, she will pay \$34 per design hour for 500 hours of work. Should Cyber Queen Services hire a new designer or outsource the work to Kai Yu? Explain your answer.

### LO 3 Special Order Decision

**E3A.** Fun Sporting Goods, Inc., manufactures a complete line of sporting equipment. Lei Enterprises operates a large chain of discount stores. Lei has approached Fun with a special order for 20,000 deluxe baseballs. Instead of being packaged separately, the balls are to be packed in boxes containing 500 baseballs each. Lei is willing to pay \$2.50 per baseball. Fun's standard annual expected production is 400,000 baseballs, but Fun is on track to produce 410,000 baseballs as the current year's production. Fun's maximum production capacity is 450,000 baseballs. The following additional information is available:

Standard unit cost data for 400,000 baseballs:

Direct materials	\$ 1.00
Direct labor	0.50
Overhead:	
Variable	0.60
Fixed ( $\$100,000 \div 400,000$ )	0.25
Packaging per unit	0.20
Advertising ( $\$60,000 \div 400,000$ )	0.15
Other fixed selling and administrative expenses ( $\$120,000 \div 400,000$ )	0.30
Product unit cost	<u>\$ 3.00</u>
Unit selling price	\$ 4.00
Total estimated bulk packaging costs for special order (20,000 baseballs: 500 per box)	\$2,000

1. Should Fun Sporting Goods accept Lei's offer?
2. What would be the minimum order price per baseball if Fun would like to earn a profit of \$3,000 from the special order?

#### LO 4 Elimination of Unprofitable Segment Decision

**E4A.** Gold's Glass, Inc., has three divisions: Commercial, Nonprofit, and Residential. The segmented income statement for last year revealed the following:

<b>Gold's Glass, Inc.</b>				
<b>Divisional Profit Summary and Decision Analysis</b>				
	<b>Commercial Division</b>	<b>Nonprofit Division</b>	<b>Residential Division</b>	<b>Total Company</b>
Sales	\$300,000	\$523,000	\$837,000	\$1,660,000
Less variable costs	<u>157,000</u>	<u>425,000</u>	<u>472,000</u>	<u>1,054,000</u>
Contribution margin	\$143,000	\$ 98,000	\$365,000	\$ 606,000
Less direct fixed costs	<u>114,000</u>	<u>116,000</u>	<u>139,000</u>	<u>369,000</u>
Segment margin	<u>\$ 29,000</u>	<u>\$ (18,000)</u>	<u>\$226,000</u>	<u>\$ 237,000</u>
Less common fixed costs				168,000
Operating income				<u>\$ 69,000</u>

1. How will Gold's Glass be affected if the Nonprofit Division is dropped?
2. Assume the elimination of the Nonprofit Division causes the sales of the Residential Division to decrease by 10 percent. How will Gold's Glass be affected if the Nonprofit Division is dropped?

#### LO 5 Scarce Resource Usage

**E5A.** ZE, Inc., manufactures two products that require both machine processing and labor operations. Although there is unlimited demand for both products, ZE could devote all its capacities to a single product. Unit prices, cost data, and processing requirements follow.

	<b>Product E</b>	<b>Product Z</b>
Unit selling price	\$75	\$200
Unit variable costs	\$25	\$80
Machine hours per unit	0.4	1.2
Labor hours per unit	2.0	6.0

Next year, the company will be limited to 160,000 machine hours and 120,000 labor hours. Fixed costs for the year are \$1,000,000.

1. **ACCOUNTING CONNECTION** ► Compute the most profitable combination of products to be produced next year. Explain your answer.
2. Prepare an income statement using the contribution margin format for the product volume computed in 1.

#### LO 5 Sales Mix Decision

**E6A.** GAME Enterprises manufactures three computer games called Rocket Star, Game Master, and Rock Warrior. The product line data follow.

	<b>Rocket Star</b>	<b>Game Master</b>	<b>Rock Warrior</b>
Current unit sales demand	20,000	30,000	18,000
Machine hours per unit	2.0	1.0	2.5
Selling price per unit	\$20.00	\$16.00	\$30.00
Unit variable manufacturing costs	\$12.50	\$10.00	\$18.75
Unit variable selling costs	\$6.50	\$5.00	\$6.25

(Continued)



The current production capacity is 100,000 machine hours.

1. Which computer game should be manufactured first? Which should be manufactured second? Which last?
2. How many of each type of computer game should be manufactured and sold to maximize the company's contribution margin based on the current production activity of 100,000 machine hours? What is the total contribution margin for that combination?

#### LO 6 Sell-or-Process-Further Decision

**E7A. ACCOUNTING CONNECTION** ► Beef Products, Inc., processes cattle. It can sell the meat as sides of beef or process it further into final cuts (steaks, roasts, and hamburger). As part of the company's strategic plan, management is looking for new markets for meat or meat by-products. The production process currently separates hides and bones for sale to other manufacturers. However, management is considering whether it would be profitable to process the hides into leather and the bones into fertilizer. The costs of the cattle and of transporting, hanging, storing, and cutting sides of beef are \$100,000. The company's accountant provided these data:

Product	Sales Revenue if Sold at Split-Off	Sales Revenue if Sold After Further Processing	Additional Processing Costs
Meat	\$100,000	\$200,000	\$80,000
Bones	20,000	40,000	25,000
Hides	50,000	60,000	5,000

Should the products be processed further? Explain your answer.

#### LO 6 Sell-or-Process-Further Decision

**E8A. ACCOUNTING CONNECTION** ► Four Star Pizza manufactures make-at-home frozen pizza and calzone kits and sells them for \$5 each. It is currently considering a proposal to manufacture and sell fully prepared products. The following relevant information has been gathered by management:

Product	Sales Revenue if No Additional Processing	Sales Revenue if Processed Further	Additional Processing Costs
Pizza	\$5	\$15	\$6
Calzone	5	10	6

Use incremental analysis to determine which products Four Star should offer. Explain your answer.

#### LO 7 Capital Investment Decision: Net Present Value Method

**E9A.** Tuen and Associates wants to buy an automated coffee roaster/grinder/brewer. This piece of equipment would have a useful life of six years, would cost \$190,000, and would increase annual net cash inflows by \$50,000. Assume that there is no residual value at the end of six years. The company's minimum rate of return is 14 percent. Using the net present value method, prepare an analysis to determine whether the company should purchase the machine. (*Hint:* Use Table 2 in Appendix B.)

#### LO 7 Capital Investment Decision: Net Present Value Method

**E10A. ACCOUNTING CONNECTION** ► Full Service Station is planning to invest in automatic car wash equipment valued at \$210,000. The owner estimates that the equipment will increase annual net cash inflows by \$40,000. The equipment is expected to have a ten-year useful life with an estimated residual value of \$20,000. The company requires a 14 percent minimum rate of return. Using the net present value method, prepare an analysis to determine whether the company should purchase the equipment. How important is the estimate of residual value to this decision? (*Hint:* Use Tables 1 and 2 in Appendix B.)



**LO 7 Capital Investment Decision: Net Present Value Method**

**E11A.** Assume the same facts for Full Service Station as in **E10A**, except that the company requires a 20 percent minimum rate of return. Using the net present value method, prepare an analysis to determine whether the company should purchase the equipment. (*Hint:* Use Tables 1 and 2 in Appendix B.)

**LO 7 Capital Investment Decision: Payback Period Method**

**E12A.** Eco Wet, Inc., a manufacturer of gears for lawn sprinklers, is thinking about adding a new fully automated machine. This machine can produce gears that the company now produces on its third shift. The machine has an estimated useful life of ten years and will cost \$500,000. The residual value of the new machine is \$50,000. Gross cash revenue from the machine will be about \$420,000 per year, and related operating expenses, including depreciation, should total \$400,000. Depreciation is estimated to be \$80,000 annually. The payback period should be five years or less. Use the payback period method to determine whether the company should invest in the new machine. Show the computations that support your answer.

**LO 7 Capital Investment Decision: Accounting Rate-of-Return Method**

**E13A.** Sound Perfection, Inc., a manufacturer of stereo speakers, is thinking about adding a new machine. This machine can produce speaker parts that the company now buys from outsiders. The machine has an estimated useful life of 14 years and will cost \$450,000. The residual value of the new machine is \$50,000. Gross cash revenue from the machine will be about \$300,000 per year, and related cash expenses should total \$210,000. Depreciation is estimated to be \$30,000 annually. Sound Perfection's management has decided that only capital investments that yield at least a 20 percent return will be accepted. Using the accounting rate-of-return method, decide whether the company should invest in the machine. Show the computations that support your decision.

**LO 7 Using the Present Value Tables**

**E14A.** For each of the following situations, identify the correct factor to use from Table 1 or Table 2 in Appendix B. Then compute the appropriate present value.

1. Annual net cash inflows of \$10,000 for five years, discounted at 6 percent
2. An amount of \$20,000 to be received at the end of ten years, discounted at 4 percent
3. The amount of \$10,000 to be received at the end of two years, and \$7,000 to be received at the end of years 4, 5, and 6, discounted at 10 percent

**EXERCISES: SET B**

Visit the textbook companion website at [www.cengagebrain.com](http://www.cengagebrain.com) to access Exercise Set B for this chapter.

**PROBLEMS****LO 2 Outsourcing Decision**

**SPREADSHEET**

- ✓ 1: Incremental cost to make: \$93,750
- ✓ 2: Variable unit cost to make: \$16

**P1.** Freeze Refrigerator Company purchases ice makers and installs them in its products. The ice makers cost \$138 per case, and each case contains 12 ice makers. The supplier recently gave notice that the price will rise by 50 percent immediately. Freeze Refrigerator has idle equipment that with only a few minor changes could be used to produce similar ice makers.

Cost estimates have been prepared under the assumption that the company could make the product itself. Direct materials would cost \$100.80 per 12 ice makers. Direct labor required would be 10 minutes per ice maker at a labor rate of \$18.00 per hour. Variable overhead would be \$4.60 per ice maker. Fixed overhead, which would be

(Continued)

incurred under either decision alternative, would be \$32,420 a year for depreciation and \$234,000 a year for other costs. Production and usage are estimated at 75,000 ice makers a year. (Assume that any idle equipment cannot be used for any other purpose.)

### REQUIRED

1. Prepare an incremental analysis to determine whether the ice makers should be made within the company or purchased from the outside supplier at the higher price.
2. Compute the variable unit cost to (a) make one ice maker and (b) buy one ice maker.

### LO 3

### Special Order Decision

- ✓ 1: Contribution margin from order: \$6,420
- ✓ 2: Total variable costs per unit: \$621.50

**P2.** On March 26, Buoy Industries received a special order request for 120 ten-foot aluminum fishing boats. Operating on a fiscal year ending May 31, the company already has orders that will allow it to produce at budget levels for the period. However, extra capacity exists to produce the 120 additional boats.

The terms of the special order call for a selling price of \$675 per boat, and the customer will pay all shipping costs. No sales personnel were involved in soliciting the order.

The ten-foot fishing boat has the following cost estimates:

- Direct materials, aluminum, two 49 × 89 sheets at \$155 per sheet
- Direct labor, 14 hours at \$15.00 per hour
- Variable overhead, \$7.25 per direct labor hour
- Fixed overhead, \$4.50 per direct labor hour
- Variable selling expenses, \$46.50 per boat
- Variable shipping expenses, \$57.50 per boat

### REQUIRED

1. Prepare an analysis for Buoy's management to use in deciding whether to accept or reject the special order. What decision should be made?
2. To make an \$8,000 profit on this order, what would be the lowest possible price that Buoy could charge per boat?

### LO 5, 8

### Sales Mix Decision

- ✓ 2: Product C5 contribution margin per machine hour: \$2.50

**P3.** Common Chemical Company's management is evaluating its product mix in an attempt to maximize profits. For the past two years, Common has produced four products, and all have large markets in which to expand market share. Common's controller has gathered data from current operations and wants you to analyze them for him. Sales and operating data follow.

	Product A1	Product B7	Product C5	Product D9
Variable production costs	\$71,000	\$91,000	\$91,920	\$97,440
Variable selling costs	\$10,200	\$5,400	\$12,480	\$30,160
Fixed production costs	\$20,400	\$21,600	\$29,120	\$18,480
Fixed administrative costs	\$3,400	\$5,400	\$6,240	\$10,080
Total sales	\$122,000	\$136,000	\$156,400	\$161,200
Units produced and sold	85,000	45,000	26,000	14,000
Machine hours used*	17,000	18,000	20,800	16,800

\*Common's scarce resource, machine hours, is being used to full capacity.

### REQUIRED

1. Compute the machine hours needed to produce one unit of each product. (Round to two decimal places.)
2. Determine the contribution margin per machine hour for each product.
3. Which product line(s) should be targeted for market share expansion?

LO 6, 8

## SPREADSHEET

- ✓ 1: Incremental contribution margin for bagels with cream cheese: \$1.50
- ✓ 1: Incremental contribution margin for bagel sandwiches: \$2.00
- ✓ 3: Operating income from further processing bagel sandwiches with cheese: \$0.50

## Sell-or-Process-Further Decision

**P4.** Bakers Bagels, Inc., produces and sells 20 types of bagels by the dozen. Bagels are priced at \$6.00 per dozen (or \$0.50 each) and cost \$0.20 per unit to produce. The company is considering further processing the bagels into two products: bagels with cream cheese and bagel sandwiches. It would cost an additional \$0.50 per unit to produce bagels with cream cheese, and the new selling price would be \$2.50 each. It would cost an additional \$1.00 per sandwich to produce bagel sandwiches, and the new selling price would be \$3.50 each.

## REQUIRED

1. Identify the relevant per-unit costs and revenues for the alternatives. Are there any sunk costs?
2. Based on the information in requirement 1, should Bakers Bagels expand its product offerings?
3. **ACCOUNTING CONNECTION** ▶ Suppose that Bakers Bagels did expand its product line to include bagels with cream cheese and bagel sandwiches. Based on customer feedback, the company determined that it could further process those two products into bagels with cream cheese and fruit and bagel sandwiches with cheese. The company's accountant compiled the following information:

Product (per unit)	Sales Revenue if Sold without Further Processing	Sales Revenue if Processed Further	Additional Processing Costs
Bagels with cream cheese	\$2.50	\$3.50	Fruit: \$1.00
Bagel sandwiches	3.50	4.50	Cheese: \$0.50

Perform an incremental analysis to determine if Bakers Bagels should process its products further. Explain your findings.

LO 7, 8

## CASH FLOW

- ✓ 1a: Net present value: (\$26,895)
- ✓ 1b: Accounting rate of return: 8.2%
- ✓ 1c: Payback period: 3.7 years

## Capital Investment Decision

**P5.** Edge Company's production vice president believes keeping up-to-date with technological changes is what makes the company successful and feels that a machine introduced recently would fill an important need. The machine has an estimated useful life of four years, a purchase price of \$250,000, and a residual value of \$25,000. The company controller has estimated average annual net income of \$11,250 and the following cash flows for the new machine:

Cash Flow Estimates			
Year	Cash Inflows	Cash Outflows	Net Cash Inflows
1	\$325,000	\$250,000	\$75,000
2	320,000	250,000	70,000
3	315,000	250,000	65,000
4	310,000	250,000	60,000

The company uses a 12 percent minimum rate of return and a three-year payback period for capital investment evaluation purposes.

## REQUIRED

1. Analyze the data about the machine. Use the following evaluation approaches in your analysis:
  - (a) the net present value method (Round to the nearest dollar.)
  - (b) the accounting rate-of-return method (Round to one decimal place.)
  - (c) the payback period method (Round to one decimal place.)
2. **ACCOUNTING CONNECTION** ▶ Summarize the information generated in requirement 1, and make a recommendation.

## ALTERNATE PROBLEMS

### LO 2 Outsourcing Decision

SPREADSHEET

✓ 2: Variable unit cost to make: \$28.00

**P6.** Sisters Restaurant purchases cheesecakes and offers them as dessert items on its menu. The cheesecakes cost \$24 each, and a cake contains 8 pieces. The supplier recently gave notice that the price will rise by 20 percent immediately. Sisters has idle equipment that with only a few minor changes could be used to produce similar cheesecakes.

Cost estimates have been prepared under the assumption that the company could make the product itself. Direct materials would cost \$7 per cheesecake. Direct labor required would be 0.5 hour per cheesecake at a labor rate of \$24 per hour. Variable overhead would be \$9 per cheesecake. Fixed overhead, which would be incurred under either decision alternative, would be \$35,200 a year for depreciation and \$230,000 a year for other costs. Production and usage are estimated at 3,600 cheesecakes a year. (Assume that any idle equipment cannot be used for any other purpose.)

#### REQUIRED

1. Prepare an incremental analysis to determine whether the cheesecakes should be made within the company or purchased from the outside supplier at the higher price.
2. Compute the variable unit cost to (a) make one cheesecake and (b) buy one cheesecake.

### LO 3 Special Order Decision

✓ 1: Total variable costs per unit: \$48.50

**P7.** Leisure Resorts, Ltd., has approached EZ Printers, Inc., with a special order to produce 300,000 two-page brochures. Most of EZ's work consists of recurring short-run orders. Leisure Resorts is offering a one-time order, and EZ has the capacity to handle the order over a two-month period.

Leisure Resorts' management has stated that the company would be unwilling to pay more than \$48 per 1,000 brochures. EZ's controller assembled the following cost data for this decision analysis:

Direct materials (paper)	\$26.80 per 1,000 brochures
Direct labor costs	\$6.80 per 1,000 brochures
Direct materials (ink)	\$4.40 per 1,000 brochures
Variable production overhead	\$6.20 per 1,000 brochures
Machine maintenance (fixed cost)	\$1.00 per direct labor dollar
Other fixed production overhead	\$2.40 per direct labor dollar
Variable packing costs	\$4.30 per 1,000 brochures
General and administrative expenses (fixed costs) to be allocated	\$5.25 per direct labor dollar

#### REQUIRED

1. Prepare an analysis for EZ's management to use in deciding whether to accept or reject Leisure Resorts' offer. What decision should be made?
2. What is the lowest possible price EZ can charge per thousand and still make a \$6,000 profit on the order?

### LO 5, 8 Sales Mix Decision

✓ 1: Office visits contribution margin per hour: \$100

✓ 2: Three hours for office visits

✓ 2: Total daily contribution margin: \$820

**P8.** Dr. Stott, who specializes in internal medicine, wants to analyze his sales mix to find out how the time of his physician assistant, Connie Mortiz, can be used to generate the highest operating income.

Mortiz sees patients in Dr. Stott's office, consults with patients over the telephone, and conducts one daily weight-loss support group attended by up to 50 patients. Statistics for the three services follow.

	Office Visits	Phone Calls	Weight-Loss Support Group
Maximum number of patient billings per day	20	40	50
Hours per billing	0.25	0.10	1.0
Billing rate	\$50	\$25	\$10
Variable costs	\$25	\$12	\$5

Mortiz works seven hours a day.

**REQUIRED**

- Determine the best sales mix. Rank the services offered in order of their profitability.
- Based on the ranking in requirement 1, how much time should Mortiz spend on each service in a day? (*Hint:* Remember to consider the maximum number of patient billings per day.) What would be the daily total contribution margin generated by Mortiz?
- Dr. Stott believes the ranking is incorrect. He knows that the daily 60-minute meeting of the weight-loss support group has 50 patients and should continue to be offered. If the new ranking for the services is (1) weight-loss support group, (2) phone calls, and (3) office visits, how much time should Mortiz spend on each service in a day? What would be the total contribution margin generated by Mortiz, assuming the weight-loss support group has the maximum number of patient billings?
- ACCOUNTING CONNECTION** ► Which ranking would you recommend? What additional amount of total contribution margin would be generated if your recommendation were to be accepted?

LO 6, 8

SPREADSHEET

- ✓ 1: Total costs for BIG SALE: \$14,600
- ✓ 2: Incremental loss: \$2,400

**Sell-or-Process-Further Decision**

**P9.** CU, Inc., developed a promotional program for a local shopping center a few years ago. Having invested \$360,000 in developing the original promotion campaign, the firm is ready to present its client with an add-on contract offer that includes the original promotion areas of (1) a TV advertising campaign, (2) a series of brochures for mass mailing, and (3) a special rotating BIG SALE schedule for 10 of the 28 tenants in the shopping center. The revenue terms from the original contract with the shopping center and the offer for the add-on contract, which extends the original contract terms, follow.

	<b>Original Contract Terms</b>	<b>Extended Contract Including Add-On Terms</b>
TV advertising campaign	\$520,000	\$ 580,000
Brochure series	210,000	230,000
Rotating BIG SALE schedule	170,000	190,000
Totals	<u>\$900,000</u>	<u>\$1,000,000</u>

CU estimates that the following additional costs will be incurred by extending the contract:

	<b>TV Campaign</b>	<b>Brochures</b>	<b>BIG SALE Schedule</b>
Direct labor	\$30,000	\$ 9,000	\$7,000
Variable overhead costs	22,000	14,000	6,000
Fixed overhead costs*	12,000	4,000	2,000

\*80 percent are direct fixed costs applied to this contract.

**REQUIRED**

- Compute the costs that will be incurred for each part of the add-on portion of the contract.
- ACCOUNTING CONNECTION** ► Should CU offer the add-on contract, or should it ask for a final settlement check based on the original contract only? Defend your answer.
- ACCOUNTING CONNECTION** ► If management of the shopping center indicates that the terms of the add-on contract are negotiable, how should CU respond?

## LO 7, 8

- ✓ 1: Net present value  
ETZ machine: (\$32,379)
- ✓ 2: Accounting rate of return  
ETZ machine: 20.7%
- ✓ 3: Payback period ETZ machine:  
5.4 years

**Capital Investment Decision**

**P10.** Express Corporation wants to buy a new stamping machine. The machine will provide the company with a new product line: pressed food trays for kitchens. Two machines are being considered; the data for each machine follow.

	<b>ETZ Machine</b>	<b>LKR Machine</b>
Cost of machine	\$350,000	\$370,000
Net income	\$39,204	\$48,642
Annual net cash inflows	\$64,404	\$75,642
Residual value	\$28,000	\$40,000
Estimated useful life in years	10	10

The company's minimum rate of return is 16 percent, and the maximum allowable payback period is 5.0 years.

**REQUIRED**

1. Compute the net present value for each machine. (Round to the nearest dollar.)
2. Compute the accounting rate of return for each machine. (Round to one decimal place.)
3. Compute the payback period for each machine. (Round to one decimal place.)
4. **ACCOUNTING CONNECTION** ► From the information generated in requirements 1–3, decide which machine should be purchased. Why?

**CASES**

## LO 1, 8

**Conceptual Understanding: Defining and Identifying Relevant Information**

**C1. BUSINESS APPLICATION** ► Big Burgers is in the fast-food restaurant business. One component of its marketing strategy is to increase sales by expanding in foreign markets. It uses both financial and nonfinancial quantitative and qualitative information when deciding whether to open restaurants abroad. Big's decided to open a restaurant in Prague (Czech Republic) five years ago. The following information helped the managers in making that decision:

**Financial Quantitative Information**

- Operating information
- Estimated food, labor, and other operating costs (e.g., taxes, insurance, utilities, and supplies)
- Estimated selling price for each food item
- Capital investment information
- Cost of land, building, equipment, and furniture
- Financing options and amounts

**Nonfinancial Quantitative Information**

- Estimated daily number of customers, hamburgers to be sold, employees to work
- High-traffic time periods
- Income of people living in the area
- Ratio of population to number of restaurants in the market area
- Traffic counts in front of similar restaurants in the area

**Qualitative Information**

- Government regulations, taxes, duties, tariffs, political involvement in business operations
- Property ownership restrictions
- Site visibility
- Accessibility of store location



- Training process for local managers
- Hiring process for employees
- Local customs and practices

Big Burgers has hired you as a consultant and given you an income statement comparing the operating incomes of its five restaurants in Eastern Europe. You have noticed that the Prague location is operating at a loss (including unallocated fixed costs) and must decide whether to recommend closing that restaurant.

Review the information used in making the decision to open the restaurant. Identify the types of information that would also be relevant in deciding whether to close the restaurant. What additional information would be relevant in making your decision?

**LO 1, 8** **Group Activity: Identifying Relevant Decision Information**

**C2. BUSINESS APPLICATION** ▶ Select two destinations for a one-week vacation, and gather information about them from brochures, magazines, travel agents, the Internet, and friends. Then list the relevant quantitative and qualitative information in order of its importance to your decision. Analyze the information, and select a destination.

Which factors were most important to your decision? Why? Which were least important? Why? How would the process of identifying relevant information differ if the president of your company asked you to prepare a budget for the next training meeting to be held at a location of your choice?

Your instructor will divide the class into groups and ask each group to discuss this case. One student from each group will summarize his or her group's findings and debrief the entire class.

**LO 6, 8** **Conceptual Understanding: Decision to Add a New Department**

**C3. (CMA adapted)** Cakes Company's management is considering a proposal to install a third production department in its factory building. With the company's existing production setup, direct materials are processed through the Mixing Department to produce Materials A and B in equal proportions. The Shaping Department then processes Material A to yield Product C. Material B is sold as is at \$20.25 per pound. Product C has a selling price of \$100.00 per pound. There is a proposal to add a Baking Department to process Material B into Product D. It is expected that any quantity of Product D can be sold for \$30.00 per pound.

Costs per pound under this proposal follow.

	<b>Mixing Department (Materials A and B)</b>	<b>Shaping Department (Product C)</b>	<b>Baking Department (Product D)</b>
Costs from Mixing Department	—	\$52.80	\$13.20
Direct materials	\$20.00	—	—
Direct labor	6.00	9.00	3.50
Variable overhead	4.00	8.00	4.00
Fixed overhead:			
Traceable (direct, avoidable)	2.25	2.25	1.80
Allocated (common, unavoidable)	0.75	0.75	0.75
<b>Totals</b>	<u>\$33.00</u>	<u>\$72.80</u>	<u>\$23.25</u>

1. If sales and production levels are expected to remain constant in the foreseeable future and there are no foreseeable alternative uses for the factory space, should Cakes Company add a Baking Department and produce Product D, if 100,000 pounds of D can be sold? Show calculations of incremental revenues and costs to support your answer.

*(Continued)*



2. **BUSINESS APPLICATION** ► List at least two qualitative reasons why Cakes Company may not want to install a Baking Department and produce Product D, even if this decision appears profitable.
3. **BUSINESS APPLICATION** ► List at least two qualitative reasons why Cakes Company may want to install a Baking Department and produce Product D, even if it appears that this decision is unprofitable.

**LO 7, 8** **Interpreting Management Reports: Capital Investment Analysis**

**C4.** Angelo Bank is planning to replace some old ATM machines and has decided to use the York Machine. Anita Chavez, the controller, has prepared the analysis shown here. She has recommended the purchase of the machine based on the positive net present value shown in the analysis.

The York Machine has an estimated useful life of five years and an expected residual value of \$35,000. Its purchase price is \$385,000. Two existing ATMs, each having a carrying value of \$25,000, can be sold to a neighboring bank for a total of \$50,000. Annual operating cash inflows are expected to increase in the following manner:

Year 1	\$79,900
Year 2	76,600
Year 3	79,900
Year 4	83,200
Year 5	86,500

Angelo Bank uses straight-line depreciation. The minimum rate of return is 12 percent.

**Angelo Bank  
Capital Investment Analysis  
Net Present Value Method**

Year	Net Cash Inflows	Present Value Factor	Present Value
1	\$85,000	0.909	\$ 77,265
2	80,000	0.826	66,080
3	85,000	0.751	63,835
4	90,000	0.683	61,470
5	95,000	0.621	58,995
5 (residual value)	35,000	0.621	21,735
Total present value			\$ 349,380
Initial investment		\$385,000	
Less proceeds from the sale of existing ATM machines		<u>50,000</u>	
Net capital investment			<u>(335,000)</u>
Net present value			<u>\$ 14,380</u>

1. Analyze Chavez's work. (Round to the nearest dollar.) What changes need to be made in her capital investment analysis?
2. What would be your recommendation to bank management about the purchase of the York Machine?

**LO 7, 8** **Ethical Dilemma: Capital Investment Decisions and the Globally Competitive Business Environment**

**C5.** Bramer Corporation's controller, Mara Jossen, was asked to prepare a capital investment analysis for a robot-guided aluminum window machine. This machine would automate the entire window-casing manufacturing line. She has just returned from an international seminar on the subject of qualitative inputs into the capital investment decision process and is eager to incorporate those new ideas into the analysis. In addition to the normal net present value analysis (which produced a significant negative result), Jossen factored in figures for customer satisfaction, scrap reduction, reduced inventory needs,

and reputation for quality. With the additional information included, the analysis produced a positive response to the decision question.

When the chief financial officer finished reviewing Jossen's work, he threw the papers on the floor and said, "What kind of garbage is this! You know it's impossible to quantify such things as customer satisfaction and reputation for quality. How do you expect me to go to the board of directors and explain your work? I want you to redo the entire analysis and follow only the traditional approach to net present value. Get it back to me in two hours!"

What is Jossen's dilemma? What ethical courses of action are available to her?

### Continuing Case: Cookie Company

**C6. Part 1: Short-Run Decision Analysis** As the CEO of your cookie company, you are interested in how public companies with a segment that includes cookies report their operating results. Because public companies are required to report on their segments, it is possible to evaluate the performance of comparable segments of different companies.

Access the website of **Kraft Foods, Inc.**, which markets Nabisco cookies ([www.kraftfoodscompany.com/About](http://www.kraftfoodscompany.com/About)), and the website of **Kellogg Company**, which markets Keebler cookies ([www.kelloggcompany.com](http://www.kelloggcompany.com)). Find information about these companies' major segments. Which segments are comparable, and which are not comparable? Which segments of these companies do you think include their brand of cookies?

**Part 2: Capital Budgeting** Suppose your cookie company is now a corporation that has granted franchises to more than 50 stores. Currently, only 10 of the 50 stores have computerized machines for mixing cookie dough. Because of a tremendous increase in demand for cookie dough, you, as the corporation's president, are considering purchasing 10 more computerized mixing machines by the end of this month. You are writing a memo evaluating this purchase that you will present at the board of directors' meeting next week.

According to your research, the 10 new machines will cost a total of \$320,000. They will function for an estimated five years and should have a total residual value of \$32,000. All of your corporation's capital investments are expected to produce a 20 percent minimum rate of return, and they should be recovered in three years or less. All fixed assets are depreciated using the straight-line method. The forecasted increase in operating results for the aggregate of the 10 new machines follows.

Cash Flow Estimates		
Year	Cash Inflows	Cash Outflows
1	\$310,000	\$210,000
2	325,000	220,000
3	340,000	230,000
4	300,000	210,000
5	260,000	180,000

- In preparation for writing your memo, answer the following questions:
  - What kinds of information do you need to prepare this memo?
  - Why is the information relevant?
  - Where would you find the information?
  - When would you want to obtain the information?
- Using the following methods, analyze the purchase of the machines and decide if your corporation should purchase them.
  - the net present value method (Round to the nearest dollar.)
  - the accounting rate-of-return method (Round percentages to one decimal place.)
  - the payback period method (Round to one decimal place.)



## Accounting for Investments

A company invests in the stock or debt securities of other firms for one or more of the following reasons:

- A company may temporarily have excess funds on which it can earn a return.
- Investments may be an integral part of the company's business, as in the case of a bank.
- A company may invest in other firms for the purpose of partnering with or controlling them.

### Concepts and Management Issues Related to Investments

*Recognition, valuation, classification, disclosure,* and ethics apply to accounting for investments.

#### Recognition

*Recognition* of investments as assets follows the general rule for recording transactions described earlier in the text. Purchases of investments are recorded on the date on which they are made, and sales of investments are reported on the date of sale. At the time of the transaction, there is either a transfer of funds or a definite obligation to pay. Income from investments is reported as other income on the income statement. Any gains or losses on investments are also reported on the income statement. Gains and losses appear as adjustments in the operating activities section of the statement of cash flows. The cash amounts of purchases and sales of investments appear in the investing activities section of the statement of cash flows.

#### Valuation

Like other purchase transactions, investments are *valued* according to the *cost principle*—that is, their cost at the time they are purchased. This cost includes any commissions or fees. However, after the purchase, the value of investments on the balance sheet is adjusted to reflect subsequent conditions, including the following:

- Changes in the market value or fair value of the investments
- Changes caused by the passage of time (as in amortization)
- Changes in the operations of the investee companies

Long-term investments must be evaluated annually for any impairment or decline in value that is more than temporary. If such an impairment exists, a loss on the investment must be recorded.

IFRS

Under certain conditions, companies are required to measure investments at fair value. Recall that *fair value* is defined as the *exchange price* associated with an actual or potential business transaction between market participants. This requirement applies to all types of investments, except an investment in a subsidiary that is consolidated with

the parent's financial statements. Fair value is not difficult to determine when there is a ready market in which there are buyers and sellers for an asset. However, if a ready market does not exist, another valuation technique must be used. For example, valuation might be determined by referring to the current fair value of another investment that is substantially the same. If that option is not available, valuation might be determined through discounted cash flow analysis.<sup>1</sup> Through the convergence project of the FASB and IASB, valuation practices under GAAP have come more in line with international financial reporting standards (IFRS).

## Classification

Investments in debt and equity securities are *classified* as either short-term or long-term. **Short-term investments** (or *marketable securities*) have a maturity of more than 90 days but are intended to be held only until cash is needed for current operations. (As pointed out in an earlier chapter, investments with a maturity of *less* than 90 days are classified as cash equivalents.) **Long-term investments**, which are intended to be held for more than one year, are reported in the investments section of the balance sheet. Although long-term investments may be just as marketable as short-term assets, management intends to hold them for an indefinite time.

Short-term and long-term investments must be further classified as trading securities, available-for-sale securities, or held-to-maturity securities.<sup>2</sup>

- **Trading securities** are debt or equity securities bought and held principally for the purpose of being sold in the near term.
- **Available-for-sale securities** are debt or equity securities that do not meet the criteria for either trading or held-to-maturity securities. They may be short- or long-term, depending on what management intends to do with them.
- **Held-to-maturity securities** are debt securities that management intends to hold until their maturity date.

Exhibit 1 illustrates the classification of short- and long-term investments.

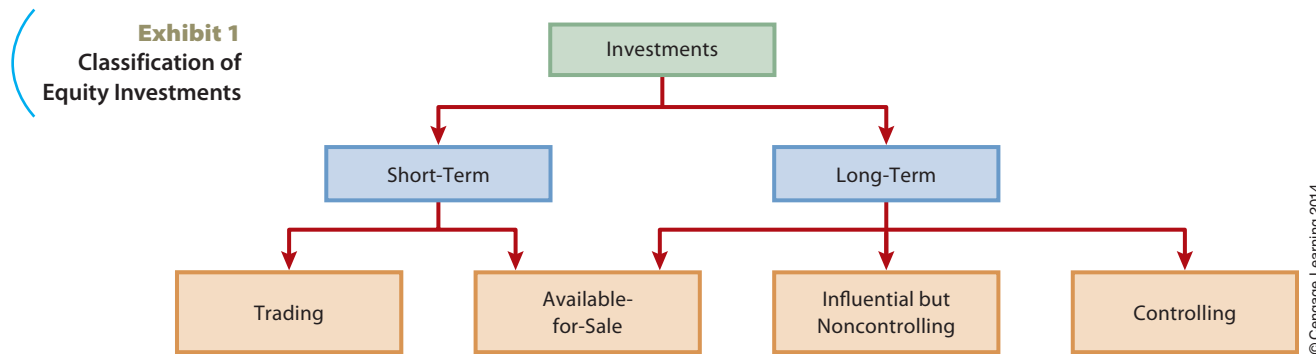


Exhibit 2 shows the accounting treatment of various levels of equity investments, that is, ownership of another company's stock. It also shows the relationship between the percentage of ownership in a company's stock and the investing company's level of control.

In general, the percentage of ownership in another company's stock has the following effects:

- **Noninfluential and noncontrolling investment:** A firm that owns less than 20 percent of the stock of another company has no influence on the other company's operations.
- **Influential but noncontrolling investment:** A firm that owns between 20 to 50 percent of another company's stock can exercise *significant influence* over that company's operating and financial policies, even though it holds 50 percent or less of

**Exhibit 2**  
Accounting for  
Equity Investments

Level of Control	Percentage of Ownership	Classification	Accounting Treatment
Noninfluential and noncontrolling	Less than 20%	Short-term investments—trading securities	Recorded at cost initially; cost adjusted after purchase for changes in market value; unrealized gains and losses reported on income statement
		Short-term or long-term investments—available-for-sale securities	Recorded at cost initially; cost adjusted for changes in market value with unrealized gains and losses to other comprehensive income
Influential but noncontrolling	Between 20% and 50%	Long-term investments	Equity method: recorded at cost initially; cost subsequently adjusted for investor's share of net income or loss and for dividends received
Controlling	More than 50%	Long-term investments	Financial statements consolidated

© Cengage Learning 2014

the voting stock. Indications of significant influence include representation on the board of directors, participation in policymaking, exchange of managerial personnel, and technological dependency between the two companies.

- **Controlling investment:** A firm that owns more than 50 percent of another company's stock.

## Disclosure

Companies provide detailed information about their investments and how they account for them in the notes to their financial statements. Such *disclosures* help users assess the impact of the investments.

## Ethics of Investing

When a company engages in investment transactions, there is always the possibility that its employees may use their knowledge about the transactions for personal gain. In the United States, **insider trading**, or making use of inside information for personal gain, is unethical and illegal. Before a publicly held company releases significant information about an investment to its stockholders and the general public, its officers and employees are not allowed to buy or sell stock in the company or in the firm whose shares the company is buying. Only after the information is released to the public can insiders engage in such trading. The Securities and Exchange Commission vigorously prosecutes any individual, whether employed by the company in question or not, who buys or sells shares of a publicly held company based on information not yet available to the public.

Not all countries prohibit insider trading. Until recently, insider trading was legal in Germany; but with the goal of expanding its securities markets, that country reformed its securities laws. It established the Federal Authority for Securities Trading (FAST), in part to oversee insider trading. However, historically, FAST devotes few staff members to investigations of insider trading, whereas the SEC has a much larger staff for these types of investigations.<sup>3</sup> Other countries continue to permit insider trading.

## Short-Term Investments in Trading Securities

As pointed out earlier, all trading securities are short-term investments, while available-for-sale securities may be either short-term or long-term.

### Trading Securities

Trading securities are always short-term investments and are frequently bought and sold to generate profits on short-term changes in their prices. They are *classified* as current assets on the balance sheet and are *valued* at fair value, which is usually the same as market value. An increase or decrease in the fair value of a company's total trading portfolio (the group of securities it holds for trading purposes) is included in net income in the period in which the increase or decrease occurs.

#### Purchase of Trading Securities

**Transaction** Jackson Company buys 10,000 shares of **IBM** for \$900,000 (\$90 per share) and 10,000 shares of **Microsoft** for \$300,000 (\$30 per share) on October 25, 2014. The purchase is made for trading purposes—that is, Jackson's management intends to realize a gain by holding the shares for only a short period.

**Analysis** The journal entry to record the investment at cost

- ▲ *increases Short-Term Investments* with a debit for the cost of \$1,200,000 (\$900,000 + \$300,000)
- ▼ *decreases Cash* with a credit of \$1,200,000

#### Journal Entry

**A** = **L** + **OE**  
 +1,200,000  
 -1,200,000

2014  
 Oct. 25 Short-Term Investments 1,200,000  
           Cash 1,200,000  
           To record investment in stocks for trading  
           (\$900,000 + \$300,000 = \$1,200,000)

**Comment** This investment is *classified* as short-term, because the intent is to resell the securities in the near future rather than to hold them for more than one year.

#### Year-End Valuation and Adjustment

**Transaction** At year-end, **IBM**'s stock price has decreased to \$80 per share and **Microsoft**'s has risen to \$32 per share. The trading portfolio is now *valued* at \$1,120,000:

Security	Market Value	Cost	Gain (Loss)
IBM (10,000 shares)	\$ 800,000	\$ 900,000	\$(100,000)
Microsoft (10,000 shares)	320,000	300,000	20,000
Totals	<u>\$1,120,000</u>	<u>\$1,200,000</u>	<u>\$ (80,000)</u>

**Analysis** Because the current fair value of the portfolio is \$80,000 less than the original cost of \$1,200,000, an *unrealized loss* has occurred. The journal entry to record the year-end adjustment

- ▲ *increases Unrealized Loss on Short-Term Investments* with a debit for the cost of \$80,000
- ▲ *increases Allowance to Adjust Short-Term Investments to Market* with a credit of \$80,000



$$\begin{array}{r}
 \mathbf{A} \\
 -80,000
 \end{array}
 =
 \begin{array}{r}
 \mathbf{L} \\
 \\
 \end{array}
 +
 \begin{array}{r}
 \mathbf{OE} \\
 -80,000
 \end{array}$$

**STUDY NOTE:** The Allowance to Adjust Short-Term Investments to Market account is never changed when securities are sold. It changes only when an adjusting entry is made at year-end.

### Journal Entry

2014			
Dec. 31	Unrealized Loss on Short-Term Investments	80,000	
	Allowance to Adjust Short-Term Investments to Market		80,000
	To record unrealized loss on trading portfolio		

**Comment** The unrealized loss will appear on the income statement as a reduction in income. The loss is unrealized because the securities have not been sold. If unrealized gains occur due to the increase in *value* of the portfolio, they are treated the same way.

The Allowance to Adjust Short-Term Investments to Market account appears on the balance sheet as a contra-asset, as follows.

Short-term investments (at cost)	\$1,200,000
Less allowance to adjust short-term investments to market	80,000
Short-term investments (at market)	<u>\$1,120,000</u>

Or, more simply:

Short-term investments (at market value, cost is \$1,200,000)	\$1,120,000
---	-------------

### Sale of Trading Securities

**Transaction** Jackson sells its 10,000 shares of **Microsoft** for \$35 per share on March 2, 2015.

**Analysis** The journal entry to record a realized gain on trading securities

- ▲ *increases Cash* with a debit for the selling price of \$350,000
- ▼ *decreases Short-Term Investments* with a credit of \$300,000
- ▲ *increases Gain on Sale of Investments* with a credit for the difference of \$50,000

### Journal Entry

2015			
Mar. 2	Cash	350,000	
	Short-Term Investments		300,000
	Gain on Sale of Investments		50,000
	To record sale of 10,000 shares of Microsoft for \$35 per share; cost was \$30 per share		

**Comment** The realized gain will appear on the income statement. The realized gain is unaffected by the adjustment for the unrealized loss at the end of 2014. The two transactions are treated independently. If the stock had been sold for less than cost, a realized loss on investments would have been recorded. Realized losses also appear on the income statement.

### Year-End Valuation and Adjustment

**Transaction** During 2015, Jackson buys 4,000 shares of **Apple** at \$32 per share and has no transactions involving its shares of **IBM**. By December 31, 2015, the price of IBM's stock has risen to \$95 per share, or \$5 per share more than the original cost, and Apple's stock price has fallen to \$29, or \$3 less than the original cost. We can now analyze Jackson's trading portfolio as follows.

Security	Market Value	Cost	Gain (Loss)
IBM (10,000 shares)	\$ 950,000	\$ 900,000	\$ 50,000
Apple (4,000 shares)	116,000	128,000	(12,000)
Totals	<u>\$1,066,000</u>	<u>\$1,028,000</u>	<u>\$ 38,000</u>

**Analysis** The market value of Jackson's trading portfolio now exceeds the cost by \$38,000 (\$1,066,000 – \$1,028,000). This amount represents the targeted ending balance for the Allowance to Adjust Short-Term Investments to Market account. Recall that at the end of 2014, that account had a credit balance of \$80,000, meaning that the market value of the trading portfolio was less than the cost. Because no entries are made to the account during 2015, it retains its balance until adjusting entries are made at the end of the year. The adjustment for 2015 must be \$118,000—enough to result in a debit balance of \$38,000 in the allowance account. The journal entry to record the year-end adjustment

▼ *decreases Allowance to Adjust Short-Term Investments to Market* with a debit of \$118,000

▲ *increases Unrealized Gain on Short-Term Investments* with a credit of \$118,000

### Journal Entry

$$\text{A} = \text{L} + \text{OE}$$

$$+118,000 = \quad +118,000$$

2015			
Dec. 31	Allowance to Adjust Short-Term Investments to Market	118,000	
	Unrealized Gain on Short-Term Investments		118,000
	To record unrealized gain on trading portfolio (\$80,000 + \$38,000 = \$118,000)		

**Comment** The 2015 ending balance of Jackson's allowance account can be determined as follows.

#### Allowance to Adjust Short-Term Investments to Market

Dec. 31, 2015 Adj.	118,000	Dec. 31, 2014 Bal.	80,000
Dec. 31, 2015 Bal.	38,000		

Short-term investments are presented on the balance sheet as follows.

Short-term investments (at cost)	\$1,028,000
Plus allowance to adjust short-term investments to market	<u>38,000</u>
Short-term investments (at market)	<u>\$1,066,000</u>

Or, more simply:

Short-term investments (at market value, cost is \$1,028,000)	\$1,066,000
---	-------------

## Available-for-Sale Securities

Short-term available-for-sale securities are accounted for in the same way as trading securities, with two exceptions:

- An unrealized gain or loss is reported as other comprehensive income (loss).
- If a decline in the value of a security is considered permanent, it is charged as a loss on the income statement.

## Long-Term Investments in Equity Securities

The accounting treatment of long-term investments in equity securities, such as common stock, depends on the extent to which the investing company can exercise control over the other company.

## Noninfluential and Noncontrolling Investment

As noted earlier, available-for-sale securities are debt or equity securities that cannot be *classified* as trading or held-to-maturity securities. When long-term equity securities are involved, a further criterion for classifying them as available for sale is that they be non-influential and noncontrolling investments of less than 20 percent of the voting stock. Accounting for long-term available-for-sale securities requires using the **cost-adjusted-to-market method**. With this method, the securities are initially recorded at cost and are thereafter adjusted periodically for changes in market value by using an allowance account.<sup>4</sup>

Available-for-sale securities are *classified* as long term if management *intends* to hold them for more than one year. When accounting for long-term available-for-sale securities, the unrealized gain or loss resulting from the adjustment is reported as other comprehensive income (loss).

At the end of each accounting period, the total cost and the total market value of these long-term investments must be determined. If the total market value is less than the total cost, the difference must be credited to a contra-asset account called Allowance to Adjust Long-Term Investments to Market. Because of the long-term nature of the investment, the debit part of the entry, which represents a decrease in value below cost, is treated as a temporary decrease and does not appear as a loss on the income statement. It is shown in an account called Unrealized Loss on Long-Term Investments.\* This account is reported on a statement of other comprehensive income. If the market value exceeds the cost, the allowance account is added to Long-Term Investments, and the unrealized gain appears on the statement of other comprehensive income.

When a company sells its long-term investments in stock, the difference between the sale price and the cost of the stock is recorded and reported as a realized gain or loss on the income statement. Dividend income from such investments is recorded by a debit to Cash and a credit to Dividend Income.

In the sections that follow, we show how to account for Nardini Corporation’s purchase and sale of long-term investments in equity securities of two corporations—Herald and Taza.

### Purchase of a Long-Term Investment

**Transaction** On June 1, 2014, Nardini Corporation paid cash for the following long-term investments: 10,000 shares of Herald Corporation common stock (representing 2 percent of outstanding stock) at \$25 per share; 5,000 shares of Taza Corporation common stock (representing 3 percent of outstanding stock) at \$15 per share.

**Analysis** The journal entry to record the investment at cost

▲ *increases Long-Term Investments* with a debit of \$325,000

▼ *decreases Cash* with a credit of \$325,000

### Journal Entry

**A** = **L** + **OE**  
 +325,000  
 -325,000

2014			
June 1	Long-Term Investments	325,000	
	Cash		325,000
	To record investments in Herald common stock (10,000 shares × \$25 = \$250,000) and Taza common stock (5,000 shares × \$15 = \$75,000)		

\* If the decrease in market value of a long-term investment is deemed permanent or if the investment is deemed impaired, the decline or impairment is recorded by debiting a loss account that will affect the income statement instead of the Unrealized Loss account.

**Comment** These investments are *classified* as long term because of management's intent to hold them more than one year.

### Year-End Adjustment

**Transaction** At the end of 2014, the market price of Herald's common stock is \$21; the market price of Taza's is \$17.

**Analysis** Nardini Corporation's trading portfolio is now *valued* at \$295,000:

Company	Shares	Market Price	Total Market	Total Cost
Herald	10,000	\$21	\$210,000	\$250,000
Taza	5,000	17	85,000	75,000
			<u>\$295,000</u>	<u>\$325,000</u>

Because the current fair value of the portfolio is \$30,000 less than the original cost of \$325,000, an *unrealized* loss has occurred. The journal entry to record the year-end adjustment

- ▲ *increases Unrealized Loss on Long-Term Investments* with a debit of \$30,000
- ▲ *increases Allowance to Adjust Long-Term Investments to Market* with a credit of \$30,000

### Journal Entry

$$\begin{array}{r} \mathbf{A} \\ -30,000 \end{array} = \begin{array}{r} \mathbf{L} \\ \phantom{-30,000} \end{array} + \begin{array}{r} \mathbf{OE} \\ -30,000 \end{array}$$

2014			
Dec. 31	Unrealized Loss on Long-Term Investments	30,000	
	Allowance to Adjust Long-Term Investments to Market		30,000
	To record reduction of long-term investment to market		

**Comment** As noted previously, the Unrealized Loss on Long-Term Investments does not appear on the income statement but appears on the statement of other comprehensive income. The Allowance to Adjust Long-Term Investments to Market is a contra-asset account that reduces investments on the balance sheet.

### Sale of a Long-Term Investment

**Transaction** On April 1, 2015, a change in policy required the sale of 2,000 shares of Herald common stock at \$23.

**Analysis** The journal entry to record this sale

- ▲ *increases Cash* with a debit for the selling price of \$46,000
- ▲ *increases Loss on Sale of Investments* with a debit of \$4,000
- ▼ *decreases Long-Term Investments* with a credit of \$50,000

### Journal Entry

$$\begin{array}{r} \mathbf{A} \\ +46,000 \\ -50,000 \end{array} = \begin{array}{r} \mathbf{L} \\ \phantom{+46,000} \\ -50,000 \end{array} + \begin{array}{r} \mathbf{OE} \\ -4,000 \end{array}$$

2015			
Apr. 1	Cash	46,000	
	Loss on Sale of Investments	4,000	
	Long-Term Investments*		50,000
	To record sale of 2,000 shares of Herald common stock		
	*2,000 × \$23 =	\$46,000	
	2,000 × \$25 =	<u>50,000</u>	
	Loss	<u>\$ 4,000</u>	

**Comment** Nardini's sale of stock was the result of a change in policy. This illustrates that *intent* is often the only difference between long-term investments and short-term investments.



The effects of these transactions on T accounts are as follows.

Allowance to Adjust Long-Term Investments to Market (A Contra-Asset Account)			
Dec. 31, 2015 Adj.	12,000	Dec. 31, 2014 Bal.	30,000
		Dec. 31, 2015 Bal.	18,000

Unrealized Loss on Long-Term Investments (A Contra-Equity Account)			
Dec. 31, 2014 Bal.	30,000	Dec. 31, 2015 Adj.	12,000
Dec. 31, 2015 Bal.	18,000		

The opposite effects will exist if market value exceeds cost, resulting in an unrealized gain.

## An Influential but Noncontrolling Investment

As noted, ownership of 20 percent or more of a company's voting stock is considered sufficient to influence the company's operations. When that is the case, the **equity method** should be used to account for the stock investment. The equity method presumes that an investment of 20 percent or more is not a passive investment and that the investor should therefore share proportionately in the success or failure of the company. The three main features of this method are as follows.

- The investor records the original purchase of the stock at cost.
- The investor records its share of the company's periodic net income as an increase in the Investment account, with a corresponding credit to an income account. Similarly, it records its share of a periodic loss as a decrease in the Investment account, with a corresponding debit to a loss account.
- When the investor receives a cash dividend, the Cash account is increased, and the Investment account is decreased.

In the sections that follow, we use the equity method to account for ITO Corporation's purchase and sale of long-term investments in equity securities.

### Purchase of an Equity Investment

**Transaction** On January 1 2014, ITO Corporation acquired 40 percent of Quay Corporation's voting common stock for \$180,000.

**Analysis** The journal entry to record the investment at cost

- ▲ *increases Investment in Quay Corporation* with a debit of \$180,000
- ▼ *decreases Cash* with a credit of \$180,000

### Journal Entry

**A** = **L** + **OE**  
 +180,000  
 -180,000

2014			
Jan. 1	Investment in Quay Corporation	180,000	
	Cash		180,000
	To record investment in Quay Corporation common stock for a 40 percent ownership		

**Comment** This entry is similar to the entries made for other investments, but note that with a 40 percent share of ownership, ITO can exert significant influence over Quay's operations.





company, a parent-subsidary relationship is said to exist. The investing company is the **parent company**; the other company is a **subsidiary**.

Because a parent company and its subsidiaries are separate legal entities, each prepares separate financial statements. However, because of their special relationship, they are viewed for external financial reporting purposes as a single economic entity. For this reason, the FASB requires that they combine their financial statements into a single set of statements called **consolidated financial statements**.\*\*

## Investments in Debt Securities

As noted in previous chapters, debt securities are considered financial instruments because they are claims that will be paid in cash. When a company purchases debt securities, it records them at cost plus any commissions and fees. Like investments in equity securities, short-term investments in debt securities are *valued* at fair value at the end of the period and are accounted for as trading securities or available-for-sale securities. However, the accounting treatment is different if they qualify as held-to-maturity securities.

### Held-to-Maturity Securities

As noted earlier, held-to-maturity securities are debt securities that management intends to hold to their maturity date. Such securities are recorded at cost and are *valued* on the balance sheet at cost adjusted for the effects of interest. In the sections that follow, we show how to account for the purchase and sale of investments in debt securities for Webber Company.

#### Purchase of Held-to-Maturity Securities

**Transaction** On December 1, 2014, Webber Company pays \$97,000 for U.S. Treasury bills, which are short-term debt of the federal government. The bills will mature in 120 days at \$100,000.

**Analysis** Webber would record the purchase much as it would other short-term investments. Thus, the journal entry to record the investment at cost

- ▲ *increases Short-Term Investments* with a debit for the cost of \$97,000
- ▼ *decreases Cash* with a credit for \$97,000

#### Journal Entry

**A** = **L** + **OE**  
 +97,000  
 -97,000

2014			
Dec. 1	Short-Term Investments	97,000	
	Cash		97,000
	To record purchase of U.S. Treasury bills that mature in 120 days		

**Comment** If the maturity date of the treasury bills were less than 90 days, they would be *classified* as cash equivalents, rather than short-term investments.

#### Year-End Accrual of Interest

**Transaction** At Webber's year-end on December 31, the interest income earned to date must be accrued in an adjusting entry.

**Analysis** The journal entry to record the year-end adjustment

- ▲ *increases Short-Term Investments* with a debit for the accrued interest of \$750 ( $\$3,000 \times 30/120$ )
- ▲ *increases Interest Income* with a credit for \$750

\*\*The concepts and procedures related to the preparation of consolidated financial statements are the subject of more advanced courses.

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+750				+750

**Journal Entry**

2014			
Dec. 31	Short-Term Investments	750	
	Interest Income		750
	To record accrual of interest on U.S. Treasury bills (\$3,000 × 30/120 = \$750)		

**Comment** On December 31, the U.S. Treasury bills would be shown on the balance sheet as a short-term investment at their amortized cost of \$97,750 (\$97,000 + \$750). The market *value* of the investment is ignored.

**Receipt of Interest**

**Transaction** On March 31, 2015, Webber receives the maturity value of the treasury notes.

**Analysis** The journal entry to record the receipt of interest

▲ *increases Cash* with a debit for the maturity value of \$100,000

▼ *decreases Short-Term Investments* with a credit for \$97,750

▲ *increases Interest Income* by a credit of the difference of \$2,250

**Journal Entry**

<b>A</b>	=	<b>L</b>	+	<b>OE</b>
+100,000				+2,250
-97,750				

2015			
Mar. 31	Cash	100,000	
	Short-Term Investments		97,750
	Interest Income		2,250
	To record receipt of cash at maturity of U.S. Treasury bills and recognition of related income		

**Comment** Note that the total interest income of \$3,000 has been divided into the amount earned in 2014 (\$750) and the amount earned in 2015 (\$2,250). There is no gain or loss on the transaction.

**Long-Term Investments in Bonds**

Like all investments, investments in bonds are recorded at cost, which, in this case, is the price of the bonds plus the broker's commission. When bonds are purchased between interest payment dates, the purchaser must also pay an amount equal to the interest that has accrued on the bonds since the last interest payment date. Then, on the next interest payment date, the purchaser receives an interest payment for the whole period. The payment for accrued interest should be recorded as a debit to Interest Income, which will be offset by a credit to Interest Income when the semiannual interest is received.

Subsequent accounting for a corporation's long-term bond investments depends on the *classification* of the bonds. If the company plans to hold the bonds until they are paid off on their maturity date, they are considered held-to-maturity securities. Except in industries like insurance and banking, it is unusual for companies to buy the bonds of other companies with the express purpose of holding them until they mature, which can be in 10 to 30 years. Thus, most long-term bond investments are classified as available-for-sale securities, meaning that the company plans to sell them at some point before their maturity date. Such bonds are accounted for at fair value, much as equity or stock investments are. Fair value is usually the market value. When bonds are intended to be held to maturity, they are accounted for not at fair value but at cost, adjusted for the amortization of their discount or premium. The procedure is similar to accounting for long-term bond liabilities, except that separate accounts for discounts and premiums are not used.

## Key Terms

**available-for-sale securities** 1132  
**consolidated financial statements** 1142  
**controlling investment** 1133  
**cost-adjusted-to-market method** 1137

**equity method** 1140  
**held-to-maturity securities** 1132  
**influential but noncontrolling investment** 1132  
**insider trading** 1133  
**long-term investments** 1132

**noninfluential and noncontrolling investment** 1132  
**parent company** 1142  
**short-term investments** 1132  
**subsidiary** 1142  
**trading securities** 1132

## Chapter Assignments

### DISCUSSION QUESTIONS

1. What is the role of fair value in accounting for investments?
2. What are the differences between trading securities, available-for-sale securities, and held-to-maturity securities?
3. Why are the level and percentage of ownership important in accounting for equity investments?
4. How are trading securities valued at the balance sheet date?
5. What are unrealized gains and losses on trading securities? On what statement are they reported?
6. How does accounting for available-for-sale securities differ from accounting for trading securities?
7. At what value are held-to-maturity securities shown on the balance sheet?

### PROBLEMS

#### Trading Securities

✓ 2: Total cost: \$408,000  
 ✓ 2: Total market: \$442,000

**P1.** Omar Corporation, which has begun investing in trading securities, engaged in the following transactions:

- Jan. 6 Purchased 7,000 shares of Quaker Oats stock, \$30 per share.  
 Feb. 15 Purchased 9,000 shares of EG&G, \$22 per share.

At year-end on June 30, Quaker Oats was trading at \$40 per share, and EG&G was trading at \$18 per share.

#### REQUIRED

1. Prepare journal entries to record the purchases.
2. Record the necessary year-end adjusting entry. (Include a schedule of the trading portfolio cost and market in the explanation.)
3. Prepare the journal entry to record the sale of all the EG&G shares on August 20 for \$16 per share. Is this entry affected by the June 30 adjustment?

## Methods of Accounting for Long-Term Investments

**P2.** L Teague Corporation has the following long-term investments:

Investment	Percentage of Ownership
1. Ariel Corporation common stock	60%
2. Copper, Inc. common stock	13%
3. Staffordshire Corporation nonvoting preferred stock	50%
4. EQ, Inc. common stock	100%
5. Rue de le Brasseur (of France) common stock	35%
6. Nova Scotia Cannery (of Canada) common stock	70%

### REQUIRED

For each of these investments, tell which of the following methods should be used for external financial reporting, and why:

- Cost-adjusted-to-market method
- Equity method
- Consolidation of parent and subsidiary financial statements

### Long-Term Investments

✓ Total unrealized loss: \$60,000

**P3.** Fulco Corporation has the following portfolio of long-term available-for-sale securities at year-end, December 31, 2014:

Company	Percentage of Voting Stock Held	Cost	Year-End Market Value
A Corporation	4%	\$ 80,000	\$ 95,000
B Corporation	12%	375,000	275,000
C Corporation	5%	30,000	55,000
Total		<u>\$485,000</u>	<u>\$425,000</u>

Both the Unrealized Loss on Long-Term Investments account and the Allowance to Adjust Long-Term Investments to Market account currently have a balance of \$40,000 from the last accounting period.

### REQUIRED

Prepare T accounts with a beginning balance for each of these accounts. Record the effects of the above information on the accounts, and determine the ending balances.

### Long-Term Investments: Cost-Adjusted-to-Market and Equity Methods

✓ Value of Curry: \$2,045,000

**P4.** On January 1, Rourke Corporation purchased, as long-term investments, 8 percent of the voting stock of Taglia Corporation for \$250,000 and 45 percent of the voting stock of Curry Corporation for \$2 million. During the year, Taglia had earnings of \$100,000 and paid dividends of \$40,000. Curry had earnings of \$300,000 and paid dividends of \$200,000. The market value did not change for either investment during the year.

### REQUIRED

Which of these investments should be accounted for using the cost-adjusted-to-market method? Which should be accounted for using the equity method? At what amount should each investment be carried on the balance sheet at year-end? Give your reasoning for each choice.

### Held-to-Maturity Securities

SPREADSHEET

✓ 2014 Interest Income: \$2,000

**P5.** Dale Company experiences heavy sales in the summer and early fall, after which time it has excess cash to invest until the next spring. On November 1, 2014, the company invested \$194,000 in U.S. Treasury bills. The bills mature in 180 days at \$200,000.

### REQUIRED

Prepare journal entries to record the purchase on November 1; the adjustment to accrue interest on December 31, which is the end of the fiscal year; and the receipt of cash at the maturity date of April 30, 2015.

## SPREADSHEET

✓ 2: Adjustment to decrease investments: \$7,200,000

### Comprehensive: Accounting for Investments

**P6.** Gulf Coast Corporation is a successful oil and gas exploration business in the southwestern United States. At the beginning of 2014, the company made investments in three companies that perform services in the oil and gas industry. The details of each of these investments follow.

Gulf Coast purchased 100,000 shares of Marsh Service Corporation at a cost of \$16 per share. Marsh has 1.5 million shares outstanding and, during 2014, paid dividends of \$0.80 per share on earnings of \$1.60 per share. At the end of the year, Marsh's shares were selling for \$24 per share.

Gulf Coast also purchased 2 million shares of Crescent Drilling Company at \$8 per share. Crescent has 10 million shares outstanding. In 2014, Crescent paid a dividend of \$0.40 per share on earnings of \$0.80 per share. During the year, the president of Gulf Coast was appointed to Crescent's board of directors. At the end of the year, Crescent's stock was selling for \$12 per share.

In another action, Gulf Coast purchased 1 million shares of Logan Oil Field Supplies Company's 5 million outstanding shares at \$12 per share. The president of Gulf Coast sought membership on Logan's board of directors but was rebuffed when a majority of shareholders stated they did not want to be associated with Gulf Coast. Therefore, Gulf Coast did not gain a significant influence over Logan. Logan paid a dividend of \$0.80 per share and reported a net income of only \$0.40 per share for the year. By the end of the year, its stock price had dropped to \$4 per share.

#### REQUIRED

- For each investment, prepare journal entries to record the (a) initial investment, (b) receipt of cash dividend, and (c) recognition of income (if appropriate).
- What adjusting entry (if any) is required at the end of the year?
- Assuming that Gulf Coast sells its investment in Logan after the first of the year for \$6 per share, what journal entry would be made?
- Assuming no other transactions occur and that the market value of Gulf Coast's investment in Marsh exceeds cost by \$2,400,000 at the end of the second year, what adjusting entry (if any) would be required?
- What principal factors were considered in determining how to account for Gulf Coast's investments? Should they be shown on the balance sheet as short-term or long-term investments? What factors affect this decision?

### Long-Term Investments: Equity Method

✓ 1: Ending balance: \$734,000

**P7.** Rylander Corporation owns 35 percent of the voting stock of Waters Corporation. The Investment account on Rylander's books as of January 1, 2014 was \$720,000. During 2014, Waters reported the following quarterly earnings and dividends:

Quarter	Earnings	Dividends Paid
1	\$160,000	\$100,000
2	240,000	100,000
3	120,000	100,000
4	(80,000)	100,000
	<u>\$440,000</u>	<u>\$400,000</u>

Because of the percentage of voting shares Rylander owns, it can exercise significant influence over Waters' operations. Therefore, Rylander must account for the investment using the equity method.

#### REQUIRED

- Prepare a T account for Rylander's investment in Waters, and enter the beginning balance, the relevant entries for the year in total, and the ending balance.
- What is the effect and placement of the entries in requirement 1 on Rylander's earnings as reported on the income statement?
- What is the effect and placement of the entries in requirement 1 on the statement of cash flows?
- How would the effects on the statements differ if Rylander's ownership represented only a 15 percent share of Waters?

# APPENDIX B

## The Time Value of Money

The **time value of money** is the concept that cash flows of equal dollar amounts separated by an interval of time have different present values because of the effect of compound interest. The notions of interest, present value, present value of an ordinary annuity, and annuity due are all related to the time value of money.

### Interest

**STUDY NOTE:** Interest is a cost associated with the passage of time, whether or not there is a stated interest rate.

**Interest** is the cost associated with the use of money for a specific period of time.

#### Simple Interest

**Measure Simple interest** is the interest cost for one or more periods when the amount on which the interest is computed stays the same from period to period.

**Example** If you accept an 8 percent, \$30,000 note due in 90 days, how much will you receive in total when the note comes due?

$$\begin{aligned}\text{Interest Expense} &= \text{Principal} \times \text{Rate} \times \text{Time} \\ &= \$30,000 \times 8/100 \times 90/360 \\ &= \underline{\$600}\end{aligned}$$

The total that you will receive is computed as follows.

$$\begin{aligned}\text{Total} &= \text{Principal} + \text{Interest} \\ &= \$30,000 + \$600 \\ &= \underline{\$30,600}\end{aligned}$$

#### Compound Interest

**Measure Compound interest** is the interest cost for two or more periods when the amount on which interest is computed includes all interest paid in previous periods.

**Example** You make a deposit of \$5,000 in a savings account that pays 6 percent interest. You expect to leave the principal and accumulated interest in the account for three years. What will be your account balance at the end of the three years? Assuming that the interest is paid at the end of the year, that the interest is added to the principal at that time, and that this total in turn earns interest, the amount at the end of three years is computed as follows.

(1) Year	(2) Principal Amount at Beginning of Year	(3) Annual Amount of Interest (Col. 2 × 0.06)	(4) Accumulated Amount at End of Year (Col. 2 + Col. 3)
1	\$5,000.00	\$300.00	\$5,300.00
2	5,300.00	318.00	5,618.00
3	5,618.00	337.08	5,955.08

At the end of three years, you will have \$5,955.08 in your savings account.

## Present Value

### Present Value

**Measure Present value** is the amount that must be invested today at a given rate of compound interest to produce a given value at a future date.

**Example** Home State Bank needs \$1,000 one year from now. How much should it invest today to achieve that goal if the interest rate is 5 percent?

$$\begin{aligned}\text{Present Value} \times (1.0 + \text{Interest Rate}) &= \text{Future Value} \\ \text{Present Value} \times 1.05 &= \$1,000.00 \\ \text{Present Value} &= \$1,000.00 \div 1.05 \\ &= \underline{\underline{\$952.38^*}}\end{aligned}$$

\*Rounded

Thus, to achieve a future value of \$1,000.00, a present value of \$952.38 must be invested. Interest of 5 percent on \$952.38 for one year equals \$47.62, and the two amounts added together equal \$1,000.00.

### Present Value of a Single Sum Due in the Future

**Measure** Present value that must be invested today at a given rate of compound interest to produce a given value at a date multiple time periods in the future.

**Example** Home State Bank wants to be sure of having \$4,000 at the end of three years. How much must the company invest today in a 5 percent savings account to achieve that goal?

**Manual Computation** By adapting the preceding equation, the present value of \$4,000 at compound interest of 5 percent for three years in the future may be computed as follows.

Year	Amount at End of Year	÷	1.0 + Interest Rate	=	Present Value at Beginning of Year
3	\$4,000.00	÷	1.05	=	\$3,809.52
2	3,809.52	÷	1.05	=	3,628.11
1	3,628.11	÷	1.05	=	3,455.34

Home State Bank must invest a present value of \$3,455.34 to achieve a future value of \$4,000 in three years.

**Table Computation** Table 1 is used to compute the value today of a single amount of cash to be received sometime in the future. To use Table 1, you must first know (1) the time period in years until funds will be received, (2) the stated annual rate of interest, and (3) the dollar amount to be received at the end of the time period.

In Table 1, look down the 5 percent column, finding the row for period 3. The factor there is 0.864. Multiplied by \$1, this factor gives the present value of \$1 to be received three years from now at 5 percent interest. For Home State Bank, the present value would be solved as follows.

$$\begin{aligned}\text{Present Value} &= \text{Future Value} \times \text{Present Value Factor} \\ &= \$4,000 \times 0.864 \\ &= \underline{\underline{\$3,456}}\end{aligned}$$

Except for a rounding difference of \$0.66, this gives the same result as the previous calculation.

The factor values for Table 1 are:

$$\text{PV Factor} = (1 + r)^{-n}$$

Where  $r$  is the rate of interest and  $n$  is the number of time periods.



**STUDY NOTE:** The first payment of an ordinary annuity is always made at the end of the first year.

### Present Value of an Ordinary Annuity

**Measure** When we calculate the present value of equal amounts equally spaced over a period of time, we are computing the present value of an ordinary annuity. An **ordinary annuity** is a series of equal payments or receipts that will begin one time period from the current date.

**Example** Home State Bank has sold a piece of property and is to receive \$15,000 in three equal annual cash payments of \$5,000, beginning one year from today. What is the present value of this sale, assuming a current interest rate of 5 percent?

**Manual Computation** This present value can be determined by calculating a separate present value for each of the three payments (using Table 1) and summing the results, as follows.

Future Cash Receipts (Annuity)					
Year 1	Year 2	Year 3		Present Value Factor at 5 Percent (from Table 1)	Present Value
\$5,000			×	0.952	\$ 4,760
	\$5,000		×	0.907	4,535
		\$5,000	×	0.864	4,320
Total present value					<u>\$13,615</u>

The present value of this sale is \$13,615. Thus, there is an implied interest cost (given the 5 percent rate) of \$1,385 associated with the payment plan that allows the purchaser to pay in three installments.

**Table Computation** Table 2 is used to compute the present value of a series of equal annual cash flows. Using Table 2, look down the 5 percent column, finding the row for period 3. The factor there is 2.723. That factor, when multiplied by \$1, gives the present value of a series of three \$1 payments, spaced one year apart, at compound interest of 5 percent. For Home State Bank, the present value would be solved as follows.

$$\begin{aligned}
 \text{Present Value} &= \text{Periodic Payment} \times \text{Present Value Factor} \\
 &= \$5,000 \times 2.723 \\
 &= \underline{\underline{\$13,615}}
 \end{aligned}$$

This result is the same as the one computed earlier.

The factor values for Table 2 are:

$$\text{PV Factor} = \frac{1 - (1 + r)^{-n}}{r}$$

Where  $r$  is the rate of interest and  $n$  is the number of time periods.

To summarize, if Home State Bank is willing to accept a 5 percent rate of return, management will be equally satisfied to receive a single cash payment of \$13,615 today or three equal annual cash payments of \$5,000 spread over the next three years.

### Present Value of an Annuity Due

**Measure** An **annuity due** is a series of equal cash flows for  $N$  time periods, but the first payment occurs immediately. The present value of the first payment equals the face value of the cash flow; Table 2 then is used to measure the present value of  $N - 1$  remaining cash flows.

**Table Computation** Home State Bank will make 20 lease payments; each payment of \$10,000 is due on January 1, beginning in 2014. Determine the present value on January 1, 2014, assuming an interest rate of 8 percent.

$$\begin{aligned}
 \text{Present Value} &= \text{Immediate Payment} + \text{Present Value of 19 Subsequent Payments at 8\%} \\
 &= \$10,000 + (\$10,000 \times 9.604) \\
 &= \underline{\underline{\$106,040}}
 \end{aligned}$$

## APPLY IT!

For each of the following situations, identify the correct factor(s) to use from Table 1 or 2. Then use the factor(s) to compute the appropriate present value.

1. Annual net cash inflows of \$35,000 for five years, discounted at 16 percent
2. An amount of \$25,000 to be received at the end of ten years, discounted at 12 percent
3. The amount of \$28,000 to be received at the end of two years, and \$15,000 to be received at the end of years 4, 5, and 6, discounted at 10 percent.
4. The amount of 10 payments of \$5,000 due on January 1, beginning immediately in 2014. Assume an interest rate of 10 percent.

### SOLUTION

1. From Table 2, use factor 3.274, as follows.

$$\$35,000 \times 3.274 = \underline{\$114,590} \text{ present value}$$

**TABLE 1**  
Present Value of \$1 to Be Received at the End of a Given Number of Time Periods

Periods	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	12%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909	0.893
2	0.980	0.961	0.943	0.925	0.907	0.890	0.873	0.857	0.842	0.826	0.797
3	0.971	0.942	0.915	0.889	0.864	0.840	0.816	0.794	0.772	0.751	0.712
4	0.961	0.924	0.888	0.855	0.823	0.792	0.763	0.735	0.708	0.683	0.636
5	0.951	0.906	0.883	0.822	0.784	0.747	0.713	0.681	0.650	0.621	0.567
6	0.942	0.888	0.837	0.790	0.746	0.705	0.666	0.630	0.596	0.564	0.507
7	0.933	0.871	0.813	0.760	0.711	0.665	0.623	0.583	0.547	0.513	0.452
8	0.923	0.853	0.789	0.731	0.677	0.627	0.582	0.540	0.502	0.467	0.404
9	0.914	0.837	0.766	0.703	0.645	0.592	0.544	0.500	0.460	0.424	0.361
10	0.905	0.820	0.744	0.676	0.614	0.558	0.508	0.463	0.422	0.386	0.322
11	0.896	0.804	0.722	0.650	0.585	0.527	0.475	0.429	0.388	0.350	0.287
12	0.887	0.788	0.701	0.625	0.557	0.497	0.444	0.397	0.356	0.319	0.257
13	0.879	0.773	0.681	0.601	0.530	0.469	0.415	0.368	0.326	0.290	0.229
14	0.870	0.758	0.661	0.577	0.505	0.442	0.388	0.340	0.299	0.263	0.205
15	0.861	0.743	0.642	0.555	0.481	0.417	0.362	0.315	0.275	0.239	0.183
16	0.853	0.728	0.623	0.534	0.458	0.394	0.339	0.292	0.252	0.218	0.163
17	0.844	0.714	0.605	0.513	0.436	0.371	0.317	0.270	0.231	0.198	0.146
18	0.836	0.700	0.587	0.494	0.416	0.350	0.296	0.250	0.212	0.180	0.130
19	0.828	0.686	0.570	0.475	0.396	0.331	0.277	0.232	0.194	0.164	0.116
20	0.820	0.673	0.554	0.456	0.377	0.312	0.258	0.215	0.178	0.149	0.104
21	0.811	0.660	0.538	0.439	0.359	0.294	0.242	0.199	0.164	0.135	0.093
22	0.803	0.647	0.522	0.422	0.342	0.278	0.226	0.184	0.150	0.123	0.083
23	0.795	0.634	0.507	0.406	0.326	0.262	0.211	0.170	0.138	0.112	0.074
24	0.788	0.622	0.492	0.390	0.310	0.247	0.197	0.158	0.126	0.102	0.066
25	0.780	0.610	0.478	0.375	0.295	0.233	0.184	0.146	0.116	0.092	0.059
26	0.772	0.598	0.464	0.361	0.281	0.220	0.172	0.135	0.106	0.084	0.053
27	0.764	0.586	0.450	0.347	0.268	0.207	0.161	0.125	0.098	0.076	0.047
28	0.757	0.574	0.437	0.333	0.255	0.196	0.150	0.116	0.090	0.069	0.042
29	0.749	0.563	0.424	0.321	0.243	0.185	0.141	0.107	0.082	0.063	0.037
30	0.742	0.552	0.412	0.308	0.231	0.174	0.131	0.099	0.075	0.057	0.033
40	0.672	0.453	0.307	0.208	0.142	0.097	0.067	0.046	0.032	0.022	0.011
50	0.608	0.372	0.228	0.141	0.087	0.054	0.034	0.021	0.013	0.009	0.003

2. From Table 1, use factor 0.322, as follows.

$$\$25,000 \times 0.322 = \underline{\$8,050} \text{ present value}$$

3. From Table 1, use the factors indicated in the table below.

Amount to Be Received	×	Present Value Factor	=	Present Value
\$28,000	×	0.826	=	\$23,128
15,000	×	0.683	=	10,245
15,000	×	0.621	=	9,315
15,000	×	0.564	=	8,460
Total				<u>\$51,148</u>

4. From Table 2, use factor 5.759 as follows.

$$\$5,000 + (\$5,000 \times 5.759) = \underline{\$33,795}$$

**TABLE 1**  
Present Value of \$1 to Be Received at the End of a Given Number of Time Periods (Continued)

14%	15%	16%	18%	20%	25%	30%	35%	40%	45%	50%	Periods
0.877	0.870	0.862	0.847	0.833	0.800	0.769	0.741	0.714	0.690	0.667	1
0.769	0.756	0.743	0.718	0.694	0.640	0.592	0.549	0.510	0.476	0.444	2
0.675	0.658	0.641	0.609	0.579	0.512	0.455	0.406	0.364	0.328	0.296	3
0.592	0.572	0.552	0.516	0.482	0.410	0.350	0.301	0.260	0.226	0.198	4
0.519	0.497	0.476	0.437	0.402	0.328	0.269	0.223	0.186	0.156	0.132	5
0.456	0.432	0.410	0.370	0.335	0.262	0.207	0.165	0.133	0.108	0.088	6
0.400	0.376	0.354	0.314	0.279	0.210	0.159	0.122	0.095	0.074	0.059	7
0.351	0.327	0.305	0.266	0.233	0.168	0.123	0.091	0.068	0.051	0.039	8
0.308	0.284	0.263	0.225	0.194	0.134	0.094	0.067	0.048	0.035	0.026	9
0.270	0.247	0.227	0.191	0.162	0.107	0.073	0.050	0.035	0.024	0.017	10
0.237	0.215	0.195	0.162	0.135	0.086	0.056	0.037	0.025	0.017	0.012	11
0.208	0.187	0.168	0.137	0.112	0.069	0.043	0.027	0.018	0.012	0.008	12
0.182	0.163	0.145	0.116	0.093	0.055	0.033	0.020	0.013	0.008	0.005	13
0.160	0.141	0.125	0.099	0.078	0.044	0.025	0.015	0.009	0.006	0.003	14
0.140	0.123	0.108	0.084	0.065	0.035	0.020	0.011	0.006	0.004	0.002	15
0.123	0.107	0.093	0.071	0.054	0.028	0.015	0.008	0.005	0.003	0.002	16
0.108	0.093	0.080	0.060	0.045	0.023	0.012	0.006	0.003	0.002	0.001	17
0.095	0.081	0.069	0.051	0.038	0.018	0.009	0.005	0.002	0.001	0.001	18
0.083	0.070	0.060	0.043	0.031	0.014	0.007	0.003	0.002	0.001		19
0.073	0.061	0.051	0.037	0.026	0.012	0.005	0.002	0.001	0.001		20
0.064	0.053	0.044	0.031	0.022	0.009	0.004	0.002	0.001			21
0.056	0.046	0.038	0.026	0.018	0.007	0.003	0.001	0.001			22
0.049	0.040	0.033	0.022	0.015	0.006	0.002	0.001				23
0.043	0.035	0.028	0.019	0.013	0.005	0.002	0.001				24
0.038	0.030	0.024	0.016	0.010	0.004	0.001	0.001				25
0.033	0.026	0.021	0.014	0.009	0.003	0.001					26
0.029	0.023	0.018	0.011	0.007	0.002	0.001					27
0.026	0.020	0.016	0.010	0.006	0.002	0.001					28
0.022	0.017	0.014	0.008	0.005	0.002						29
0.020	0.015	0.012	0.007	0.004	0.001						30
0.005	0.004	0.003	0.001	0.001							40
0.001	0.001	0.001									50

**TABLE 2**  
Present Value of \$1 Received Each Period for a Given Number of Time Periods

Periods	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%	12%
1	0.990	0.980	0.971	0.962	0.952	0.943	0.935	0.926	0.917	0.909	0.893
2	1.970	1.942	1.913	1.886	1.859	1.833	1.808	1.783	1.759	1.736	1.690
3	2.941	2.884	2.829	2.775	2.723	2.673	2.624	2.577	2.531	2.487	2.402
4	3.902	3.808	3.717	3.630	3.546	3.465	3.387	3.312	3.240	3.170	3.037
5	4.853	4.713	4.580	4.452	4.329	4.212	4.100	3.993	3.890	3.791	3.605
6	5.795	5.601	5.417	5.242	5.076	4.917	4.767	4.623	4.486	4.355	4.111
7	6.728	6.472	6.230	6.002	5.786	5.582	5.389	5.206	5.033	4.868	4.564
8	7.652	7.325	7.020	6.733	6.463	6.210	5.971	5.747	5.535	5.335	4.968
9	8.566	8.162	7.786	7.435	7.108	6.802	6.515	6.247	5.995	5.759	5.328
10	9.471	8.983	8.530	8.111	7.722	7.360	7.024	6.710	6.418	6.145	5.650
11	10.368	9.787	9.253	8.760	8.306	7.887	7.499	7.139	6.805	6.495	5.938
12	11.255	10.575	9.954	9.385	8.863	8.384	7.943	7.536	7.161	6.814	6.194
13	12.134	11.348	10.635	9.986	9.394	8.853	8.358	7.904	7.487	7.103	6.424
14	13.004	12.106	11.296	10.563	9.899	9.295	8.745	8.244	7.786	7.367	6.628
15	13.865	12.849	11.938	11.118	10.380	9.712	9.108	8.559	8.061	7.606	6.811
16	14.718	13.578	12.561	11.652	10.838	10.106	9.447	8.851	8.313	7.824	6.974
17	15.562	14.292	13.166	12.166	11.274	10.477	9.763	9.122	8.544	8.022	7.120
18	16.398	14.992	13.754	12.659	11.690	10.828	10.059	9.372	8.756	8.201	7.250
19	17.226	15.678	14.324	13.134	12.085	11.158	10.336	9.604	8.950	8.365	7.366
20	18.046	16.351	14.878	13.590	12.462	11.470	10.594	9.818	9.129	8.514	7.469
21	18.857	17.011	15.415	14.029	12.821	11.764	10.836	10.017	9.292	8.649	7.562
22	19.660	17.658	15.937	14.451	13.163	12.042	11.061	10.201	9.442	8.772	7.645
23	20.456	18.292	16.444	14.857	13.489	12.303	11.272	10.371	9.580	8.883	7.718
24	21.243	18.914	16.936	15.247	13.799	12.550	11.469	10.529	9.707	8.985	7.784
25	22.023	19.523	17.413	15.622	14.094	12.783	11.654	10.675	9.823	9.077	7.843
26	22.795	20.121	17.877	15.983	14.375	13.003	11.826	10.810	9.929	9.161	7.896
27	23.560	20.707	18.327	16.330	14.643	13.211	11.987	10.935	10.027	9.237	7.943
28	24.316	21.281	18.764	16.663	14.898	13.406	12.137	11.051	10.116	9.307	7.984
29	25.066	21.844	19.189	16.984	15.141	13.591	12.278	11.158	10.198	9.370	8.022
30	25.808	22.396	19.600	17.292	15.373	13.765	12.409	11.258	10.274	9.427	8.055
40	32.835	27.355	23.115	19.793	17.159	15.046	13.332	11.925	10.757	9.779	8.244
50	39.196	31.424	25.730	21.482	18.256	15.762	13.801	12.234	10.962	9.915	8.305

**TABLE 2**  
Present Value of \$1 Received Each Period for a Given Number of Time Periods (Continued)

14%	15%	16%	18%	20%	25%	30%	35%	40%	45%	50%	Periods
0.877	0.870	0.862	0.847	0.833	0.800	0.769	0.741	0.714	0.690	0.667	1
1.647	1.626	1.605	1.566	1.528	1.440	1.361	1.289	1.224	1.165	1.111	2
2.322	2.283	2.246	2.174	2.106	1.952	1.816	1.696	1.589	1.493	1.407	3
2.914	2.855	2.798	2.690	2.589	2.362	2.166	1.997	1.849	1.720	1.605	4
3.433	3.352	3.274	3.127	2.991	2.689	2.436	2.220	2.035	1.876	1.737	5
3.889	3.784	3.685	3.498	3.326	2.951	2.643	2.385	2.168	1.983	1.824	6
4.288	4.160	4.039	3.812	3.605	3.161	2.802	2.508	2.263	2.057	1.883	7
4.639	4.487	4.344	4.078	3.837	3.329	2.925	2.598	2.331	2.109	1.922	8
4.946	4.772	4.607	4.303	4.031	3.463	3.019	2.665	2.379	2.144	1.948	9
5.216	5.019	4.833	4.494	4.192	3.571	3.092	2.715	2.414	2.168	1.965	10
5.453	5.234	5.029	4.656	4.327	3.656	3.147	2.752	2.438	2.185	1.977	11
5.660	5.421	5.197	4.793	4.439	3.725	3.190	2.779	2.456	2.197	1.985	12
5.842	5.583	5.342	4.910	4.533	3.780	3.223	2.799	2.469	2.204	1.990	13
6.002	5.724	5.468	5.008	4.611	3.824	3.249	2.814	2.478	2.210	1.993	14
6.142	5.847	5.575	5.092	4.675	3.859	3.268	2.825	2.484	2.214	1.995	15
6.265	5.954	5.669	5.162	4.730	3.887	3.283	2.834	2.489	2.216	1.997	16
6.373	6.047	5.749	5.222	4.775	3.910	3.295	2.840	2.492	2.218	1.998	17
6.467	6.128	5.818	5.273	4.812	3.928	3.304	2.844	2.494	2.219	1.999	18
6.550	6.198	5.877	5.316	4.844	3.942	3.311	2.848	2.496	2.220	1.999	19
6.623	6.259	5.929	5.353	4.870	3.954	3.316	2.850	2.497	2.221	1.999	20
6.687	6.312	5.973	5.384	4.891	3.963	3.320	2.852	2.498	2.221	2.000	21
6.743	6.359	6.011	5.410	4.909	3.970	3.323	2.853	2.498	2.222	2.000	22
6.792	6.399	6.044	5.432	4.925	3.976	3.325	2.854	2.499	2.222	2.000	23
6.835	6.434	6.073	5.451	4.973	3.981	3.327	2.855	2.499	2.222	2.000	24
6.873	6.464	6.097	5.467	4.948	3.985	3.329	2.856	2.499	2.222	2.000	25
6.906	6.491	6.118	5.480	4.956	3.988	3.330	2.856	2.500	2.222	2.000	26
6.935	6.514	6.136	5.492	4.964	3.990	3.331	2.856	2.500	2.222	2.000	27
6.961	6.534	6.152	5.502	4.970	3.992	3.331	2.857	2.500	2.222	2.000	28
6.983	6.551	6.166	5.510	4.975	3.994	3.332	2.857	2.500	2.222	2.000	29
7.003	6.566	6.177	5.517	4.979	3.995	3.332	2.857	2.500	2.222	2.000	30
7.105	6.642	6.234	5.548	4.997	3.999	3.333	2.857	2.500	2.222	2.000	40
7.133	6.661	6.246	5.554	4.999	4.000	3.333	2.857	2.500	2.222	2.000	50

# ENDNOTES

## Chapter 1

- 1 Based on *Statement of Financial Accounting Concepts No. 1*, “Objectives of Financial Reporting by Business Enterprises” (Norwalk, Conn.: Financial Accounting Standards Board, 1978), par. 9.
- 2 Ibid.
- 3 Information based on ExxonMobil, Form 10-K, For the Fiscal Year Ended December 31, 2011, and International Monetary Fund’s World Economic Outlook Database.
- 4 *Accounting Principles Board Statement No. 4*, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises” (New York: AICPA, 1970), par. 138.
- 5 Based on Securities and Exchange Commission, *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by US Issuers*, August 2008.
- 6 Based on “Brand Research Shows CPAs Viewed Positively in Marketplace,” *AICPA News Update*, October 20, 2008.
- 7 Based on *Statement Number 1C*, “Standards of Ethical Conduct for Management Accountants” (Montvale, N.J.: Institute of Management Accountants, 1983; revised 1997).
- 8 CVS Corporation, Earnings Release, February 8, 2012.
- 9 Based on National Commission on Fraudulent Financial Reporting, *Report of the National Commission on Fraudulent Financial Reporting* (Washington, D.C.: 1987), p. 2.
- 10 Target Corporation, Form 10-K, For the Fiscal Year Ended January 29, 2011.
- 11 Costco Wholesale Corporation, *Annual Report*, 2011.
- 12 Southwest Airlines Co., *Annual Report*, 1996.

## Chapter 2

- 1 ASC 820 and IFRS 13.
- 2 Based on *Statement of Financial Accounting Standards No. 157*, “Fair Value Measurements” (Norwalk, Conn.: Financial Accounting Standards Board, 2007).
- 3 The Boeing Company, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 4 Ibid.
- 5 Data from The Bank of New York Mellon Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2011.

## Chapter 3

- 1 Based on Securities and Exchange Commission, *Staff Accounting Bulletin No. 10*, 1999.
- 2 In our discussion, we assume that the amount of depreciation has been established.
- 3 Based on Netflix, Inc., Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 4 Based on Ken Brown, “Wall Street Plays Numbers Games with Savings, Despite Reforms,” *The Wall Street Journal*, July 22, 2003.
- 5 Based on Mark S. Beasley and others, “Fraudulent Financial Reporting 1998–2007: An Analysis of U.S. Companies,” *Committee of Sponsoring Organizations*, 2010, p. 3.
- 6 Based on “Microsoft Settles with SEC,” *CBSNews.com*, June 5, 2002.
- 7 Data from Lyric Opera of Chicago, Financial Statements, April 30, 2011.
- 8 Data from The Walt Disney Company, Form 10-K, For the Fiscal Year Ended October 1, 2011.

## Chapter 4

- 1 Based on Zahary Coffin, “The Top Ten Effects of XBRL: The Future of Internet Reporting,” p. 1, [circa.europa.eu/irc](http://circa.europa.eu/irc).

## Chapter 5

- 1 <http://www.fasb.org>, July 12, 2008.
- 2 *Statement of Financial Accounting Concepts No. 1*, “Objectives of Financial Reporting by Business Enterprises” (Norwalk, Conn.: Financial Accounting Standards Board, 1978), pars. 32–54.

- 3 *Statement of Financial Accounting Concepts No. 2*, “Qualitative Characteristics of Accounting Information” (Norwalk, Conn.: Financial Accounting Standards Board, 1980), par. 20.
- 4 Based on L. Todd Johnson, “Relevance and Reliability,” *The FASB Report*, February 28, 2005.
- 5 Based on Securities and Exchange Commission, *Staff Accounting Bulletin No. 99*, 1999.
- 6 *Accounting Principles Board, Opinion No. 20*, “Accounting Changes” (New York: AICPA, 1971), par. 17.
- 7 Based on Ray J. Groves, “Here’s the Annual Report. Got a Few Hours?” *The Wall Street Journal Europe*, August 26–27, 1994.
- 8 Roger Lowenstein, “Intrinsic Value: Investors Will Fish for Footnotes in ‘Abbreviated’ Annual Reports,” *The Wall Street Journal*, September 14, 1995.
- 9 Dell Computer Corporation, Form 10-K, For the Fiscal Year Ended January 31, 2011.
- 10 Based on “Ex-Chief of WorldCom Is Found Guilty in \$11 Billion Fraud,” *The New York Times*, March 16, 2005.
- 11 Based on Roger Lowenstein, “Intrinsic Value: The ‘20% Club’ No Longer Is Exclusive,” *The Wall Street Journal*, May 4, 1995.
- 12 Based on Securities and Exchange Commission, *Staff Accounting Bulletin No. 99*, 1999.

## Chapter 6

- 1 Based on “Credit Card Statistics,” *CreditCards.com*, April 21, 2012.
- 2 For a comparison of complete journal entries made under the perpetual and periodic inventory systems, see the Review Problem in this chapter.
- 3 Based on Rafael Solorzano, “Forecast of E-Commerce Sales for 2011 and Beyond,” [www.fortune3.com](http://www.fortune3.com), January 27, 2011.
- 4 Based on Joel Millman, “Here’s What Happens to Many Lovely Gifts After Santa Rides Off,” *The Wall Street Journal*, December 26, 2001.
- 5 Based on Matthew Rose, “Magazine Revenue at Newsstands Falls in Worst Year Ever,” *The Wall Street Journal*, May 15, 2001.
- 6 Helpful ratios for calculating the three components of the financing period will be covered in subsequent chapters on inventories, receivables, and current liabilities.

## Chapter 7

- 1 Data from Toyota Motor Corporation, Form 10-K, For the Fiscal Year Ended March 31, 2011.
- 2 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 3 Toyota Motor Corporation, Form 10-K, For the Fiscal Year Ended March 31, 2011.
- 4 Based on Ernst & Young, *U.S. GAAP vs. IFRS: The Basics*, 2007.
- 5 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 6 Based on Dell Computer, Form 10-K, For the Fiscal Year Ended February 3, 2012.
- 7 Based on Securities and Exchange Commission, SEC Announces Fraud Charges Against Former Rite Aid Senior Management, June 21, 2002.
- 8 Based on Highbeam Research, “Former Rent-Way Executive Gets Prison, Fine in Fraud Case,” November 23, 2003.
- 9 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2008).
- 10 Data from ExxonMobil Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2006.
- 11 Data from ExxonMobil Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 12 Data from Walgreen Co., Form 10-K, For the Fiscal Year Ended August 31, 2011.

## Chapter 8

- 1 Based on Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control—Integrated Framework, 1985–2012*.
- 2 Based on *Professional Standards*, vol. 1, Sec. AU 325.16.



- 3 Based on Elizabeth Woyke, “Attention Shoplifters,” *BusinessWeek*, September 11, 2006.
- 4 Based on Grant Thornton, “Understanding and Preventing Retail Fraud,” National Retail Federation, April 2009.
- 5 Based on Tom Lauricella, Shafali Anand, and Valerie Bauerlein, “A \$34 Billion Cash Fund to Close Up,” *The Wall Street Journal*, December 11, 2007.
- 6 Nike, Inc., Form 10-K, For the Fiscal Year Ended May 31, 2012.
- 7 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 8 Based on “Credit Card Statistics,” *CreditCards.com*, April 21, 2011.
- 9 Costco Wholesale Corporation, Form 10-K, For the Fiscal Year Ended August 28, 2011.
- 10 Ibid.
- 11 Based on Committee of Sponsoring Organizations of the Treadway Commission, “Press Release: Financial Fraud at U.S. Public Companies,” May 20, 2010.
- 12 Based on Amy Merrick, “Starbucks Accuses Employee, Husband of Embezzling \$3.7 Million from Firm,” *The Wall Street Journal*, November 20, 2000.

## Chapter 9

- 1 Based on Jesse Drucker, “Sprint Expects Loss of Subscribers,” *The Wall Street Journal*, September 24, 2002.
- 2 Based on International Accounting Standards Board, *Framework for the Preparation and Presentation of Financial Statements* (October 2008).
- 3 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2010).
- 4 Based on “Bad Loans Rattle Telecom Vendors,” *BusinessWeek*, February 19, 2001.
- 5 Based on Scott Thurm, “Better Debt Bolsters Bottom Lines,” *The Wall Street Journal*, August 18, 2003.
- 6 Based on Circuit City Stores, Inc., Form 10-K, For the Fiscal Year Ended February 28, 2005.
- 7 Based on Deborah Solomon and Damian Paletta, “U.S. Drafts Sweeping Plans to Fight Crisis as Turmoil worsens in Credit Markets,” *The Wall Street Journal*, September 19, 2008.
- 8 Based on Heather Timmons, “Do Household’s Numbers Add Up?” *BusinessWeek*, December 10, 2001.
- 9 Based on Steve Daniels, “Bank One Reserves Feed Earnings,” *Crain’s Chicago Business*, December 15, 2003.
- 10 Based on Jonathon Weil, “Accounting Scheme Was Straightforward but Hard to Detect,” *The Wall Street Journal*, March 20, 2003.
- 11 Nike, Inc., Form 10-K, For the Fiscal Year Ended May 31, 2012.
- 12 Information based on promotional brochures of Mitsubishi Corp.
- 13 Based on Elizabeth McDonald, “Unhatched Chickens,” *Forbes*, February 19, 2001.
- 14 Based on CompuCredit Holdings Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2009.
- 15 Data from Walgreen Co., Form 10-K, For the Fiscal Year Ended August 31, 2011.

## Chapter 10

- 1 Based on *Statement of Financial Accounting Standard No. 144*, “Accounting for the Impairment or Disposal of Long-Lived Assets” (Norwalk, Conn.: Financial Accounting Standards Board, 2001).
- 2 Based on Edward J. Riedl, “An Examination of Long-lived Asset Impairments,” *The Accounting Review*, Vol. 79, No. 3, pp. 823–852.
- 3 Based on *Statement of Financial Accounting Standards No. 34*, “Capitalization of Interest Cost” (Norwalk, Conn.: Financial Accounting Standards Board, 1979), pars. 9–11.
- 4 Leasehold improvements are sometimes included in the intangible assets section because they revert to the lessor and are therefore more of a right than a physical asset.
- 5 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 6 Ibid.
- 7 This method of revising depreciation is used widely in industry and is supported by *Opinion No. 9* and *Opinion No. 20* of the Accounting Principles Board.
- 8 Some special rules apply and are addressed in more advanced courses.

- 9 If the useful life of a plant asset is less than the expected life of the resource, the shorter life should be used to compute depreciation, using straight-line or declining-balance methods.
- 10 Based on *Statement of Financial Accounting Standards No. 25*, “Suspension of Certain Accounting Requirements for Oil and Gas Producing Companies” (Norwalk, Conn.: Financial Accounting Standards Board, 1979).
- 11 Based on Jonathan Weil, “Oil Reserves Can Sure Be Slick,” *The Wall Street Journal*, March 11, 2004.
- 12 Based on *Statement of Financial Accounting Standards No. 142*, “Goodwill and Other Intangible Assets” (Norwalk, Conn.: Financial Accounting Standards Board, 2001), pars. 11–17.
- 13 Based on “BrandZ Top 100 Most Valuable Global Brands 2011,” [www.millardbrown.com](http://www.millardbrown.com), 2011.
- 14 Note that if the company developed the bottle cap internally instead of purchasing the patent, the costs of developing the cap—such as researchers’ salaries and the costs of supplies and equipment used in testing—would be expensed as incurred.
- 15 Data from General Motors Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 16 Data from Abbott Laboratories, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 17 Based on *Statement of Financial Accounting Standards No. 2*, “Accounting for Research and Development Costs” (Norwalk, Conn.: Financial Accounting Standards Board, 1974), par. 12.
- 18 Based on *Statement of Financial Accounting Standards No. 86*, “Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed” (Norwalk, Conn.: Financial Accounting Standards Board, 1985).
- 19 Based on *Statement of Financial Accounting Standards No. 142*, “Goodwill and Other Intangible Assets” (Norwalk, Conn.: Financial Accounting Standards Board, 2001), pars. 11–17.
- 20 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 21 Data from General Mills, Inc., *Quarterly Report*, 2012; H.J. Heinz Company, Form 10-K, For the Fiscal Year Ended April 29, 2012; Cisco Systems, *Quarterly Report*, 2012.
- 22 Based on Southwest Airlines Co., *Annual Report*, 2002.
- 23 Costco Wholesale Corporation, Form 10-K, For the Fiscal Year Ended August 28, 2011.
- 24 International Business Machines Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 25 Data from Starwood Hotel & Resorts Worldwide, Inc., Form 10-K, For the Fiscal Year Ended December 21, 2011; Marriott International, Inc., Form 10-K, For the Fiscal Year Ended December 30, 2011.

## Chapter 11

- 1 The Hershey Company, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 2 Based on “Small Business Poll on Compensating Employees,” quoted on [sbinformation.about.com](http://sbinformation.about.com), June 6, 2010.
- 3 The Hershey Company, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 4 Based on “Press Room,” [www.webfyer.com](http://www.webfyer.com), January 4, 2010.
- 5 Based on “Overview of U.S. Coupon Distribution and Redemption Trends,” March 29, 2012, NCH Marketing Services, [www.nchmarketing.com](http://www.nchmarketing.com).
- 6 Based on *Statement of Financial Accounting Standards No. 5*, “Accounting for Contingencies” (Norwalk, Conn.: Financial Accounting Standards Board, 1975).
- 7 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2012).
- 8 Microsoft Corporation, Form 10-K, For the Fiscal Year Ended June 30, 2011.
- 9 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2012).
- 10 Data from Microsoft Corporation, Form 10-K, For the Fiscal Year Ended June 30, 2011.
- 11 Based on *Accounting Standards Codification (ASC) 820*, “Fair Value Measurements and Disclosures [Norwalk, Conn.: Financial Accounting Standards Board, revised by Accounting Standards Update (ASU 2011-04 in 2011)].
- 12 Based on *Accounting Standards Codification (ASC) 820*, “Fair Value Measurements and Disclosures [Norwalk, Conn.: Financial Accounting Standards Board, revised by Accounting Standards Update (ASU 2011-04 in 2011)] and IFRS 13, “Fair Value Measurement,” International Accounting Standards Board, (2011).



- 13 Based on “Clarifications on Fair-Value Accounting,” U.S. Securities and Exchange Commission, *Release 2008-234*, October 1, 2008.
- 14 Data from WorldCom (MCI, Inc.), Form 10-K, For the Fiscal Year Ended December 31, 2004.
- 15 Advertisement, *Chicago Tribune*, December 2007.
- 16 Data from Oracle Corporation, Form 10-K, For the Fiscal Year Ended May 31, 2011; Cisco Systems, Inc., Form 10-K, For the Fiscal Year Ended July 30, 2011.

## Chapter 12

- 1 Based on “Nokia Unveils Plans for Chinese Centre,” *Financial Times London*, May 9, 2000.

## Chapter 13

- 1 Based on “Key Stats,” Securities Industry and Financial Markets Association, April 2012.
- 2 Based on “The FASB’s Basic Ownership Approach and a Reclassification of Preferred Stock as a Liability,” *www.cfo.com*, July 18, 2008.
- 3 Based on Amir Efrati, “Google Preserves Cash and Control,” *The Wall Street Journal*, April 13, 2012.
- 4 Based on Michael Rapaport and Jonathan Weil, “More Truth-in-Labeling for Accounting Carries Liabilities,” *The Wall Street Journal*, August 23, 2003.
- 5 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 6 Data from Abbott Laboratories, Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 7 Based on American Institute of Certified Public Accountants, *Accounting Research Bulletin No. 43* (New York: AICPA, 1953), chap. 7, sec. B, par. 10.
- 8 Based on American Institute of Certified Public Accountants, *Accounting Research Bulletin No. 43* (New York: AICPA, 1953), chap. 7, sec. B, par. 13.
- 9 Based on Nike, Inc., Form 10-K, For the Fiscal Year Ended May 31, 2007.
- 10 Based on Yahoo! Finance.com, June 3, 2012.
- 11 Based on “General Mills Declares Two-for-One Stock Split,” *MarketWatch.com*, May 3, 2010.
- 12 Data from Microsoft Corporation, Form 10-K, For the Fiscal Year Ended June 30, 2011.
- 13 Ibid.
- 14 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 15 Data from Google, Inc., Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 16 Based on “Spotlight on Stock Options Backdating,” *www.sec.gov*, 2010.
- 17 Based on Mariss Marr, “Dreamworks Shares Rise 38% on First Day,” *The Wall Street Journal*, October 10, 2004; Yahoo! Finance.com, December 26, 2007.
- 18 Data from IBM Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2009; Based on “IBM Board Approves \$5 Billion for Stock Repurchase,” *www.wopular.com*, June 17, 2010.
- 19 Based on Yahoo! Finance.com, 2007.

## Chapter 14

- 1 Data from Southwest Airlines, Form 10-K, For the Fiscal Year Ended December 31, 2011. We cover deferred income taxes in greater detail in a later chapter.
- 2 Based on Mary Williams Walsh, “\$53 Billion Shortfall for New Jersey Retiree Care,” *The New York Times*, July 25, 2007.
- 3 Based on *www.morningstar.com*, May 9, 2012.
- 4 Based on Accounting Principles Board, *Opinion No. 21*, “Interest on Receivables and Payables” (New York: AICPA, 1971), par. 15.
- 5 Based on *Statement of Financial Accounting Standards No. 13*, “Accounting for Leases” (Norwalk, Conn.: Financial Accounting Standards Board, 1976), par. 10.
- 6 Based on *Statement of Financial Accounting Standards No. 158*, “Employers’ Accounting for Defined Benefit Pension and Other Postretirement Plans” (Norwalk, Conn.: Financial Accounting Standards Board, 2007).
- 7 Based on Lee Hawkins, Jr., “S&P Cuts Rating on GM and Ford to Junk Status,” *The Wall Street Journal*, May 6, 2005.
- 8 Data from McDonald’s, Inc., Form 10-K, For the Fiscal Year Ended December 31, 2011.
- 9 Based on Tom Sullivan and Sonia Ryst, “Kodak \$1 Billion Issue Draws Crowds,” *The Wall Street Journal*, October 8, 2003.

- 10 Adapted from quotations in *The Wall Street Journal Online*, December 18, 2007.
- 11 Data from Intel Corporation, Form 10-K, For the Fiscal Year Ended December 31, 2011.

## Chapter 15

- 1 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011).
- 2 Based on Martin Peers and Robin Sidel, “WorldCom Causes Analysts to Evaluate EBITDA’s Role,” *The Wall Street Journal*, July 15, 2002.
- 3 Based on Ian McDonald, “Companies Are Rolling in Cash. Too Bad,” *The Wall Street Journal*, August 20, 2006; Justin Lahart, “U.S. Firms Build Up Record Cash Piles,” *The Wall Street Journal*, June 11, 2010.
- 4 Based on Lulu Chang, “Companies Hoarding Cash,” *CNBC*, July 19, 2010.
- 5 Based on “Free Cash Flow Standouts,” *Upside Newsletter*, October 3, 2005.
- 6 Amazon.com, *Form 10-K*, For the Fiscal Year Ended December 31, 2011.
- 7 Gary Slutsker, “Look at the Birdie and Say: ‘Cash Flow,’” *Forbes*, October 25, 1993.
- 8 Jonathan Clements, “Yacktman Fund Is Bloodied but Unbowed,” *The Wall Street Journal*, November 8, 1993.
- 9 Jeffery Laderman, “Earnings, Schmearnings—Look at the Cash,” *BusinessWeek*, July 24, 1989.
- 10 Amazon.com, *Form 10-K*, For the Fiscal Year Ended December 31, 2011.
- 11 Data from Fleetwood Enterprises, Inc., *10Q*, July 29, 2001.
- 12 Enron Corporation, *Press Release*, October 16, 2001.

## Chapter 16

- 1 Based on “Fourteen Key Business Ratios,” *dnb.com*, 2012.
- 2 Based on *Statement of Financial Accounting Standards No. 131*, “Segment Disclosures” (Norwalk, Conn.: Financial Accounting Standards Board, 1997).
- 3 Based on Belverd E. Needles, Jr., Anton Shigaev, Marian Powers, and Mark L. Frigo, “Strategy and Integrated Financial Ratio Performance Measures: A Longitudinal Multi-Country Study of High Performance Companies,” in *Studies in Financial and Managerial Accounting*, vol. 20, edited by Marc Epstein and Jean-Francois Manzoni (London: JAI Elsevier Science Ltd., 2010), pp. 211–252.
- 4 Based on Belverd E. Needles, Jr., Marian Powers, and Mark L. Frigo, “Performance Measurement and Executive Compensation: Practices of High Performance Companies,” in *Studies in Financial and Managerial Accounting*, vol. 18, edited by Marc Epstein and Jean-Francois Manzoni (London: JAI Elsevier Science Ltd., 2008).
- 5 Based on Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011.
- 6 Ibid.
- 7 Based on “After Charge for Licensing, McDonald’s Posts a Record Loss,” *The New York Times*, July 25, 2007; Christina Cheddar Berk, “Campbell’s Profit Jumps 31 Percent,” *The Wall Street Journal*, November 22, 2005.
- 8 Based on American Institute of Certified Public Accountants, *Accounting Trends & Techniques* (New York: AICPA, 2011); Starbucks Corporation, Form 10-K, For the Fiscal Year Ended October 2, 2011. Starbucks Corporation, Form 10-K, For the Fiscal Year Ended September 27, 2009.
- 9 Based on Jonathan Weil, “Pro Forma in Earnings Reports?... As If,” *The Wall Street Journal*, April 24, 2003.
- 10 Based on David Henry, “The Numbers Game,” *BusinessWeek*, May 14, 2001.
- 11 Starbucks Corporation, *Proxy Statement*, 2011.
- 12 Ibid.
- 13 Ibid.
- 14 Based on “Technology Firms Post Strong Earnings but Stock Prices Decline Sharply,” *The Wall Street Journal*, January 21, 1988; Donald R. Seace, “Industrials Plunge 57.2 Points—Technology Stocks’ Woes Cited,” *The Wall Street Journal*, January 21, 1988.

## Chapter 17

- 1 [http://imanet.org/about\\_ethics\\_statement.asp](http://imanet.org/about_ethics_statement.asp).
- 2 Based on Andrew Ross Sorkin, “Albertsons Nears Deal, Yet Again, To Sell Itself,” *The New York Times*, January 23, 2006.
- 3 Based on Karen Lundegaard, “Bumpy Ride,” *The Wall Street Journal*, May 21, 2001.
- 4 Based on Curtis C. Verschoor, “Economic Crime Results from Unethical Culture,” *Strategic Finance*, March 2009.
- 5 *Statement No. 1A* (New York: Institute of Management Accountants, 1982).

## Chapter 20

- 1 Adapted from “Just In Time, Toyota Production System & Lean Manufacturing,” [http://www.strategosinc.com/just\\_in\\_time.htm](http://www.strategosinc.com/just_in_time.htm).

## Chapter 22

- 1 Based on Omar Aguilar, “How Strategic Performance Management Is Helping Companies Create Business Value,” *Strategic Finance*, January 2003.
- 2 Jeremy Hope and Robin Frase, “Who Needs Budgets?” *Harvard Business Review*, February 2003.

## Chapter 23

- 1 EVA is a registered trademark of the consulting firm Stern Stewart & Company.

## Chapter 25

- 1 Based on Alan Fuhrman, “Your e-Banking Future,” *Strategic Finance*, April 2002.

## Appendix A

- 1 Based on *Statement of Financial Accounting Standards No. 157*, “Fair Value Measurements” (Norwalk, Conn.: Financial Accounting Standards Board, 2007); *Statement of Financial Accounting Standards No. 159*, “The Fair Value Option for Financial Assets and Financial Liabilities” (Norwalk, Conn.: Financial Accounting Standards Board, 2007).
- 2 Based on *Statement of Financial Accounting Standards No. 115*, “Accounting for Certain Investments in Debt and Equity Securities” (Norwalk, Conn.: Financial Accounting Standards Board, 1993).
- 3 Based on Greg Steinmetz and Cacilie Rohwedder, SAP Insider Probe Points to Reforms Needed in Germany,” *The Wall Street Journal*, May 8, 1997.
- 4 Based on *Statement of Financial Accounting Standards No. 115*, “Accounting for Certain Investments in Debt and Equity Securities” (Norwalk, Conn.: Financial Accounting Standards Board, 1993).

# GLOSSARY

- A**
- Accelerated method** A method of depreciation that allocates relatively large amounts of the depreciable cost of an asset to earlier years and smaller amounts to later years. (p. 377)
- Account balance** The difference in dollars between the total debit footing and the total credit footing of an account. (p. 44)
- Accounting** An information system that measures, processes, and communicates financial information about an economic entity. (p. 2)
- Accounting conventions** Rules of thumb, or general principles, for recording transactions and preparing financial statements. Also called *constraints*. (p. 172)
- Accounting cycle** A series of steps whose basic purpose is to produce financial statements for decision makers. (p. 46)
- Accounting equation** Assets = Liabilities + Owner's Equity. (p. 6)
- Accounting rate-of-return method** A method of evaluating capital investments designed to measure the estimated performance of a potential capital project. It is calculated by dividing the project's average annual net income by the average cost of the investment. (p. 1108)
- Accounts** Basic units for accumulating and storing accounting data from similar transactions. (p. 42)
- Accounts payable** Short-term obligations to suppliers for goods and services. Also called *trade accounts payable*. (p. 412)
- Accounts receivable** Short-term financial assets that arise from sales on credit at the wholesale or retail level. (p. 336)
- Accounts receivable aging method** A method of estimating uncollectible accounts based on the assumption that a predictable proportion of each dollar of accounts receivable outstanding will not be collected. (p. 341)
- Accrual** The recognition of an expense or revenue that has arisen but has not yet been recorded. (p. 91)
- Accrual accounting** Recording transactions in the periods in which they occur, rather than in the periods in which cash is received or paid. Also called the *matching rule*. (p. 87)
- Accrued expenses** Expenses incurred but not recorded in the accounts; unrecorded expenses. (p. 94)
- Accrued liabilities** Liabilities that are not already in the accounting records. (p. 414)
- Accrued revenues** Revenues for which a service has been performed or goods delivered but for which no entry has been made; unrecorded revenues. (p. 97)
- Accumulated Depreciation** Contra-asset accounts used to accumulate depreciation on specific long-term assets. (p. 93)
- Activity base** The activity for which relationships are established. Also called *denominator activity* or *cost driver*. (p. 924)
- Activity-based costing (ABC)** A method of assigning costs that calculates a more accurate product cost than traditional methods by categorizing all indirect costs by activity, tracing the indirect costs to those activities, and assigning those costs to products using a cost driver related to the cause of the cost. (pp. 817, 885)
- Activity-based management (ABM)** An approach to managing an organization that identifies all major operating activities, determines the resources consumed by each activity and the cause of the resource usage, categorizes the activities as either adding value to a product or service or not adding value, and seeks to reduce or eliminate non-value-adding activities. (p. 885)
- Actual costing method** A method of cost measurement that uses the actual costs of direct materials, direct labor, and overhead to calculate a product or service unit cost. (p. 775)
- Additions** Enlargements to the physical layout of a plant asset. (p. 370)
- Adjusted trial balance** A trial balance prepared after all adjusting entries have been recorded and posted to the accounts. (p. 99)
- Adjusting entries** Entries made to apply accrual accounting to transactions that span accounting periods. (p. 90)
- Aging of accounts receivable** The process of listing each customer's receivable account according to the due date of the account. (p. 341)
- Allowance for Uncollectible Accounts** A contra-asset account that reduces accounts receivable to the amount expected to be collected in cash. Also called *Allowance for Doubtful Accounts* and *Allowance for Bad Debts*. (p. 339)
- Allowance method** A method of accounting for uncollectible accounts by expensing estimated uncollectible accounts in the period in which the related sales take place. (p. 338)
- American Institute of Certified Public Accountants (AICPA)** The professional association of certified public accountants. (p. 13)
- Amortization** The periodic allocation of the cost of an intangible asset to the periods it benefits. (p. 368)
- Articles of incorporation** An official document filed with and approved by a state that authorizes the incorporators to do business as a corporation. (p. 492)
- Asset impairment** Loss of revenue-generating potential of a long-lived asset before the end of its useful life; the difference between an asset's carrying value and its fair value, as measured by the present value of the expected cash flows. (p. 369)
- Asset turnover** A measure of profitability that shows how efficiently assets are used to produce sales; calculated as Net Revenue ÷ Average Total Assets. (pp. 182, 671, 1015)
- Assets** The economic resources of a company that are expected to benefit future operations. (p. 6)
- Audit** An examination of a company's financial statements and the accounting systems, controls, and records that produced them in order to render an independent professional opinion about whether they have been presented fairly, in all material respects, in conformity with GAAP. (p. 12)

**Authorization** The approval of transactions or activities. (p. 303)

**Authorized shares** The maximum number of shares a corporation can issue without a change in its state charter. (p. 497)

**Average-cost method** An inventory costing method in which inventory is priced at the average cost of the goods available for sale during the period. (p. 269)

**Average costing method** A process costing method that assigns an average cost to all products made during an accounting period. (p. 846)

**Avoidable costs** Costs that can be eliminated by dropping a segment. (p. 1096)

## B

**Backflush costing** A product costing approach in which all product costs are first accumulated in the Cost of Goods Sold account and at the end of the period are “flushed back,” or worked backward, into the appropriate inventory accounts. (p. 893)

**Balance sheet** The financial statement that shows a business’s assets, liabilities, and owner’s equity as of a specific date. Also called the *statement of financial position*. (p. 8)

**Balanced scorecard** A framework that links the perspectives of an organization’s four basic stakeholder groups—financial (investors), learning and growth (employees), internal business processes, and customers—with the organization’s mission and vision, performance measures, strategic and tactical plans, and resources. (p. 1018)

**Bank reconciliation** The process of accounting for the difference between the balance appearing on a company’s bank statement and the balance in its Cash account. (p. 312)

**Bank statement** A printed or electronic record of the balance in a bank account and the amounts that have been paid into it and withdrawn from it over a given period of time. (p. 310)

**Base year** In financial analysis, the first year to be considered in any set of data. (p. 664)

**Batch-level activities** Activities performed each time a batch of goods is produced. (p. 886)

**Benchmarking** A technique for determining a company’s competitive advantage by comparing its performance with that of its closest competitors. (p. 1020)

**Benchmarks** Measures of the best practices in an industry. (p. 1020)

**Betterments** Improvements that do not add to the physical layout of a plant asset. (p. 370)

**Bill of activities** A list of activities and related costs that is used to compute the costs assigned to activities and the product unit cost. (p. 887)

**Board of directors** A group of individuals that are elected or appointed to oversee the activities of a corporation. (p. 492)

**Bond** A security, usually long term, representing money that a corporation or other entity borrows from the investing public. (p. 549)

**Bond certificate** Evidence of an organization’s debt to a bondholder. (p. 549)

**Bond indenture** A contract that defines the terms of a bond issue. (p. 549)

**Bond issue** The total value of bonds issued at one time. (p. 549)

**Bonding** The process of carefully checking an employee’s background and insuring the company against theft by that person. (p. 304)

**Bonds payable** The most common type of long-term debt for companies. (p. 546)

**Bonus** An amount that accrues to the original partners when a new partner pays more to the partnership than the interest received or that accrues to the new partner when the amount paid to the partnership is less than the interest received. (p. 463)

**Book value** A company’s total assets less its liabilities; stockholders’ equity or net assets. (p. 518)

**Book value per share** The equity of the owner of one share of stock in a corporation’s net assets. (p. 518)

**Bookkeeping** The process of recording financial transactions and keeping financial records. (p. 3)

**Brand name** A registered name that can be used only by its owner to identify a product or service. (p. 387)

**Breakeven point** The point at which total revenues equal total costs. (p. 931)

**Budget(s)** Plan of action based on forecasted transactions, activities, and

events; includes a forecasted income statement, statement of cash flows, and balance sheet. (pp. 778, 958)

**Budget committee** A committee made up of top management that has overall responsibility for budget implementation. (p. 978)

**Budgeted balance sheet** A statement that projects an organization’s financial position at the end of an accounting period. (p. 974)

**Budgeted income statement** A projection of an organization’s net income for an accounting period based on the revenues and expenses estimated for that accounting period. (p. 970)

**Budgeting** The process of identifying, gathering, summarizing, and communicating financial and nonfinancial information about an organization’s future activities. (p. 958)

**Business** An economic unit that aims to sell goods and services to customers at prices that will provide an adequate return to its owners. (p. 17)

**Business plan** A comprehensive statement of how a company will achieve its strategic, tactical, and operating objectives. (p. 778)

**Business transactions** Economic events that affect a business’s financial position and that should be recorded in the accounting records. (pp. 3, 40)

## C

**Call price** A specified price, usually above face value, at which a corporation can buy back its bonds before maturity. (p. 550)

**Callable bonds** Bonds that the issuing corporation can buy back and retire at a call price before their maturity dates. (p. 550)

**Callable preferred stock** Preferred stock that the issuing corporation can redeem or retire at a stated price. (p. 499)

**Capital expenditure** An expenditure for the purchase or expansion of a long-term asset, which is recorded in an asset account. (p. 370)

**Capital expenditures budget** A detailed plan outlining the anticipated amount and timing of capital outlays for long-term assets during an accounting period. (p. 971)

**Capital investment analysis** The process of making decisions about



- capital investments. It includes identifying the need for a capital investment, analyzing courses of action to meet that need, preparing reports for managers, choosing the best alternative, and dividing funds among competing needs. Also called *capital budgeting*. (p. 1090)
- Capital investment decisions** Management decisions about when and how much to spend on capital facilities and other long-term projects. (p. 1102)
- Capital lease** A long-term lease that resembles a purchase or sale on installment and in which the lessee assumes the risk of ownership. (p. 548)
- Carrying value** The unexpired portion of an asset's cost. Also called *book value*. (pp. 93, 369)
- Cash** Coins and currency on hand, checks and money orders from customers, and deposits in checking and savings accounts; for purposes of the statement of cash flows, both cash and cash equivalents. (p. 602)
- Cash basis of accounting** Accounting for revenues and expenses on a cash-received and cash-paid basis. (p. 88)
- Cash budget** A projection of the cash that an organization will receive and the cash that it will pay out during an accounting period. (p. 971)
- Cash dividends** A distribution of earnings to a corporation's stockholders; a corporation's board of directors has the sole authority to declare them. (p. 414)
- Cash equivalents** Short-term investments that will revert to cash in 90 days or less from the time they are purchased; examples include money market accounts, commercial paper, and U.S. Treasury bills. (pp. 311, 602)
- Cash flow yield** A measure of a company's ability to generate operating cash flows in relation to net income; calculated as Net Cash Flows from Operating Activities ÷ Net Income. (pp. 622, 673)
- Cash flows** The inflows and outflows of cash into and out of a business. (p. 10)
- Cash flows to assets** A measure of the ability of assets to generate operating cash flows; calculated as Net Cash Flows from Operating Activities ÷ Average Total Assets. (pp. 624, 674)
- Cash flows to sales** A measure of the ability of sales to generate operating cash flows; calculated as Net Cash Flows from Operating Activities ÷ Net Sales. (pp. 623, 673)
- Cash-generating efficiency** A company's ability to generate cash from its current or continuing operations. (p. 622)
- Cash payments journal** A journal used to record transactions involving payments of cash. Also called a *cash disbursements journal*. (p. 257)
- Cash receipts journal** A journal used to record transactions involving receipts of cash. (p. 254)
- Certified public accountant (CPA)** A public accountant who has met stringent state licensing requirements. (p. 12)
- Chart of accounts** A list of account numbers and titles that facilitates finding accounts in the ledger. (p. 42)
- Check** An authorization for the bank to pay the vendor in the amount of the invoice less any applicable discount. (p. 310)
- Check authorization** A form that an accounting department prepares after it has compared a receiving report with a purchase order and invoice and that authorizes the issuance of a check to pay the invoice. (p. 310)
- Classification** The process of assigning transactions to the appropriate accounts. (p. 41)
- Classified financial statements** General-purpose external financial statements that are divided into subcategories. (p. 175)
- Closing entries** Entries made at the end of an accounting period that set the stage for the next period by clearing temporary accounts of their balances and transferring them to the owner's Capital account; they summarize a period's revenues and expenses. (p. 132)
- Commercial paper** Unsecured loans sold to the public, usually through professionally managed investment firms, as a means of borrowing short-term funds. (p. 413)
- Commitment** A legal obligation that does not meet the technical requirements for recognition as a liability. (p. 425)
- Common-size statement** A financial statement in which the components are expressed as percentages of a total figure in the statement. (p. 667)
- Common stock** Shares of stock that carry voting rights but that rank below preferred stock in terms of dividends and the distribution of assets. (p. 497)
- Comparability** The convention of presenting information in a way that enables decision makers to recognize similarities, differences, and trends over different periods in the same company and among different companies. (p. 172)
- Compensation committee** A committee of independent directors appointed by a public corporation's board of directors to determine how top executives will be compensated. (p. 687)
- Complete information** All the information necessary for a reliable decision. (p. 172)
- Compound entry** A journal entry in which more than two accounts are involved. (p. 50)
- Compound interest** The interest cost for two or more periods when, after each period, the interest of that period is added to the amount on which interest is computed in future periods. (p. 426)
- Confirmative value** Information that confirms or changes previous evaluations. (p. 171)
- Conservatism** The convention that when faced with two equally acceptable alternatives, the accountant chooses the one least likely to overstate assets and income. (p. 173)
- Consignment** Merchandise that its owner (the consignor) places on the premises of another company (the consignee) with the understanding that payment is expected only when the merchandise is sold and that unsold items may be returned to the consignor. (p. 265)
- Consistency** The convention requiring that once a company has adopted an accounting procedure, it must use it from one period to the next unless a note to the financial statements informs users of a change in procedure. (pp. 172, 684)
- Contingent liability** A potential liability that arises from a past transaction and is dependent on a future event. (pp. 351, 424)
- Continuity** The difficulty associated with not knowing how long a business will survive. (p. 87)
- Continuous budget** A rolling 12-month budget that summarizes

- budgets for the next 12 months. Each month managers prepare a budget for that month, 12 months hence. (p. 978)
- Continuous improvement** The management concept that one should never be satisfied with what is, but should instead constantly seek improved efficiency and lower cost through better methods, products, services, processes, or resources. (p. 896)
- Contra account** An account whose balance is subtracted from an associated account in the financial statements. (p. 93)
- Contributed Capital** Assets that stockholders have invested in a corporation. Also called *Paid-in Capital*. (pp. 178, 492)
- Contribution margin (CM)** The amount that remains after all variable costs are subtracted from sales. (p. 929)
- Contribution margin income statement** An income statement that is formatted to emphasize cost behavior rather than organizational functions (sometimes referred to as a variable costing income statement). (p. 929)
- Control activities** Policies and procedures that management establishes to ensure that the objectives of internal control are met. (p. 303)
- Control environment** A company's ethics, philosophy and operating style, organizational structure, method of assigning authority and responsibility, and personnel policies and practices. (p. 303)
- Controllable costs and revenues** Costs and revenues that are the result of a manager's actions, influence, or decisions. (p. 1007)
- Controlling account** An account in the general ledger that maintains the total of the individual account balances in a subsidiary ledger. Also called *control account*. (p. 249)
- Conversion costs** The costs of converting direct materials into a finished product; the sum of direct labor costs and overhead costs. Also called *processing costs*. (pp. 764, 847, 894)
- Convertible bonds** Bonds that can be exchanged for the issuing corporation's common stock. (p. 550)
- Convertible preferred stock** Preferred stock that the owner can exchange for common stock. (p. 499)
- Copyright** An exclusive right granted by the federal government to reproduce and sell literary, musical, and other artistic materials and computer programs for a period of the author's life plus 70 years. (p. 387)
- Core competency** The activity that a company does best and that gives it an advantage over its competitors. (p. 882)
- Corporation** A business unit granted a state charter recognizing it as a separate legal entity having its own rights, privileges, and liabilities distinct from those of its owners. (p. 5)
- Cost** The net purchase price of an asset plus all reasonable and necessary expenditures to get it in place and ready for use. (p. 375)
- Cost allocation** The process of assigning a collection of indirect costs to a specific cost object using an allocation base known as a cost driver. (p. 813)
- Cost behavior** The way costs respond to changes in volume or activity. (p. 922)
- Cost-benefit** The convention that the benefits gained from providing accounting information should be greater than the costs of providing that information. Also called *cost constraint*. (p. 172)
- Cost center** A responsibility center whose manager is accountable only for controllable costs that have well-defined relationships between the center's resources and certain products or services. (p. 1008)
- Cost constraint** The convention that the benefits gained from providing accounting information should be greater than the costs of providing that information. Also called *cost-benefit*. (p. 172)
- Cost driver** An activity base that causes a cost pool to increase in amount as the cost driver increases in volume. (p. 813)
- Cost flow** The association of costs with their assumed flow versus their actual goods flow in the operations of a company. (p. 265)
- Cost hierarchy** A framework for classifying activities according to the level at which their costs are incurred. (p. 886)
- Cost object** The destination of an assigned, or allocated, cost. (p. 813)
- Cost of capital** The minimum desired rate of return on an investment, such as assets invested in an investment center. (p. 1017)
- Cost of goods available for sale** The sum of beginning inventory and the net cost of purchases during an accounting period. (p. 221)
- Cost of goods manufactured** The cost of all units completed and moved to Finished Goods Inventory during an accounting period. (p. 770)
- Cost of goods manufactured budget** A detailed plan that summarizes the estimated costs of production during an accounting period. (p. 968)
- Cost of goods sold** The amount a merchandiser paid for the merchandise it sold during an accounting period or the cost to a manufacturer of making the products it sold during an accounting period. Also called *cost of sales* or *cost of revenue*. (pp. 209, 770)
- Cost-plus contracts** Job contracts that require the customer to pay all costs incurred in performing the job plus a predetermined amount of profit. (p. 811)
- Cost pool** The collection of overhead costs assigned to a cost object. (p. 813)
- Cost principle** The practice of recording transactions at the exchange price at the point of recognition. (p. 41)
- Cost-volume-profit (CVP) analysis** An examination of the cost behavior patterns that underlie the relationships among cost, volume of output, and profit. (p. 931)
- Costs of quality** Both the costs of achieving quality and the costs of poor quality in the manufacture of a product or the delivery of a service. (p. 896)
- Coupon bonds** Bonds not registered with the issuing organization that bear coupons stating the amount of interest due and the payment date. (p. 551)
- Credit** The right side of an account. (p. 44)
- Creditors** Those who lend money or deliver goods and services to a company before being paid. (p. 16)
- Crossfooting** Adding and subtracting numbers across a row. (p. 145)

**Cumulative preferred stock** Preferred stock on which unpaid dividends accumulate over time and that must be satisfied before a dividend can be paid to common stockholders. (p. 498)

**Current assets** Cash and other assets that a company can reasonably expect to convert to cash, sell, or consume within one year or its normal operating cycle, whichever is longer. (p. 175)

**Current liabilities** Obligations due to be paid or performed within one year or within the normal operating cycle, whichever is longer. (pp. 177, 410)

**Current ratio** A measure of liquidity, or short-term debt-paying ability; calculated as Current Assets ÷ Current Liabilities. (pp. 180, 679)

**Customer list** A list of customers or subscribers. (p. 387)

## D

**Days' inventory on hand** A measure that shows the average number of days taken to sell inventory; calculated as Days in Accounting Period ÷ Inventory Turnover. (pp. 281, 677)

**Days' payable** A measure that shows the average number of days a company takes to pay its accounts payable; calculated as Days in Accounting Period ÷ Payables Turnover. (pp. 434, 679)

**Days' sales uncollected** A measure that shows the number of days, on average, that a company must wait to receive payment for credit sales; calculated as Days in Accounting Period ÷ Receivables Turnover. (pp. 350, 678)

**Debit** The left side of an account. (p. 44)

**Debt to equity ratio** A measure of profitability that shows the proportion of a company's assets that is financed by creditors and the proportion financed by the owner or owners (stockholders); calculated as Total Liabilities ÷ Total Owner's/Stockholders' Equity. (pp. 185, 579, 675)

**Declaration date** The date on which a board of directors declares a dividend. (p. 511)

**Declining-balance method** An accelerated method of depreciation in which depreciation is computed by

applying a fixed rate to the carrying value (the declining balance) of a tangible long-lived asset. (p. 377)

**Deferral** The postponement of the recognition of an expense already paid or of revenue received in advance. (p. 91)

**Deferred income taxes** A postponement in paying taxes as the result of using different methods to calculate income taxes for financial reporting and tax purposes. (p. 548)

**Defined benefit plan** A pension plan in which the employer contributes an amount annually to fund estimated future pension liability. (p. 576)

**Defined contribution plan** A pension plan in which the employer makes a fixed annual contribution, usually a percentage of the employee's gross pay. (p. 576)

**Definitely determinable liabilities** Current liabilities that are set by contract or statute and that can be measured exactly. (p. 412)

**Delivery expense** The transportation cost of delivering merchandise incurred by the seller. Also called *freight-out*. (p. 214)

**Depletion** The exhaustion of a natural resource through mining, cutting, pumping, or other extraction, and the way in which the cost is allocated. (p. 368)

**Deposits in transit** Deposits a company has sent to its bank but that the bank did not receive in time to enter on the bank statement. (p. 312)

**Depreciable cost** The cost of an asset less its residual value. (p. 375)

**Depreciation** The portion of the cost of a long-term asset allocated to any one accounting period. Also called *depreciation expense*. (pp. 93, 368)

**Differential cost** A cost that changes among alternatives. Also called an *incremental cost*. (p. 1091)

**Direct charge-off method** A method of accounting for uncollectible accounts by directly debiting an expense account when bad debts are discovered; it violates the matching rule but is required for computing federal income tax. (p. 337)

**Direct costs** Costs that can be conveniently and economically traced to a cost object. (p. 762)

**Direct labor budget** A detailed plan that estimates the direct labor hours

needed during an accounting period and the associated costs. (p. 966)

**Direct labor costs** The costs of the labor needed to make a product or perform a service that can be conveniently and economically traced to specific units of the product or service. (p. 763)

**Direct labor efficiency variance** The difference between the standard direct labor hours allowed for good units produced and the actual direct labor hours worked multiplied by the standard direct labor rate. Also called *direct labor quantity* or *usage variance*. (p. 1057)

**Direct labor rate standard** The hourly direct labor rate that is expected to prevail during the next accounting period for each function or job classification. (p. 1050)

**Direct labor rate variance** The difference between the standard direct labor rate and the actual direct labor rate multiplied by the actual direct labor hours worked. Also called *direct labor spending variance*. (p. 1057)

**Direct labor time standard** The expected labor time required for each department, machine, or process to complete the production of one unit or one batch of output. (p. 1050)

**Direct materials costs** The costs of the materials used in making a product that can be conveniently and economically traced to specific units of the product. (p. 763)

**Direct materials price standard** A careful estimate of the cost of a specific direct material in the next accounting period. (p. 1049)

**Direct materials price variance** The difference between the standard price and the actual price per unit multiplied by the actual quantity purchased. Also called *direct materials spending* or *rate variance*. (p. 1054)

**Direct materials purchases budget** A detailed plan that identifies the quantity of purchases required to meet budgeted production and inventory needs and the costs associated with those purchases. (p. 964)

**Direct materials quantity standard** An estimate of the amount of direct materials, including scrap and waste, that will be used in an accounting period. (p. 1049)

**Direct materials quantity variance** The difference between the standard



- quantity allowed and the actual quantity used multiplied by the standard price. Also called *direct materials efficiency* or *usage variance*. (p. 1054)
- Direct method** The procedure for converting the income statement from an accrual basis to a cash basis by adjusting each item on the income statement. (p. 605)
- Discontinued operations** Segments that are no longer part of a company's operations. (p. 686)
- Discount** The amount by which a bond's face value exceeds its issue price, which occurs when the market interest rate is higher than the face interest rate. (p. 550)
- Discounting** A method of selling notes receivable to a bank in which the bank derives its profit by deducting the interest from the maturity value of the note. (p. 352)
- Discretionary cost center** A responsibility center whose manager is accountable for costs only and in which the relationship between resources and the products or services produced is not well defined. (p. 1008)
- Dishonored note** A promissory note that the maker cannot or will not pay at the maturity date. (p. 347)
- Dissolution** The loss of authority to continue a partnership as a separate entity due to a change in the original association of partners. (p. 461)
- Diversified companies** Companies that operate in more than one industry. Also called *conglomerates*. (p. 661)
- Dividend yield** A measure of a stock's current return to an investor in the form of dividends; calculated as  $\text{Dividends per Share} \div \text{Market Price per Share}$ . (pp. 520, 681)
- Dividends** A distribution of a corporation's assets (usually cash generated by past earnings) to its stockholders. (pp. 179, 493)
- Dividends in arrears** Past dividends on cumulative preferred stock that remain unpaid. (p. 498)
- Double-declining-balance method** An accelerated method of depreciation in which a fixed rate equal to twice the straight-line percentage is applied to the carrying value (the declining balance) of a tangible long-lived asset. (p. 377)
- Double-entry system** The accounting system in which each transaction is recorded with at least one debit and one credit so that the total amount of debits equals the total amount of credits. (p. 42)
- Double taxation** Taxation of corporate earnings twice—once as income of the corporation and once as income to the stockholders in the form of dividends. (p. 494)
- Due care** Competence and diligence in carrying out professional responsibilities. (p. 14)
- Duration of a note** The time between a promissory note's issue date and its maturity date. (p. 346)
- E**
- Early extinguishment of debt** The retirement of a bond issue before its maturity date. (p. 550)
- Earnings management** The manipulation of revenues and expenses to achieve a specific outcome. (p. 102)
- Economic entity** A unit that exists independently, such as a business, hospital, or a governmental body. (p. 2)
- Economic Stimulus Act of 2008** A federal income tax law that allows a small company to expense the first \$250,000 of equipment expenditures. (p. 379)
- Economic value added (EVA)** The shareholder wealth created by an investment center; calculated as  $\text{After-Tax Operating Income} - [\text{Cost of Capital in Dollars} \times (\text{Total Assets} - \text{Current Liabilities})]$ . (p. 1017)
- Effective interest method** A method of amortizing bond discounts or premiums that applies a constant interest rate (the market rate when the bonds were issued) to the bonds' carrying value at the beginning of each interest period. (p. 559)
- Electronic funds transfer (EFT)** The transfer of funds from one bank to another through electronic communication. (p. 312)
- Employee** A worker who is paid a wage or salary and who is under the organization's direct supervision and control. (p. 416)
- Engineering method** A method that separates costs into their fixed and variable components by performing a step-by-step analysis of the tasks, costs, and processes involved in completing an activity or product. (p. 929)
- Equivalent production** A measure that applies a percentage-of-completion factor to partially completed units to compute the equivalent number of whole units produced during a period for each type of input. Also called *equivalent units*. (p. 847)
- Estimated liabilities** Definite debts or obligations whose exact amounts cannot be known until a later date. (p. 420)
- Estimated useful life** The total number of service units expected from a long-term asset. (p. 375)
- Ethics** A code of conduct that addresses whether actions are right or wrong. (p. 19)
- Exchange gain or loss** A gain or loss due to exchange rate fluctuation between the date of sale and the date of payment; it is reported on the income statement. (p. 230)
- Exchange rate** The value of one currency in terms of another. (p. 4)
- Ex-dividend** A description of stock between the record date and the date of payment, during which the right to the dividend remains with the person who owned the stock on the record date. (p. 511)
- Expenditure** A payment or an obligation to make future payment for an asset or a service. (p. 370)
- Expenses** Decreases in owner's equity resulting from the costs of goods and services used in the course of earning revenues. Also called *cost of doing business* or *expired costs*. (pp. 7, 86)
- Extraordinary repairs** Repairs that significantly enhance a plant asset's estimated useful life or residual value and thereby increase its carrying value. (p. 370)
- F**
- Face interest rate** The fixed rate of interest paid to bondholders based on the face value of the bonds. (p. 549)
- Face value** The principal amount of each share of stock; also called *par value*. (p. 549)
- Facility-level activities** Activities performed to support a facility's general manufacturing process. (p. 886)

- Factor** An entity that buys accounts receivable. (p. 351)
- Factoring** The sale or transfer of accounts receivable. (p. 351)
- Fair value** The exchange price of an actual or potential business transaction between market participants. (p. 40)
- Faithful representation** The qualitative characteristic of information that financial information must be complete, neutral, and free from material error. (p. 172)
- Financial accounting** The process of generating and communicating accounting information in the form of financial statements to those outside the organization. (p. 2)
- Financial Accounting Standards Board (FASB)** The most important body for developing rules on accounting practice; it issues Statements of Financial Accounting Standards. (p. 13)
- Financial analysis** The evaluation and interpretation of financial statements and related performance measures to determine whether a business is well managed and achieving its goals. (p. 18)
- Financial budgets** Budget projections of the financial results for an accounting period. (p. 958)
- Financial leverage** A corporation's ability to increase earnings for stockholders by earning more on assets than it pays in interest on the debt it incurred to finance the assets. Also called *trading on equity*. (p. 578)
- Financial position** The economic resources that belong to a company and the claims (equities) against those resources at a particular time. (p. 6)
- Financial ratio analysis** A technique of financial performance evaluation that identifies key relationships between components of the financial statements. (p. 670)
- Financial ratios** Comparisons between the elements on financial statements from one period to another and from one company to another. (p. 18)
- Financial statement analysis** An evaluation method that shows how items in a company's financial statements relate to the company's financial performance objectives. Also called *financial performance measurement*. (p. 660)
- Financial statements** The primary means of communicating important accounting information to users. They include the income statement, statement of owner's equity, balance sheet, and statement of cash flows. (p. 2)
- Financing activities** Activities undertaken by management to obtain adequate funds (as from stockholders and creditors) to begin and to continue operating a business. (pp. 17, 603)
- Financing period** The amount of time from the purchase of inventory until it is sold and payment is collected, less the amount of time creditors give the company to pay for the inventory. (pp. 228, 677)
- Finished Goods Inventory account** An inventory account that shows the costs assigned to all completed products that have not been sold. (p. 768)
- First-in, first-out (FIFO) costing method** A process costing method in which the cost flow follows the actual flow of production so that the costs assigned to the first products processed are the first costs transferred out when those products flow to the next process, department, or work cell. (p. 845)
- First-in, first-out (FIFO) method** An inventory costing method based on the assumption that the costs of the first items acquired should be assigned to the first items sold. (p. 269)
- Fiscal year** Any 12-month accounting period. (p. 87)
- Fixed cost(s)** A cost that remains constant within a defined range of activity or time period. (pp. 764, 924)
- Fixed cost formula** A horizontal line in the relevant range,  $Y = b$ , where  $Y$  is total fixed cost and  $b$  is the fixed cost in the relevant range. (p. 924)
- Fixed overhead budget variance** The difference between budgeted and actual fixed overhead costs. Also called *budgeted fixed overhead variance*. (p. 1064)
- Fixed overhead volume variance** The difference between budgeted fixed overhead costs and the overhead costs that are applied to production using the standard fixed overhead rate. (p. 1064)
- Flexible budget** A summary of expected costs for a range of activity levels. Also called a *variable budget*. (p. 1011)
- Flexible budget formula** An equation that determines the expected, or budgeted, cost for any level of output; calculated as (Variable Cost per Unit  $\times$  Number of Units Produced) + Budgeted Fixed Costs. (p. 1011)
- FOB destination** A term indicating that the seller retains title to the merchandise until it reaches its destination and that the seller bears the shipping costs. (p. 213)
- FOB shipping point** A term indicating that the buyer assumes title to the merchandise at the shipping point and bears the shipping costs. (p. 213)
- Footings** Working totals of columns of numbers. To foot means to total a column of numbers. (p. 44)
- Form 8-K** Current reports filed by U.S. public corporations with the Securities and Exchange Commission. (p. 662)
- Form 10-K** An annual report filed by U.S. public corporations with the Securities and Exchange Commission. (p. 662)
- Form 10-Q** A quarterly report filed by U.S. public corporations with the Securities and Exchange Commission. (p. 662)
- Franchise** The right to an exclusive territory or market. (p. 387)
- Fraudulent financial reporting** The intentional preparation of misleading financial statements. (p. 19)
- Free cash flow** The amount of cash that remains after deducting the funds a company must commit to continue operating at its planned level; calculated as Net Cash Flows from Operating Activities – Dividends – Purchases of Plant Assets + Sales of Plant Assets. (pp. 392, 624, 674)
- Free from material error** Information that meets a minimum level of accuracy so it does not distort what is being reported. (p. 172)
- Freight-in** The transportation cost of receiving merchandise. (p. 213)
- Full-costing method** A method of accounting for the costs of exploring and developing oil and gas resources in which all costs are recorded as assets and depleted over the estimated life of the producing resources. (p. 386)
- Full disclosure** The convention requiring that a company's financial statements and the accompanying notes present all information relevant

to the users' understanding of the statements. Also called *transparency*. (pp. 173, 684)

**Full product cost** A cost that includes not only the costs of direct materials and direct labor but also the costs of all production and nonproduction activities required to satisfy the customer. (p. 882)

**Future value** The amount an investment will be worth at a future date if invested at simple interest or compound interest. (p. 426)

## G

**General and administrative expenses** Expenses for accounting, personnel, credit checking, collections, and any other expenses that apply to overall operations. (p. 210)

**General journal** The simplest and most flexible type of journal. (p. 58)

**General ledger** A book or file that contains all of a company's accounts arranged in the order of the chart of accounts. Also called the *ledger*. (p. 42)

**Generally accepted accounting principles (GAAP)** The conventions, rules, and procedures that define accepted accounting practice at a particular time. (p. 12)

**Goal/vision** The overriding objective of a business to increase the value of the stakeholders' interest in the business. (p. 777)

**Going concern** The assumption that unless there is evidence to the contrary, a business will continue to operate indefinitely. (p. 87)

**Goods flow** The actual physical movement of goods in the operations of a company. (p. 265)

**Goodwill** The excess of the amount paid for a business over the fair market value of the business's net assets. (pp. 177, 387)

**Governmental Accounting Standards Board (GASB)** The board responsible for issuing accounting standards for state and local governments. (p. 14)

**Gross margin** The difference between net sales and cost of goods sold. Also called *gross profit*. (p. 209)

**Gross profit method** A method of inventory estimation based on the assumption that the ratio of gross margin for a business remains

relatively stable from year to year. Also called *gross margin method*. (p. 278)

**Gross sales** Total revenue from cash and credit sales during an accounting period. (p. 209)

**Group depreciation** The grouping of similar items to calculate depreciation. (p. 379)

## H

**High-low method** A three-step approach to separating a mixed cost into its variable and fixed components. (p. 928)

**Horizontal analysis** A technique for analyzing financial statements in which changes from the previous year to the current year are computed in both dollar amounts and percentages. (p. 664)

## I

**Imprest system** A system for controlling small cash disbursements by establishing a fund at a fixed amount and periodically reimbursing the fund by the amount necessary to restore the original cash balance. (p. 312)

**Income from operations** Gross margin minus operating expenses. Also called *operating income*. (p. 211)

**Income statement** A financial statement that summarizes the revenues earned and expenses incurred by a business over an accounting period. (p. 8)

**Income Summary account** A temporary account used in the closing process that holds a summary of all revenues and expenses before the net income or loss is transferred to the owner's Capital account. (p. 132)

**Incremental analysis** A technique used in decision analysis that compares alternatives by focusing on the differences in their projected revenues and costs. Also called *differential analysis*. (p. 1090)

**Incremental revenue** Total revenue if product/service is sold at split-off point minus total revenue if product/service is sold after further processing. (p. 1101)

**Independence** The avoidance of all relationships that impair or appear to impair an accountant's objectivity. (p. 14)

**Independent contractor** An individual who offers services for a fee but who is not under the organization's direct control or supervision. (p. 416)

**Index number** In trend analysis, a number that shows changes in related items over time and that is calculated by setting the base year equal to 100 percent. (p. 666)

**Indirect costs** Costs that cannot be conveniently or economically traced to a cost object. (p. 762)

**Indirect labor costs** The costs of labor for production-related activities that cannot be conveniently or economically traced to a unit of the product or service. (p. 763)

**Indirect materials costs** The costs of materials that cannot be conveniently and economically traced to a unit of the product or service. (p. 763)

**Indirect method** The procedure for converting the income statement from an accrual basis to a cash basis by adjusting net income for items that do not affect cash flows, including depreciation, amortization, depletion, gains, losses, and changes in current assets and current liabilities. (p. 606)

**Information and communication** A component of internal control that refers to the way in which the accounting system gathers and treats information and how it communicates individual responsibilities within the system. (p. 303)

**Initial public offering (IPO)** A company's first issue of capital stock to the public. (p. 491)

**Inspection time** The time spent looking for product flaws or reworking defective units. (p. 891)

**Institute of Management Accountants (IMA)** A professional organization made up primarily of managerial accountants. (p. 14)

**Intangible assets** Long-term assets with no physical substance whose value stems from the rights or privileges accruing to their owners. (pp. 177, 368)

**Integrity** Honesty, candidness, and the subordination of personal gain to service and the public trust. (p. 14)

**Interest** The cost of borrowing money or the return on lending money, depending on whether one is the borrower or the lender. (pp. 346, 426)

**Interest coverage ratio** A measure of the degree of protection a company

has from default on interest payments; calculated as  $(\text{Income Before Income Taxes} + \text{Interest Expense}) \div \text{Interest Expense}$ . (pp. 580, 676)

**Interest receivable** Any interest accrued on promissory notes. (p. 339)

**Interim financial statements**

Financial statements issued for a period of less than one year, usually a quarter or a month. (p. 662)

**Interim periods** Accounting periods of less than one year. (p. 87)

**Internal control** A process designed by a company to establish the reliability of the accounting records and financial statements in accordance with generally accepted accounting principles (GAAP) and to ensure that the company's assets are protected. (p. 302)

**Internal Revenue Service (IRS)** The agency that interprets and enforces the tax laws governing the assessment and collection of revenue for operating the federal government. (p. 14)

**International Accounting Standards Board (IASB)**

An organization that encourages worldwide cooperation in the development of accounting principles; it has approved more than 40 international standards of accounting. (p. 13)

**International financial reporting standards (IFRS)** Accounting standards set by the IASB that are used in many parts of the world, including Europe, and by foreign companies registered in the United States. (p. 13)

**Inventory accounting** An accounting system in which the primary objective is to apply accrual accounting to the determination of cost of inventory sold during the accounting period. (p. 264)

**Inventory cost** The invoice price of an asset less purchases discounts, plus freight-in, plus applicable taxes and tariffs. (p. 264)

**Inventory turnover** A ratio indicating the number of times a company's average inventory is sold during an accounting period; calculated as  $\text{Cost of Goods Sold} \div \text{Average Inventory}$ . (pp. 280, 677)

**Investing activities** Activities undertaken by management to spend capital in productive ways that will help a business achieve its goals. (pp. 17, 603)

**Investment center** A responsibility center whose manager is accountable for profit generation and who can also make significant decisions about the resources the center uses. (p. 1008)

**Investments** Assets, usually long-term, that are not used in the normal operation of a business and that management does not intend to convert to cash within the next year. (p. 177)

**Investors** Stockholders who have a direct financial interest in the success of the company in which they have invested. (p. 16)

**Invoice** A form that a vendor sends to a purchaser describing the goods delivered and the quantity, price, and terms of payment. (p. 310)

**Issued shares** The shares of stock sold or otherwise transferred to stockholders. (p. 497)

**J**

**Job order** A customer order for a specific number of specially designed, made-to-order products. (p. 804)

**Job order cost card** A document on which all costs incurred in the production of a particular job order are recorded; part of the subsidiary ledger for the Work in Process Inventory account. (p. 804)

**Job order costing system** A product costing system that traces the costs of direct materials, direct labor, and overhead to a specific batch of products or a specific job order; used by companies that make unique or special-order products. (p. 804)

**Joint costs** The common costs shared by two or more products before they are split off. Also called *common costs*. (p. 1101)

**Joint products** Two or more products made from a common material or process that cannot be identified as separate products or services during some or all of the production process. (p. 1101)

**Joint venture** An association of two or more entities for the purpose of achieving a specific goal, such as the manufacture of a product in a new market. (p. 474)

**Journal** A chronological record of all transactions; the place where transactions first enter the accounting records. Also called *book of original entry*. (p. 47)

**Journal entry** A journal notation that records a single transaction. (p. 47)

**Journal form** A way of recording a transaction in which the date, debit account, and debit amount appear on one line and the credit account and credit amount appear on the next line. (p. 48)

**Just-in-time (JIT) operating environment** A method of reducing levels of inventory by working closely with suppliers to coordinate and schedule deliveries so that goods arrive just at the time they are needed. (p. 281)

**Just-in-time (JIT) operating philosophy** A system that requires that all resources—materials, personnel, and facilities—be acquired and used only as needed; it focuses on eliminating or reducing waste in the production of products and services. (p. 889)

**K**

**Kaizen** Suggestions from employees for improvements to the production process. (p. 891)

**L**

**Last-in, first-out (LIFO) method** An inventory costing method based on the assumption that the costs of the last items purchased should be assigned to the first items sold. (p. 270)

**Lean operation** An operating philosophy that requires that all resources—materials, personnel, and facilities—be acquired and used only as needed to create value for customers; its objective is to reduce costs by eliminating waste. (p. 889)

**Leasehold** A right to occupy land or buildings under a long-term rental contract. (p. 387)

**Leasehold improvements** Improvements to leased property that become the property of the lessor at the end of the lease. (p. 373)

**Ledger account form** An account form that has four dollar amount columns: one column for debit entries, one column for credit entries, and two columns (debit and credit) for showing the balance of the account. (p. 59)



- Legal capital** The number of shares of stock issued times the par value; the minimum amount a corporation can report as contributed capital. (p. 494)
- Liabilities** A business's present obligations to pay cash, transfer assets, or provide services to other entities in the future. (p. 6)
- License** The right to use a formula, technique, process, or design. (p. 387)
- LIFO liquidation** The reduction of inventory below previous levels because sales of older, lower-priced units have exceeded the purchases of units for the current period. (p. 273)
- Limited liability** The limited risk of loss that applies to stockholders' investments in corporations. It is limited to the amount stockholders paid for their shares of stock (p. 5)
- Limited liability company (LLC)** A business organization in which the members are partners and their liability is limited to their investment in the business. (p. 475)
- Limited life** A characteristic of a partnership; the fact that any event that breaches the partnership agreement—including the admission, withdrawal, or death of a partner—terminates the partnership. (p. 452)
- Limited partnership (LP)** A form of partnership in which partners' liabilities are limited to their investment. (p. 474)
- Line of credit** An arrangement with a bank that allows a company to borrow funds as needed. (p. 411)
- Liquidating dividend** A dividend that exceeds retained earnings and that a corporation usually pays only when it is going out of business or reducing its operations. (p. 510)
- Liquidation** A special form of dissolution in which a business ends by selling assets, paying liabilities, and distributing any remaining assets to the partners. (p. 467)
- Liquidity** Having enough cash available to pay debts when they are due and to take care of unexpected needs for cash. (pp. 17, 180)
- Long-term assets** Assets that have a useful life of more than one year, are used in the operation of a business, and are not intended for resale. Less commonly called fixed assets. (p. 368)
- Long-term liabilities** Debts and obligations due beyond one year or beyond the normal operating cycle. (pp. 178, 410, 546)
- Lower-of-cost-or-market (LCM) rule** A method of valuing inventory at an amount less than cost when the replacement cost falls below historical cost. (p. 266)
- M**
- Make-or-buy decisions** Decisions about whether to make a part internally or buy it from an external supplier. (p. 1093)
- Management** The people who have overall responsibility for operating a business and meeting its goals of profitability and liquidity. (p. 15)
- Management information system (MIS)** The interconnected subsystems that provide the information needed to run a business. (p. 3)
- Managerial accounting** The process of generating and communicating accounting information about operating, investing, and financing activities for internal use by managers. (pp. 3, 760)
- Manufacturing company** A company that makes and sells products. (p. 208)
- Manufacturing cost flow** The flow of manufacturing costs (direct materials, direct labor, and overhead) through the Materials Inventory, Work in Process Inventory, and Finished Goods Inventory accounts into the Cost of Goods Sold account. (p. 768)
- Margin of safety** The number of sales units or amount of sales dollars by which actual sales can fall below planned sales without resulting in a loss. (p. 931)
- Market** Current replacement cost of inventory. (p. 266)
- Market interest rate** The rate of interest paid in the market on bonds of similar risk. Also called *effective interest rate*. (p. 549)
- Marketable securities** Short-term investments that have a maturity of more than 90 days but are intended to be held only until cash is needed for current operations. (p. 602)
- Master budget** A set of operating budgets and a set of financial budgets that detail an organization's financial plans for a specific accounting period. (p. 958)
- Material** Information that if omitted or misstated could influence economic decisions made by users of financial statements. (p. 171)
- Materiality** The convention that refers to the relative importance of an item or event in a financial statement and its influence on the decisions of the users of financial statements. (p. 171)
- Materials Inventory account** An inventory account that shows the balance of the cost of unused materials. (p. 768)
- Maturity date** The date on which a promissory note must be paid. (p. 346)
- Maturity value** The total proceeds of a promissory note—face value plus interest—at the maturity date. (p. 347)
- Merchandise inventory** The goods on hand at any one time that are available for sale to customers. (p. 206)
- Merchandising company** A business that earns income by buying and selling goods. (p. 208)
- Minimum rate of return** The rate of return that must be exceeded to ensure profitability. Also called the *hurdle rate*. (p. 1104)
- Mission statement** A description of the fundamental way in which a company will achieve the goal of increasing stakeholders' value. (p. 778)
- Mixed cost formula** A linear equation,  $Y = a(X) + b$ , where  $Y$  is total mixed cost,  $a$  is the variable rate per unit,  $X$  is the units produced, and  $b$  is the fixed cost for the period. (p. 925)
- Mixed costs** Costs that have both variable and fixed components. (p. 925)
- Money measure** The recording of all business transactions in terms of money. (p. 3)
- Monitoring** Management's regular assessment of the quality of internal control. (p. 303)
- Mortgage** A debt secured by real property. (p. 547)
- Moving time** The time spent moving a product from one operation or department to another. (p. 891)
- Multistep income statement** An income statement that goes through a series of steps to arrive at net income. (p. 208)
- Mutual agency** A characteristic of a partnership; the authority of each

partner to act as an agent of the partnership within the scope of the business's normal operations. (p. 452)

## N

**Natural resources** Long-term assets purchased for the economic value that can be taken from the land and used up. (p. 368)

**Net assets** Assets minus liabilities; owner's equity. (p. 7)

**Net cost of purchases** Total purchases plus freight-in less any deductions such as purchases returns and allowances and discounts from suppliers for early payment. (p. 221)

**Net income** The difference between revenues and expenses when revenues exceed expenses. Also called *net earnings*. (pp. 7, 86, 211)

**Net loss** The difference between expenses and revenues when expenses exceed revenues. (pp. 7, 86)

**Net present value method** A method of evaluating capital investments in which all future cash flows for each proposed project are discounted to their present values and the amount of the initial investment is subtracted from their sum. The projects with the highest positive net present value—the amount that exceeds the initial investment—are selected for implementation. (p. 1104)

**Net sales** The gross proceeds from sales of merchandise (gross sales) less sales returns and allowances and any discounts allowed. Also called *net revenue*. (p. 209)

**Neutral information** Information that is free from bias intended to achieve a certain result or to bring about a particular behavior. (p. 172)

**No-par stock** Capital stock that does not have a par value. (p. 501)

**Non-value-adding activity** An activity that adds cost to a product or service but does not increase its market value. (p. 884)

**Non-value-adding cost** The cost of an activity that adds cost to a product or service but does not increase its market value. (p. 765)

**Noncash investing and financing transactions** Significant investing and financing transactions involving only long-term assets, long-term liabilities, or stockholders' equity that

do not affect current cash inflows or outflows. (p. 605)

**Noncompete covenant** A contract limiting the rights of others to compete in a specific industry or line of business for a specified period. (p. 387)

**Noncumulative preferred stock** Preferred stock that does not oblige the issuer to make up a missed dividend in a subsequent year. (p. 498)

**Normal balance** The usual balance of an account; the side (debit or credit) that increases the account. (p. 45)

**Normal capacity** The average annual level of operating capacity needed to meet expected sales demand. (p. 924)

**Normal costing method** A method of cost measurement that combines the actual direct costs of materials and labor with estimated overhead costs to determine a product or service unit cost. (p. 776)

**Normal operating cycle** The average time a company needs to go from spending cash to receiving cash. (p. 175)

**Notes payable** A promissory note that represents a loan from a bank or other creditor; a long-term debt when due in more than one year. (p. 547)

**Notes receivable** Collective term for promissory notes held by the entity to which payment is promised (payee). (p. 337)

**NSF (nonsufficient funds) checks** Checks that a company has deposited but that are not paid when the bank presents them to the issuer's bank. (p. 312)

## O

**Objectivity** Impartiality and intellectual honesty. (p. 14)

**Obsolescence** The process of becoming out of date, which is a factor in the limited useful life of tangible assets. (p. 374)

**Off-balance-sheet financing** Structuring long-term debts in such a way that they do not appear as liabilities on the balance sheet. (p. 580)

**Operating activities** Activities undertaken by management in the course of running a business. (pp. 17, 603)

**Operating budgets** Budget plans used in daily operations. (p. 958)

**Operating capacity** The upper limit of an organization's productive output capability, given its existing resources. (p. 923)

**Operating cycle** The time it takes to sell products and collect payment for them. (pp. 206, 677)

**Operating expenses** Expenses other than cost of goods sold incurred in running a business. (p. 210)

**Operating lease** A short-term lease in which the risks of ownership remain with the lessor and for which payments are recorded as rent expense. (p. 573)

**Operating objectives** Short-term goals that outline expectations for the performance of day-to-day operations. (p. 778)

**Operations costing system** A product costing system that combines parts of job order costing and process costing to create a hybrid system designed specifically for an organization's production process. (p. 804)

**Opportunity costs** The benefits that are forfeited or lost when one alternative is chosen over another. (p. 1092)

**Ordinary annuity** A series of equal payments made at the end of equal intervals of time, with compound interest on the payments. (p. 429)

**Organization chart** A visual representation of an organization's hierarchy of responsibility for the purposes of management control. (p. 1009)

**Other assets** A balance sheet category that some companies use to group all assets other than current assets and property, plant, and equipment. (p. 175)

**Other revenues and expenses** The section of a multistep income statement that includes revenues and expenses not related to a company's operating activities. Also called *nonoperating revenues and expenses*. (p. 211)

**Outsourcing** The use of other companies to perform a process or service in the value chain that is not among an organization's core competencies. (pp. 882, 1093)

**Outstanding checks** Checks that a company has issued and recorded but that do not yet appear on its bank statement. (p. 312)

**Outstanding shares** Shares that have been issued and that are still in circulation. (p. 497)

- Overapplied overhead costs** The amount by which overhead costs applied using the predetermined overhead rate exceed the actual overhead costs for the accounting period. (p. 814)
- Overhead budget** A detailed plan of anticipated manufacturing costs, other than direct materials and direct labor costs, that must be incurred to meet budgeted production needs. (p. 966)
- Overhead costs** Production-related costs that cannot be practically or conveniently traced to an end product or service. Also called *factory overhead*, *factory burden*, *manufacturing overhead*, *service overhead*, or *indirect production costs*. (p. 763)
- Owner's equity** The claims of the owner of a company to the assets of the business. (p. 7)
- Owner's investments** Assets that the owner puts into the business. (p. 7)
- P**
- Par value** An arbitrary amount assigned to each share of stock; constitutes a corporation's legal capital. (p. 494)
- Participative budgeting** A process in which personnel at all levels of an organization actively engage in making decisions about a budget. (p. 977)
- Partners' equity** The equity section of a partnership's balance sheet. (pp. 178, 454)
- Partnership** A business that is owned by two or more people and that is not incorporated. (pp. 4, 452)
- Partnership agreement** The contractual relationship between partners that identifies the details of their partnership. (p. 452)
- Patent** An exclusive right granted by the federal government for a period of 20 years to make a particular product or use a specific process. (p. 387)
- Payables turnover** The number of times, on average, that a company pays its accounts payable in an accounting period; calculated as  $(\text{Cost of Goods Sold} +/\text{- Change in Merchandise Inventory}) \div \text{Average Accounts Payable}$  (pp. 433, 678)
- Payback period method** A method of evaluating capital investments that bases the decision to invest in a capital project on the minimum length of time it will take to get back the amount of the initial investment in cash. The payback period is calculated by dividing the cost of investment by the annual net cash inflows. (p. 1106)
- Payment date** The date on which a dividend is paid. (p. 511)
- Pension fund** A fund established by the contributions of an employer and often of employees from which payments are made to employees after retirement or upon disability or death. (p. 576)
- Pension plan** A contract requiring a company to pay benefits to its employees after they retire. (p. 576)
- Percentage of gross margin** The gross margin divided by net sales. (p. 210)
- Percentage of net sales method** A method of estimating uncollectible accounts based on the assumption that a predictable proportion of each dollar of sales will not be collected. (p. 340)
- Performance-based pay** The linking of employee compensation to the achievement of measurable business targets. (p. 1022)
- Performance management and evaluation system** A set of procedures that account for and report on both financial and nonfinancial performance so that a company can identify how well it is doing, where it is going, and what improvements will make it more profitable. (p. 1006)
- Performance measurement** The use of quantitative tools to gauge an organization's performance in relation to a specific goal or an expected outcome. (p. 1006)
- Performance measures** Quantitative tools that gauge and compare an organization's performance in relation to a specific goal or an expected outcome. (pp. 18, 1006)
- Period costs** The costs of resources used during an accounting period that are not assigned to products or services. Also called *noninventoriable costs* or *selling, administrative, and general expenses*. (p. 763)
- Periodic independent verification** A periodic check of records against assets by someone other than the person responsible for accounting records and assets. (p. 304)
- Periodic inventory system** A system for determining inventory on hand by periodically taking a physical count. (p. 206)
- Periodicity** The assumption that although the lifetime of a business is uncertain, it is still useful to estimate its net income in terms of accounting periods. (p. 87)
- Permanent accounts** Balance sheet accounts that carry their balances into the next accounting period. Also called *real accounts*. (p. 132)
- Perpetual inventory system** A system for determining inventory on hand by keeping continuous records of the quantity and, usually, the cost of individual items as they are bought and sold. (p. 206)
- Petty cash fund** A fund for making small payments of cash when it is inconvenient to pay by check. (p. 314)
- Petty cash voucher** A form signed by a person who receives cash from a petty cash fund; lists the date, amount, and purpose of the expenditure. (p. 315)
- Physical controls** Controls that limit access to assets. (p. 304)
- Physical deterioration** A decline in the useful life of a depreciable asset resulting from use and from exposure to the elements. (p. 374)
- Physical inventory** An actual count of all merchandise on hand. (pp. 206, 302)
- Post-closing trial balance** A trial balance prepared after all adjusting and closing entries have been posted to ensure that all temporary accounts have zero balances and that total debits equal total credits. (p. 140)
- Posting** The process of transferring journal entry information from the journal to the ledger. (p. 59)
- Practical capacity** Theoretical capacity reduced by normal and expected work stoppages. Also called *engineering capacity*. (p. 924)
- Predetermined overhead rate** The rate calculated before an accounting period begins by dividing the cost pool of total estimated overhead costs by the total estimated cost driver for that pool. (p. 814)
- Predictive value** Information that helps capital providers make decisions about future actions. (p. 171)
- Preferred stock** Stock that has preference over common stock, usually in terms of dividends and the distribution of assets. (p. 497)



- Premium** The amount by which a bond's issue price exceeds its face value, which occurs when the market interest rate is lower than the face interest rate. (p. 550)
- Prepaid expenses** Expenses paid in advance that have not yet expired; an asset account. (p. 91)
- Present value** The amount that must be invested today at a given rate of interest to produce a given future value. (p. 427)
- Price/earnings (P/E) ratio** A measure of confidence in a company's future; calculated as Market Price per Share  $\div$  Earnings per Share. (pp. 521, 680)
- Primary processes** Components of the value chain that add value to a product or service. (p. 882)
- Prime costs** The primary costs of production; the sum of direct materials costs and direct labor costs. (p. 764)
- Pro forma financial statements** Financial statements that show projections rather than actual results and that are often used to communicate business plans to external parties. (p. 959)
- Process cost report** A report that managers use to track and analyze costs in a process costing system. (pp. 804, 845)
- Process costing system** A product costing system that traces the costs of direct materials, direct labor, and overhead to processes, departments, or work cells and then assigns the costs to the products manufactured by those processes, departments, or work cells; used by companies that produce large amounts of similar products or liquid products or that have long, continuous production runs of identical products. (pp. 804, 844)
- Process value analysis (PVA)** A technique that analyzes business processes by relating activities to the events that prompt those activities and to the resources that the activities consume. (p. 883)
- Processing time** The actual amount of time spent working on a product. (p. 891)
- Product costing system** A set of procedures that is used to account for an organization's product costs and to provide timely and accurate unit cost information for pricing, cost planning and control, inventory valuation, and financial statement preparation. (p. 804)
- Product costs** The costs assigned to inventory, which include the costs of direct materials, direct labor, and overhead. Also called *inventoriable costs*. (p. 763)
- Product-level activities** Activities performed to support a particular product line. (p. 886)
- Product unit cost** The cost of manufacturing a single unit of a product, computed either by dividing the total cost of direct materials, direct labor, and overhead by the total number of units produced, or by determining the cost per unit for each element of the product cost and summing those per unit costs. (p. 763)
- Production budget** A detailed plan showing the number of units that a company must produce to meet budgeted sales and inventory needs. (p. 963)
- Production method** A method of depreciation that assumes depreciation is solely the result of use and that allocates depreciation based on the units of use or output during each period of an asset's useful life. Also called the *units of production method*. (p. 376)
- Profit center** A responsibility center whose manager is accountable for both revenue and costs and for the resulting operating income. (p. 1008)
- Profit margin** A measure of profitability that shows the percentage of each sales dollar that results in net income; calculated as Net Income  $\div$  Net Revenues (or Net Sales). (pp. 181, 671, 1015)
- Profitability** The ability to earn enough income to attract and hold investment capital. (pp. 17, 181)
- Promissory note(s)** An unconditional promise to pay a definite sum of money on demand or at a future date. (pp. 337, 412)
- Property, plant, and equipment** Tangible long-term assets used in the day-to-day operations of a business. Also called *operating assets*, *fixed assets*, *tangible assets*, *long-lived assets*, or *plant assets*. (pp. 177, 368)
- Public Company Accounting Oversight Board (PCAOB)** A governmental body created by the Sarbanes-Oxley Act to regulate the accounting profession. It has the power to determine the standards that auditors must follow. (p. 13)
- Pull-through production** A production system in which a customer's order triggers the purchase of materials and the scheduling of production for the required products. (p. 890)
- Purchase discounts** Discounts that buyers take for early payment of merchandise; the Purchases Discounts account is a contra-purchases account used under the periodic inventory system. (p. 213)
- Purchase order** A form that a company's purchasing department sends to a vendor describing the items ordered and the quantity, price, terms, and shipping date. (p. 310)
- Purchase requisition** A formal written request for a purchase that a company's credit office (requesting department) sends to the purchasing department. (p. 310)
- Purchases account** A temporary account used under the periodic inventory system to accumulate the cost of merchandise purchased for resale during an accounting period. (p. 222)
- Purchases journal** A journal used to record purchases on credit. (p. 252)
- Purchases Returns and Allowances account** A contra-purchases account used under the periodic inventory system to accumulate cash refunds, credits on account, and other allowances made by suppliers. (p. 223)
- Push-through production** A production system in which products are manufactured in long production runs and stored in anticipation of customers' orders. (p. 890)

## Q

- Qualitative characteristics** Standards for judging accounting information. (p. 171)
- Quality of earnings** The substance of earnings and their sustainability into future periods. (p. 683)
- Queue time** The time a product spends waiting to be worked on once it enters a new operation or department. (p. 891)
- Quick ratio** A measure of short-term debt-paying ability; calculated as

(Cash + Marketable Securities + Receivables) ÷ Current Liabilities. (p. 680)

## R

**Receivables turnover** A ratio for measuring the average number of times receivables are turned into cash during an accounting period; calculated as Net Sales ÷ Average Accounts Receivable. (pp. 349, 678)

**Receiving report** A form on which an employee in a company's receiving department notes the quantity, type of goods, and their condition upon delivery from the vendor. (p. 310)

**Recognition** The determination of when a business transaction should be recorded. (p. 40)

**Recognition point** The predetermined time at which a transaction should be recorded; usually, the point at which title passes to the buyer. (p. 62)

**Record date** The date on which ownership of stock, and thus the right to receive a dividend, is determined. (p. 511)

**Registered bonds** Bonds that the issuing company registers in the names of the bondholders. (p. 551)

**Registrar** An official responsible for keeping a register or official records of stock transfers for a corporation. (p. 494)

**Regression analysis** A mathematical approach to separating a mixed cost into its variable and fixed components. (p. 929)

**Relevance** The qualitative characteristic of information that has a direct effect on a decision. (p. 171)

**Relevant range** The span of activity in which a company expects to operate. (p. 924)

**Residual income (RI)** The operating income that an investment center earns above a minimum desired return on invested assets; calculated as Investment Center's Operating Income – (Desired ROI × Assets Invested). (p. 1016)

**Residual value** The portion of an asset's acquisition cost expected to be recovered at the date of its disposal. Also called *salvage value*, *disposal value*, or *trade-in value*. (p. 375)

**Responsibility accounting** An information system that classifies data according to areas of responsibility

and reports each area's activities by including only the categories that the assigned manager can control. (p. 1006)

**Responsibility center** An organizational unit whose manager has been assigned the responsibility of managing a portion of the organization's resources. The five types of responsibility centers are a cost center, discretionary cost center, revenue center, profit center, and investment center. (p. 1006)

**Restructuring** The estimated cost of a change in a company's operations, usually involving the closing of facilities and the laying off of personnel. (p. 686)

**Retail method** A method of inventory estimation, used in retail merchandising businesses, in which inventory at retail value is reduced by the ratio of cost to retail price. (p. 277)

**Retained earnings** Stockholders' claims to assets arising from the earnings of the business; the accumulated earnings of a corporation since its inception, minus any losses, dividends, or transfers to contributed capital. Also called *Earned Capital*. (pp. 179, 496)

**Return on assets** A measure of profitability that shows how efficiently a company uses its assets to produce income; calculated as Net Income ÷ Average Total Assets. (pp. 183, 672)

**Return on equity** A measure of how much income is earned on each dollar invested by the company's owners/stockholders; calculated as Net Income ÷ Average Owner's/Stockholders' Equity. (pp. 186, 520, 676)

**Return on investment (ROI)** A traditional performance measure that takes into account both operating income and the assets invested to produce that income; calculated as Operating Income ÷ Assets Invested. (p. 1014)

**Revenue center** A responsibility center whose manager is accountable primarily for revenue and whose success is based on its ability to generate revenue. (p. 1008)

**Revenue expenditure** An expenditure for ordinary repairs and maintenance of a long-term asset, which is recorded by a debit to an expense account. (p. 370)

**Revenue recognition** The process of determining when revenue should be recorded. (p. 88)

**Revenues** Increases in owner's equity resulting from operating a business. (pp. 7, 86)

**Reversing entry** An optional journal entry made on the first day of an accounting period that is the exact opposite of an adjusting entry made at the end of the previous period. (p. 141)

**Risk assessment** The identification of areas in which risk of loss of assets or inaccuracies in accounting records is high. (p. 303)

## S

**S corporations** Corporations that U.S. tax laws treat as partnerships. (p. 475)

**Salaries** Compensation of employees at a monthly or yearly rate. (p. 415)

**Sales budget** A detailed plan, expressed in both units and dollars, that identifies the product (or service) sales expected during an accounting period. (p. 962)

**Sales discount** A discount given to a buyer for early payment of a sale made on credit; the Sales Discounts account is a contra-revenue account. (p. 212)

**Sales forecast** A projection of the estimated sales in units based on an analysis of external and internal factors. (p. 963)

**Sales journal** A journal used to record credit sales. (p. 249)

**Sales mix** The proportion of each product's unit sales relative to the company's total unit sales. (p. 934)

**Sales mix decision** A decision to select the alternative that maximizes the contribution margin per constrained resource. (p. 1098)

**Sales returns and allowances** Refunds, credits, and discounts given to customers who have received defective goods. (p. 209)

**Sales Returns and Allowances account** A contra-revenue account used to accumulate cash refunds, credits on account, and other allowances made to customers who have received defective or otherwise unsatisfactory products. (p. 218)

**Sarbanes-Oxley Act** An act of Congress that regulates financial

- reporting in public corporations. (p. 19)
- Scatter diagram** A chart of plotted points that helps determine whether a linear relationship exists between a cost item and its related activity measure. (p. 927)
- Secured bonds** Bonds that carry a pledge of certain assets as a guarantee of repayment. (p. 550)
- Securities and Exchange Commission (SEC)** A governmental agency that regulates the issuing, buying, and selling of stocks. It has the legal power to set and enforce accounting practices for firms whose securities are sold to the general public. (p. 14)
- Securitization** The grouping of receivables into batches for sale at a discount to companies and investors. (p. 351)
- Segment margin** A segment's sales revenue minus its direct costs (direct variable costs and direct fixed costs traceable to the segment). (p. 1096)
- Sell-or-process-further decision** A decision about whether to sell a joint product at the split-off point or sell it after further processing. (p. 1101)
- Selling and administrative expenses budget** A detailed plan of operating expenses, other than those related to production, that are needed to support sales and overall operations during an accounting period. (p. 967)
- Selling expenses** The costs of storing goods and preparing them for sale; preparing displays, advertising, and otherwise promoting sales; and delivering goods to a buyer if the seller has agreed to pay the cost of delivery. (p. 210)
- Separate entity** A business that is treated as distinct from its creditors, customers, and owners. (p. 4)
- Separation of duties** No one person can authorize transactions, handle assets, or keep records of assets. (p. 304)
- Serial bonds** Bonds in one issue that mature on different dates. (p. 550)
- Service unit cost** The cost to perform one service. (p. 763)
- Share of stock** A unit of ownership in a corporation. (p. 492)
- Short-run decision analysis** The systematic examination of any decision whose effects will have the greatest impact within the next year. (p. 1090)
- Short-term notes payable** Promissory notes issued by companies to meet their short-term funding needs. (p. 412)
- Simple interest** The interest cost for one or more periods when the amount on which the interest is computed stays the same from period to period. (p. 426)
- Single-step income statement** An income statement that arrives at net income in a single step. (p. 211)
- Software** Capitalized costs associated with computer programs developed for sale, lease, or internal use and amortized over the estimated economic life of the programs. (p. 387)
- Sole proprietorship** A business that is owned by one person and that is not incorporated. (p. 4)
- Source documents** Invoices, checks, receipts, or contracts that support the details of a transaction. (p. 47)
- Special order decisions** Decisions about whether to accept or reject special orders at prices below the normal market prices. (p. 1094)
- Special-purpose entities (SPEs)** Business organizations with limited lives that a company creates to achieve a specific objective, such as raising money by selling receivables. (p. 475)
- Special-purpose journals** Journals that are used to record transactions that fall into special categories such as sales, purchases, cash receipts, and cash payments. (p. 249)
- Specific identification method** An inventory costing method in which the cost of each item in ending inventory is identified as coming from a specific purchase. (p. 268)
- Split-off point** A specific point in the production process at which two or more joint products become separate and identifiable. At that point, a company may choose to sell the product as is or process it into another form for sale to a different market. (p. 1101)
- Standard costing** A method of cost control with three components: a standard, or predetermined, performance level; a measure of actual performance; and a measure of the difference, or variance, between standard and actual performance. (p. 1048)
- Standard costing method** A method of cost measurement that uses the estimated or standard costs of direct materials, direct labor, and overhead to calculate a product or service unit cost. (p. 776)
- Standard costs** Realistic estimates of costs based on analyses of both past and projected operating costs and conditions. (p. 1048)
- Standard direct labor cost** The standard wage for direct labor multiplied by the standard hours of direct labor. (p. 1050)
- Standard direct materials cost** The standard price for direct materials multiplied by the standard quantity for direct materials. (p. 1049)
- Standard fixed overhead rate** Total budgeted fixed overhead costs divided by an expression of capacity, usually normal capacity in terms of standard direct labor hours or units. (p. 1050)
- Standard overhead cost** The sum of the estimates of variable and fixed overhead costs in the next accounting period. (p. 1050)
- Standard variable overhead rate** Total budgeted variable overhead costs divided by an expression of capacity, such as the expected number of standard machine hours or standard direct labor hours. (p. 1050)
- Start-up and organization costs** The costs of forming a corporation. (p. 495)
- Statement of cash flows** A financial statement that shows the inflows and outflows of cash from operating activities, investing activities, and financing activities over an accounting period. (pp. 10, 602)
- Statement of cost of goods manufactured** A formal statement summarizing the flow of all manufacturing costs incurred during an accounting period. (p. 773)
- Statement of owner's equity** A financial statement that shows the changes in owner's equity over an accounting period. (p. 8)
- Statement of stockholders' equity** A financial statement that summarizes changes in the components of the stockholders' equity section of the balance sheet. Also called the *statement of changes in stockholders' equity*. (p. 516)
- Static budgets** Budgets that are prepared once a year and do not

- change during the annual budget period. (p. 977)
- Step cost** A cost that remains constant in a relevant range of activity and increases/decreases in a stairstep-like manner when activity is outside the relevant range. (p. 924)
- Stock dividend** A proportional distribution of shares among a corporation's stockholders. (p. 513)
- Stock option plans** Plans that give employees the right to purchase their companies' stock under specified terms. (p. 522)
- Stock split** An increase in the number of outstanding shares of stock accompanied by a proportionate reduction in the par or stated value. (p. 515)
- Stockholders** The owners of a corporation whose ownership is represented by shares of stock but who do not directly control the corporation's operations. (p. 5)
- Stockholders' equity** The equity section of a balance sheet for a corporation; the owners' claims to the business. Also called *shareholders' equity*. (pp. 178, 496)
- Storage time** The time a product spends in materials storage, work in process inventory, or finished goods inventory. (p. 891)
- Straight-line method** A method of depreciation that assumes depreciation depends only on the passage of time and that allocates an equal amount of depreciation to each accounting period in an asset's useful life. (pp. 375, 558)
- Strategic objectives** Broad, long-term goals that determine the fundamental nature and direction of a business and that serve as a guide for decision making. (p. 778)
- Strategic planning** The process by which management establishes an organization's long-term goals. (p. 976)
- Subsidiary ledger** A ledger separate from the general ledger that contains a group of related accounts. (p. 249)
- Successful efforts accounting** A method of accounting for the costs of exploring and developing oil and gas resources in which successful exploration is recorded as an asset and depleted over the estimated life of the resource and all unsuccessful efforts are immediately written off as losses. (p. 385)
- Sunk cost** A cost that was incurred because of a previous decision and that cannot be recovered through the current decision. (p. 1091)
- Supply chain** The path that leads from the suppliers of the materials from which a product is made to the final consumer. Also called the *supply network*. (pp. 778, 882)
- Supply-chain management** A system of ordering and tracking inventory conducted over the Internet. (p. 281)
- Support services** Components of the value chain that facilitate the primary processes but do not add value to a product or service. (p. 882)
- T**
- T account** The simplest form of account, which is used to analyze transactions. (p. 44)
- Tactical objectives** Mid-term goals that position an organization to achieve its long-term strategies. (p. 778)
- Temporary accounts** Revenue and expense accounts whose balances are transferred to the owner's Capital account at the end of an accounting period. Also called *nominal accounts*. (p. 132)
- Term bonds** Bonds in one issue that mature at the same time. (p. 550)
- Theoretical capacity** The maximum productive output for a given period in which all machinery and equipment are operating at optimum speed, without interruption. Also called *ideal capacity*. (p. 924)
- Theory of constraints (TOC)** A management theory that contends that limiting factors, or bottlenecks, occur during the production of any product or service, but that once managers identify such a constraint, they can focus their attention and resources on it and achieve significant improvements. (p. 896)
- Throughput time** The time it takes to move a product through the entire production process. (p. 891)
- Time value of money** The costs or benefits derived from holding or not holding money over time. (p. 426)
- Timeliness** The qualitative characteristic of information that enables users to receive information in time to influence a decision. (p. 172)
- Total direct labor cost variance** The difference between the standard direct labor cost for good units produced and actual direct labor costs. (p. 1057)
- Total direct materials cost variance** The difference between the standard cost and actual cost of direct materials. Also called *good units produced*. (p. 1054)
- Total fixed overhead cost variance** The difference between actual fixed overhead costs and the standard fixed overhead costs that are applied to good units produced using the standard fixed overhead rate. (p. 1062)
- Total manufacturing costs** The total costs of direct materials, direct labor, and overhead incurred and transferred to Work in Process Inventory account during an accounting period. Also called *current manufacturing costs*. (p. 769)
- Total overhead cost variance** The difference between actual overhead costs and standard overhead costs applied. (p. 1060)
- Total quality management (TQM)** A management tool that requires that all parts of a business work together to build quality into the business's product or service. (p. 896)
- Total variable overhead cost variance** The difference between actual variable overhead costs and the standard variable overhead costs that are applied to good units produced using the standard variable overhead rate. (p. 1061)
- Trade credit** Credit granted to customers by wholesalers or retailers. (p. 336)
- Trade discount** A deduction (usually 30 percent or more) off a list or catalogue price, which is not recorded in the accounting records. (p. 212)
- Trademark** A registered symbol that can be used only by its owner to identify a product or service. (p. 387)
- Trading securities** A type of marketable security that a company buys and sells for making a profit in the near term as opposed to holding it indefinitely for investment purposes. (p. 603)
- Transfer agents** A trust company, bank, or similar financial institution assigned by a corporation to maintain records of *investors* and account balances and transactions. (p. 494)
- Treasury stock** Shares of the corporation's own stock that it has



bought back on the open market, which reduces the ownership of the business. (p. 496)

**Trend analysis** A variation of horizontal analysis in which percentage changes are calculated for several successive years instead of for two years. (p. 666)

**Trial balance** A comparison of the total of debit and credit balances in the accounts to check that they are equal. (p. 56)

## U

**Uncollectible accounts** Accounts receivable owed by customers who cannot or will not pay. Also called *bad debts*. (p. 337)

**Underapplied overhead costs** The amount by which actual overhead costs exceed the overhead costs applied using the predetermined overhead rate for the accounting period. (p. 815)

**Understandability** The qualitative characteristic of information that enables users to comprehend the meaning of the information they receive. (p. 172)

**Underwriter** An intermediary between the corporation and the investing public who facilitates an issue of stock or other securities for a fee. (p. 494)

**Unearned revenues** Revenues received in advance for which the goods have not yet been delivered or the services performed; a liability account. (pp. 96, 418)

**Unit-level activities** Activities performed each time a unit is produced. (p. 886)

**Unlimited liability** A characteristic of a partnership; the fact that each partner has personal liability for all the debts of the partnership. (p. 452)

**Unsecured bonds** Bonds issued on an corporation's general credit. Also called *debenture bonds*. (p. 550)

## V

**Valuation** The process of assigning a monetary value to a business transaction and the resulting assets and liabilities. (p. 40)

**Value-adding activity** An activity that adds value to a product or service as perceived by the customer. (p. 883)

**Value-adding cost** The cost of an activity that increases the market value of a product or service. (p. 765)

**Value-based systems** An accounting system that provides better customer-related, activity-based information than does the traditional cost-based system. (p. 882)

**Value chain** A sequence of activities, or primary processes, that add value to a product or service; also includes support services that facilitate these activities. (p. 882)

**Variable cost(s)** A cost that changes in direct proportion to a change in productive output (or some other measure of volume). (pp. 764, 922)

**Variable cost formula** A straight line equation,  $Y = a(X)$ , where  $Y$  is total variable cost,  $a$  is the variable rate per unit, and  $X$  is the units produced. (p. 923)

**Variable costing** A method of preparing profit center performance reports that classifies a manager's controllable costs as either fixed or variable and produces a variable costing income statement. (p. 1012)

**Variable overhead efficiency variance** The difference between the standard direct labor hours allowed for good units produced and the actual hours worked multiplied by the standard variable overhead rate per hour. (p. 1062)

**Variable overhead spending variance** The difference between actual variable overhead costs and the standard variable overhead rate multiplied by the actual hours used. Also called the *variable overhead rate variance*. (p. 1062)

**Variance** The difference between a standard cost and an actual cost. (p. 1048)

**Variance analysis** The process of computing the differences between standard costs and actual costs and identifying the causes of those differences. (p. 1049)

**Verifiability** The qualitative characteristic of information that helps

assure users that information faithfully represents what it purports to depict. (p. 172)

**Vertical analysis** A technique for analyzing financial statements that uses percentages to show how the different components of a statement relate to a total figure in the statement. (p. 667)

## W

**Wages** Compensation of employees at an hourly rate. (p. 415)

**Withdrawals** Assets that the owner takes out of the business. (p. 7)

**Work cell** An autonomous production line that can perform all required operations efficiently and continuously. (p. 890)

**Work in Process Inventory account** An inventory account used to record the manufacturing costs incurred and assigned to partially completed units of product. (p. 768)

**Work sheet** A type of working paper used as a preliminary step in recording adjusting and closing entries and that is used in preparing the financial statements. (p. 143)

**Working capital** A measure of liquidity that shows the net current assets on hand to continue business operations; calculated as Total Current Assets – Total Current Liabilities. (p. 180)

**Working papers** Documents that accountants use to organize their work and that support the information in the financial statements. (p. 143)

**Write-down** A reduction in the value of an asset below its carrying value on the balance sheet. Also called a *write-off*. (p. 686)

## Z

**Zero-based budgeting** Budgets that are prepared anew each period. All budget items must be justified; nothing is taken for granted. (p. 978)

**Zero coupon bonds** Bonds that do not pay periodic interest but that pay a fixed amount on the maturity date. (p. 558)

# COMPANY NAME INDEX

- Abbott Laboratories, 389, 511  
Abercrombie & Fitch Co., 203  
Adolph Coors Company, 497  
Albertson's, 778  
Alliance Capital Management Limited Partnership, 474  
Amazon.com, 410, 415, 603, 622–625, 1008, 1093  
America Online (AOL), 129  
American Airlines, 420  
American Express, 210, 351, 684  
Amtrak, 962  
AOL Time Warner, 227, 420  
Apple Computer, 87, 370, 387–388, 392–393, 510, 578, 844, 1008  
AT&T Corporation, 388, 510  
Autoliv, Inc., 779
- Babies “R” Us, 304  
Bank of America, 312, 684  
Bank One, 352  
Bayer AG, 187  
Bell South, 553  
Benetton Group, 187  
Best Buy Co., 17  
Boeing Company, The, 63–64, 176, 374  
Brinker International, 1008
- Cadillac, 449  
Campbell Soup, 686  
Chase, 312  
China Mobile, 388  
Chrysler, 414  
Circuit City, 351  
Cisco Systems, 340, 390, 449, 622, 648  
Citibank, 312, 449  
CMS Energy, 498  
Coca-Cola Company, 388, 553, 844  
Columbia HCA Healthcare, 553  
CompuCredit, 364  
Computer Associates, 62  
Continental Airlines, 578, 598  
Coors, 844  
Costco Wholesale Corporation, 210, 229, 307, 318, 407, 778  
Crocs, 544  
CVS Corporation, 1, 3, 18, 37, 84, 130, 167, 203, 247, 264, 299, 333, 365, 407, 449–450, 544, 578, 598–599, 606, 648, 711–712
- Dell Computer Corporation, 174, 282, 299, 648  
Deloitte & Touche, 490  
Delta, 374  
Dillard's, 350  
Dow Chemical Company, 598, 844, 877  
DreamWorks Animation, 543  
Dun & Bradstreet, 661, 663
- Eastman Kodak, 597  
eBay, 687  
Enron Corporation, 19, 62, 174, 475, 646  
Enterprise Rent-A-Car, 962
- Ernst & Young, 490  
ExxonMobil Corporation, 5, 298, 622
- Facebook, 922  
Fidelity Investments Company, 37  
Fleetwood enterprises, Inc., 646  
Flickr, 922  
Ford Motor Co., 350, 622, 711  
Four Seasons Hotel, The, 883
- Gap, Inc., 3, 203, 771  
GE, 388  
General Mills, 390, 515  
General Motors (GM), 18, 389, 510, 579, 711, 961  
Godiva Chocolatier, Inc., 772  
Goodyear Tire & Rubber Company, 173, 662, 711  
Google, Inc., 388, 494–495, 497, 522, 543, 622, 687, 818, 922
- H&R Block, 818, 1001  
Harley-Davidson, 961, 1008  
HealthSouth, 352  
Heinz, 390  
Hershey Company, The, 411, 420, 772, 778  
Hertz, 1008  
Household International, 352
- IBM, 388, 407, 543, 553, 712  
Intel Corporation, 598, 648, 712  
iRobot Corporation, 1059
- JCPenney, 299  
Jiffy Lube, 1008  
Johnson & Johnson, 1001
- Kellogg Company, 844, 1129  
KnowledgeWare, 129  
KPMG International, 490  
Kraft Foods, Inc., 1129  
Kroger, 778
- L.L. Bean, 220  
Lands' End, 220  
La-Z-Boy, 886  
Lehman Brothers, 351  
Levi Strauss & Co., 818  
Lowe's, 962  
Lucent Technologies, 129, 340, 414  
Lyric Opera of Chicago, 129
- Macy's, 304, 350  
Marlboro, 388  
Marriott International, 407  
MasterCard, 210, 351  
McDonald's, 181, 210, 247, 388, 581, 686  
MCI, *See* WorldCom (MCI), 62  
Mellon Bank, 83  
Merrill Lynch, 351  
Michaels, 962  
Microsoft, 103, 388, 410, 425, 430, 520–522, 543, 578, 622  
Midas, 421  
Mitsubishi Corp., 364
- Moody's Investors Service, 663  
Motorola, 414
- Neiman Marcus, 210  
Netflix, 94, 96, 97, 98  
Nike, 281, 311, 349–350, 352, 433–434, 515  
Nokia, 489  
Nordstrom, 350  
Nortel Networks, 340
- Office Depot, 220  
Old Navy, 962  
Oracle Corporation, 449, 648
- Piedmont, 374  
PricewaterhouseCoopers, 490, 782
- Reebok International Ltd., 17  
Reed Elsevier, 187  
Rent-Way, Inc., 282  
Rite Aid Corporation, 282  
Royal Dutch/Shell Group, 386
- Safeway, 778  
Sam's Club, 210  
Sears, 350  
Simon & Schuster, 227  
Southwest Airlines Co., 17, 37, 84, 167, 203, 333, 406, 408, 544, 548, 578, 599, 648, 712, 764, 771  
Sprint, 336  
Standard & Poor's Ratings Group (S&P), 579, 663, 711  
Starbucks Corporation, 17, 210, 333, 666–667, 670–681, 684–687  
Starwood Hotels & Resorts Worldwide, Inc., 407
- Target Corporation, 19, 229  
Tiffany & Co., 210  
Time Warner, 498  
Toyota, 17, 264, 266, 818  
Toys “R” Us, 87, 1001  
Trader Joe's, 778  
TWA, 578
- United Airlines, 578  
United Parcel Service (UPS), 282, 771, 818, 962  
United Way, 1008  
US Airways, 374
- Vanguard Airlines, 374  
Verizon, 62  
Visa, 210, 351  
Vivendi, 613
- Walgreens, 247, 264, 299, 365, 450  
Wal-Mart Corp., 17, 312, 771, 778, 789, 882, 1008  
Walt Disney Company, The, 130, 553  
Wendy's International Inc., 17  
Western Airlines, 374  
Whole Foods Market, 778, 789  
WorldCom (MCI), 19, 62, 174, 393, 449, 613, 626, 977  
Xerox Corporation, 129, 498

# SUBJECT INDEX

- A**  
Accelerated method, 377  
Account, controlling, 249  
**Account balance, 44**  
**Accounting, 2**  
    applications, 8  
    as an information system, 2  
    for cash dividends, 510  
    for corporations, 491  
    **conventions, 172**  
    estimates, 684  
    information, users of, 15  
    for intangible assets, 387  
    for issuance of bonds, 551  
    for merchandising operations, 205  
    methods, 683  
    for par value stock, 501  
    for partners' equity, 454  
    for partnerships, 451  
    principles and the financial statements, 1  
    for product costs in a JIT operating environment, 891  
    rate-of-return calculation, 1108  
    **rate-of-return method, 1108**  
    for treasury stock, 505  
**Accounting cycle, 46**  
    overview of, 46  
**Accounting equation, 6**  
    transaction effects on, 61  
Accounting measurement, 2  
    concepts underlying, 2  
**Accounts, 42**  
    payable, 412  
    receivable, 336  
    receivable aging method, 341  
**Accrual, 91**  
**Accrual accounting (matching rule), 87, 432**  
    valuation of inventories, 264  
Accrual-based information  
    determination of cash flows from, 104  
    using to make management decisions, 103  
**Accrued expenses, 94**  
    and related accrued liabilities, 432  
Accrued interest, 347  
**Accrued liabilities, 414**  
**Accrued revenues, 97**  
**Accumulated depreciation, 93**  
Acquiring and financing long-term assets, 392  
Acquisition cost of property, plant, and equipment, 372  
Activities, 603  
**Activity base, 924**  
**Activity-based costing (ABC), 885**  
**Activity-based management (ABM), 885**  
**Actual costing method, 775**  
Additions, 370  
**Adjusted trial balance, 99**  
    relationship to the income statement, statement of owner's equity, and balance sheet, 100  
**Adjusting entries, 90**  
    and the financial statements, 101  
Adjusting the accounts, 85  
Adjusting the allowance account  
    credit balance, 342  
    debit balance, 342  
Adjustment for  
    design revenue, 98  
    prepaid (deferred) expenses, 92  
    prepaid rent, 92  
    supplies, 93  
    unearned (deferred) revenues, 96  
    unrecorded (accrued) wages, 95  
Adjustment process, 90  
Adjustments from the work sheet entered in the general journal, 146  
Adjustments, four types of, 91  
Admission of a new partner, 461  
Advisors of investors and creditors, 16  
    after closing, 140  
**Aging of accounts receivable, 341**  
Allocating overhead costs  
    a four-step process, 815  
    steps, 814  
**Allowance for uncollectible accounts, 339**  
**Allowance method, 338**  
**American Institute of Certified Public Accountants (AICPA), 13**  
Amortization, 368  
    of bond discounts and premiums, 557, 562  
Analysis of accounts receivable by age, 342  
Analyzing and recording business transactions, 39  
    ABC approach, 817  
    payable, 6, 412  
    payable, evaluating, 433  
    receivable, 6, 336  
    receivable aging method, 341  
    receivable as a percentage of total assets for selected industries, 336  
    traditional approach, 817  
    uncollectible accounts, 338  
    using accrual accounting to value receivables, 338  
    using the effective interest method, 559, 564  
    using the straight-line method, 558, 562  
Analyzing capital investments, 1102  
Analyzing cash flows, 622  
Annual report  
    components of, 715  
    description of company, 715  
    discussion and analysis, 715  
    financial highlights, 715  
    financial statements, 715  
    how to read, 715  
    letter to shareholders, 715  
**Articles of incorporation, 492**  
**Asset(s), 6, 175**  
    changes in, 610  
    current, 175  
    gain on sale of, 468  
    impairment, 369  
    intangible, 177  
    other, 175  
    reported by large companies, 388  
    return on, 183  
    turnover, 182, 671  
**Audit, 12**  
Auditors' reports, 722  
**Authorization, 303**  
**Authorized shares, 497**  
**Average costing method, 269, 846**  
    accounting for costs, 857  
    accounting for units, 856  
    assigning costs, 858  
**Average-cost method, 269, 275**  
**Avoidable costs, 1096**  
**B**  
**Backflush costing, 893**  
Bad debts, 337  
Balance, 44  
**Balance sheet, 8**  
    long-term liabilities, 577  
    and partner's equity, 472  
    stockholders' equity section of, 496, 517  
**Balanced scorecard, 1018**  
    of linked objectives, performance measures, and targets, sample, 1020  
Bank loans and commercial paper, 413  
**Bank reconciliation, 312, 313**  
**Bank statement, 310**  
Banking services, 312  
**Base year, 664**  
**Batch-level activities, 886**  
Behavior patterns of mixed costs, 925  
**Benchmarking, 1020**  
**Benchmarks, 1020**  
Betterments, 370  
**Bill of activities, 887**  
**Board of directors, 492**  
**Bond certificate, 549**  
Bond discount, amortizing, 557  
**Bond indenture, 549**  
Bond interest expense, year-end accrual, 570  
**Bond issue, 549**  
    at discount, 552  
    at face value, 551  
    at premium, 554  
    between interest payment dates, 569  
    costs, 554  
    prices and interest rates, 549  
**Bonding, 304**  
**Bonds, 549**  
    accounting for the issuance of, 551  
    callable, 550



- characteristics of, 550
  - convertible, 550
  - coupon, 551
  - registered and coupon, 551
  - retirement and conversion, 566
  - secured, 550
  - serial, 550
  - term, 550
  - unsecured, 550
  - using present value to value, 555
  - Bonds payable, 546, 618**
    - other issues, 568
  - Bonus, 463**
    - to new partner, 464
    - to old partners, 463
  - Book of original entry, 47
  - Book value, 93, 518**
    - for common and preferred stock, 518
    - for dividends in arrears, 518
    - per share, 518
  - Bookkeeping, 2**
  - Breakeven analysis, 931
    - graphic, 932
  - Breakeven point, 931**
    - for multiple products, 933
  - Budget, 777
    - flexible, 1011
    - implementing the, 978
    - master, 958
  - Budget committee, 978**
  - Budget procedures, 962
  - Budgeted balance sheet, 974, 975**
  - Budgeted fixed overhead variance, 1064
  - Budgeted income statement, 970**
  - Budgeting, 958**
    - advantages of, 976
    - basics, 977
    - continuous, 978
    - goals and, 976
    - long-term goals, 976
    - management process and, 976, 978
    - participative, 977
    - process, 957
    - short-term goals, 977
    - zero-based, 978
  - Budgets, 778, 958**
    - financial, 958
    - operating, 958
  - Buildings, 373
  - Business, 17**
    - analysis, 47
    - goals and activities, 17
    - issues related to current liabilities, 433
    - plan, 777
    - transactions, 2, 40
- C**
- Call price, 550**
  - Callable bonds, 550**
    - and convertible bonds, 550
  - Callable preferred stock, 499**
  - Capacity
    - engineering, 924
    - ideal, 924
    - normal, 924
  - operating, 924
    - practical, 924
    - theoretical, 924
  - Capital
    - balance ratios, 456
    - expenditure, 370
    - expenditures budget, 971**
    - investment analysis, 1090**
    - investment decisions, 1102**
    - lease recognition, 574
    - working, 180
  - Capital budgeting, 1090
    - analysis measures and methods, 1104
    - process, 1103
  - Capital lease, 548, 573**
    - payment schedule, 573
  - Carrying value (book value), 93, 369**
    - and interest expense—bonds issued at discount, 562
    - and interest expense—bonds issued at premium, 565
  - Cash, 602**
  - Cash and internal control, 301
  - Cash balances, 603
  - Cash basis of accounting, 88**
  - Cash budget, 971, 973
    - elements of, 971
  - Cash collections, 972
  - Cash control methods, 312
  - Cash dividends, 414, 510**
  - Cash equivalents, 311, 602**
    - and cash control, 311
  - Cash flow(s), 10, 602, 607**
    - consolidated statement, 604
    - effects of FIFO and LIFO on, 273
    - financial statements and, 621
    - from financing activities, 10
    - information, 522, 581
    - from investing activities, 10
    - net income and, 625
    - from operating activities, 10
    - in operating cycle, 228
    - ratios, 622
    - timing of transactions and, 63
    - trends, 626
    - yield, 622, 673
  - Cash flows to assets, 624, 674
  - Cash flows to sales, 633, 673
  - Cash gap, 228
  - Cash inflows and cash outflows, classification
    - of, 605
  - Cash payments, 972
    - for income taxes, 652
    - for interest, 652
    - for operating expenses, 651
    - for purchases, 650
  - Cash payments journal, 257**
    - relationship to general ledger and accounts payable subsidiary ledger, 258
  - Cash receipts, control of, 307
  - Cash receipts from
    - interest and dividends, 650
    - sales, 650
  - Cash receipts journal, 254**
    - relationship to general ledger and accounts receivable subsidiary ledger, 256
  - Cash receipts received
    - by mail, 307
    - over the counter, 307
  - Cash received
    - equal to carrying value, 381
    - less than carrying value, 382
    - more than carrying value, 383
  - Cash-generating efficiency, 622
  - Certified public accountant (CPA), 12**
  - Chart of accounts, 42**
    - for a small business, 43
  - Check, 310**
    - authorization, 310
  - Classification, 41, 410**
    - accrual accounting, and disclosure of long-term assets, 368
    - of cash flows, 603
    - of cash inflows and cash outflows, 605
    - of long-term assets and methods of accounting for them, 369
  - Classified balance sheet, 175
    - groups accounts into useful categories, 179
  - Classified financial statements, 175**
  - Closing entries, 132**
    - and financial statements, 146
    - effect on financial statements, 147
    - preparing from adjusted trial balance, 134
  - Closing process, overview, 133
  - Closing
    - credit balances, 135
    - debit balances, 136
    - income summary account balance, 138
    - overhead account, 815
  - Collection on account, 52
  - Commercial paper, 413**
  - Commitment, 425**
  - Common costs, 1101
  - Common step-like fixed cost behavior pattern, 925
  - Common stock, 497, 618**
  - Common types of current liabilities, 412
  - Common variable cost behavior pattern, 923
  - Common-size statement, 667**
    - balance sheets, 668
    - income statements, 669
  - Communicating, 779, 818
  - Comparability, 172**
  - Comparative balance sheets
    - showing changes in accounts, 608
    - with horizontal analysis, 665
  - Comparative income statements with horizontal analysis, 666
  - Comparative summary of alternatives, 938
  - Compensation committee, 687**
  - Complete information, 172**
  - Completed units, 809
  - Completing the accounting cycle, 131
  - Compound entry, 50**
  - Compound interest, 426**
  - Computer software costs, 389
  - Confirmative value, 171**
  - Conglomerates, 661

- Conservatism, 173**  
and the lower-of-cost-or-market (LCM) rule, 265
- Consignment, 265**
- Consistency, 172, 684**
- Consolidated statement of cash flows, 604
- Constraints, 172
- Consumer groups, customers, and the general public, 16
- Contingent liability, 351, 424**  
and commitments, 424
- Continuity, 87**
- Continuous budget, 978**
- Continuous improvement, 896**  
of the work environment, 891
- Contra account, 93**
- Contributed capital, 178, 492**
- Contribution margin (CM), 929**  
income statement(s), 929, 930
- Control account, 249**
- Control activities, 303**
- Control environment, 303**
- Control of  
cash receipts, 307  
cash received by mail, 307  
cash received over the counter, 307  
purchases and cash disbursements, 307
- Controllable costs and revenues, 1007**
- Controlling account(s), 249  
and subsidiary ledgers, 249
- Conversion costs, 764, 847, 894**
- Conversion of bonds, 567
- Convertible bonds, 550**
- Convertible preferred stock, 499**
- Co-ownership of partnership property, 453
- Core competency, 882**
- Corporate form of business, 492
- Corporate income statement, 685
- Corporate organization, 492
- Corporation, 4, 5, 178**
- Cost allocation, 813**
- Cost approach, 426
- Cost behavior, 764, 922**
- Cost center, 1008**
- Cost constraint, 172**
- Cost driver, 813, 924**
- Cost flow, 265**  
comparison chart of traditional and backflush costing, 893  
in traditional and backflush costing, 893  
through the work in process inventory accounts, 846
- Cost hierarchies, 886**  
and the bill of activities, 885  
sample activities, 886
- Cost measurement, 762
- Cost object, 813**
- Cost of capital, 1017**
- Cost of goods available for sale, 221**
- Cost of doing business, 86
- Cost of goods manufactured, 770**
- Cost of goods manufactured budget, 968, 969**
- Cost of goods sold (cost of sales), 209, 221, 770**  
Cost of goods sold and a manufacturer's income statement, 774
- Cost of sales, 209
- Cost pool, 813**
- Cost principle, 41**
- Cost recognition, 761
- Cost-benefit, 172**
- Cost-plus contracts, 811**
- Cost-volume-profit (CVP) analysis, 921, 931**  
CVP and the management process, 939
- Costing systems  
job order, 803  
process, 843
- Costs of quality, 896**
- Coupon bonds, 551
- Credere*, 44
- Credit balances, closing, 135
- Credit, 44**
- Creditors, 16
- Crossfooting, 145**
- Cumulative preferred stock, 498**
- Current assets, 175**
- Current liabilities, 177, 410**  
business issues related to, 433  
concepts underlying, 410  
fair value accounting and, 409  
financial statements and, 432
- Current portion of long-term debt, 415
- Current ratio, 180, 679
- CVS Caremark Corporation  
annual report, excerpts from, 725–745  
auditors' report, 723  
balance sheets, 718  
income statements, 717  
statements of cash flows, 719  
statements of shareholders' equity, 721
- D**
- Days' inventory on hand, 281, 677
- Days' payable, 679
- Days' sales uncollected, 350, 678
- Death of a partner, 467
- Debere*, 44
- Debit, 44**
- Debit balances, closing, 136
- Debits and credits, miscellaneous, 313
- Debt to equity ratio, 185, 579, 675
- Decision analysis, 1090
- Decision makers, 15
- Declaration date, 511**
- Declining-balance method, 377
- Deferral, 91**
- Deferred income taxes, 548**
- Deferred payment, present value of, 431
- Defined benefit plan, 576**
- Defined contribution plan, 576**
- Definite useful life, 388
- Definitely determinable liabilities, 412**
- Delivery expense, 214**
- Denominator activity, 924
- Depletion, 368, 384
- Deposits in transit, 312**
- Depreciable cost, 375
- Depreciation, 93, 374, 368, 609**  
amortization, and depletion, 609  
graphic comparison of the three methods, 378  
obsolescence, 374  
for partial years, 379  
of plant and equipment, 93  
of plant assets related to natural resources, 385  
physical deterioration, 374  
recorded, 574  
special issues in determining, 379  
straight-line method, 375
- Depreciation schedule  
double-declining-balance method, 377  
production method, 376  
straight-line method, 376
- Differential cost, 1091**
- Direct and indirect costs in traditional and JIT environments, 892
- Direct charge-off method, 337**
- Direct costs, 762**
- Direct labor**  
**budget, 966**  
**costs, 763**  
**efficiency variance, 1057**  
quantity, 1057  
**rate standard, 1050**  
**rate variance, 1057**  
spending variance, 1057  
**time standard, 1050**  
variance analysis, diagram, 1058
- Direct materials**  
business application, 1056  
**costs, 763**  
efficiency, 1054  
**price standard, 1049**  
**price variance, 1054**  
**purchases budget, 964, 965**  
**quantity standard, 1049**  
quantity variance, 1054  
spending, 1054  
variance analysis, diagram, 1055
- Direct method, 606**  
of determining net cash flows from operating activities, 649  
of preparing the statement of cash flows, 649
- Discarded plant assets, 380
- Discarding assets with carrying value, 380
- Disclosure, 266, 410
- Disclosure of noncash investing and financing transactions, 606  
of inventory methods, 266  
of receivables, 339
- Discontinued operations, 686**
- Discount, 550**  
purchase, 213  
sales, 212  
sales and purchases, 212  
trade, 212
- Discounting, 352**
- Discounts and premiums, 549
- Discretionary cost center, 1008**
- Dishonored note, 347**
- Disposal of depreciable assets, 380
- Dissolution, 461**  
of a partnership, 461

- Distributing income using stated ratios, 456
- Distribution of partnership income and losses, 455
- Diversified companies, 661**
- Dividend(s), 179, 493, 498, 499**
  - dates, 511
  - distribution, 499
  - in arrears, 498**
  - large stock, 515
  - payable, 414
  - transactions, 511
  - yield, 520, 681
- Documents and records, 304
- Double taxation, 494**
- Double-declining-balance method, 377**
- Double-entry accounting, rules of, 44
- Double-entry system, 42**
- Due care, 14**
- Duration of a note, 346**
  
- E**
- Early extinguishment of debt, 550**
- Earned capital, 179
- Earnings management, 102**
- Economic entity, 2**
- Economic planners, 16
- Economic Stimulus Act of 2008, 379**
- Economic value added (EVA), 1017**
- Effective interest method, 559**
- Electronic funds transfer (EFT), 312**
- Employee, 416**
- Engineering capacity, 924
- Engineering method, 929**
- Equipment, 373
- Equities, 6
- Equity
  - partners', 178
  - return on, 186
  - stockholders', 178
- Equity financing, 494
  - advantages and disadvantages, 495
- Equivalent production, 847**
  - for conversion costs, 848
  - for direct materials, 847
  - summary of, 848
- Estimate of overhead costs, 808
- Estimated liabilities, 420**
- Estimated useful life, 375**
- Ethics, 19**
  - in acquiring and financing long-term assets, 393
  - for business, 102
  - and estimates in accounting for receivables, 352
  - financial reporting and business transactions, 19, 62, 174
  - statement of cash flows and, 626
- Evaluating, 779, 818
  - accounts payable, 433
  - cost center performance using flexible budgeting, 1012
  - decision to issue long-term debt, 578
  - dividend policies, company performance, and stock options, 520
  - financial risk, 675
  - level of accounts receivable and ethical ramifications, 349
  - level of inventory, 280
  - liquidity, 180, 673
  - long-term debt, 579
  - market strength with financial ratios, 680
  - profit center performance using variable costing, 1012
  - profitability and total asset management, 181, 671
  - quality of earnings, 683
- Exchange gain or loss, 230**
- Exchange price, 41
- Exchange rate, 3**
- Exchanges of plant assets, 383
- Ex-dividend, 511**
- Expenditure, 370**
  - capital, 370
  - revenue, 370
- Expense(s), 7, 86**
  - general and administrative, 210
  - operating, 210
  - paid in cash, 53
  - to be paid later, 53
  - recognizing, 89
  - selling, 210
- Expired costs, 86
- Explanatory notes, 720
- Extraordinary repairs, 370**
  
- F**
- Face interest rate, 549**
- Face value, 549**
- Facility-level activities, 886**
- Factor(ing), 351**
- Factors in computing depreciation, 375
- Fair value, 40**
- Faithful representation, 172**
- Federal income taxes, 416
- Federal unemployment insurance (FUTA) tax, 417
- FIFO method (first-in, first-out), 269, 275**
  - effects on cash flows, 273
  - effects on financial statements, 272
  - effects on income taxes, 273
- Financial Accounting Standards Board (FASB), 13**
- Financial accounting, 2**
- Financial analysis, 18**
  - tools and techniques, 664
- Financial and managerial accounting, 2
- Financial budgets, 958, 970**
- Financial highlights, 715
- Financial leverage, 578**
- Financial performance measurement, 660
- Financial position, 6**
- Financial ratio analysis, 670
- Financial ratios, 18**
- Financial reporting, 170, 763
  - fraudulent, 19
  - objective of, 170
- Financial statement(s), 2, 8, 715**
  - analysis, 659, 660
  - effects of adjusting entries on, 101
  - effects of FIFO and LIFO on, 272
  - internal control, 317
  - inventory and, 278
  - performance assessment and, 681
  - relationships, 9
  - reporting of costs and, 771
  - of service, retail, and manufacturing organizations, 772
  - stockholders' equity and, 518
  - using classified, 180
- Financing activities, 17, 603, 626**
- Financing period, 228, 229, 677, 679**
- Financial ratio analysis, 670**
- Financing receivables, 350
- Finished goods inventory, 768**
- First-in, first-out (FIFO) costing method, 269, 845**
  - accounting for costs, 852
  - accounting for units, 851
  - assigning costs, 852
- Fiscal year, 87**
- Fixed cost(s), 764, 924**
  - formula, 924
- Fixed overhead**
  - budget variance, 1064**
  - variance analysis, diagram, 1063
  - volume variance, 1064**
- Flexible budget, 1011**
  - formula, 1011
  - performance analysis and, 1005, 1011
- FOB**
  - destination, 213
  - shipping point, 213
- Footings, 44**
- Foreign business transactions, 229
- Form 8-K, 662**
- Form 10-K, 662**
- Form 10-Q, 662**
- Fraudulent financial reporting, 19**
- Franchise, 387**
- Free cash flow, 392, 624, 674**
- Free from material error, 172**
- Freight-in, 213**
- Freight-out, 214
- Full disclosure (transparency), 173, 684**
- Full product cost, 882**
- Full-costing method, 386**
- Future value, 426**
  - using simple interest, 427
  
- G**
- GAAP and the independent CPA's report, 12
- Gain on sale of assets, 468
- Gains and losses, 610, 686
- General and administrative expenses, 210**
- General journal, 42, 58, 259**
  - transactions recorded in, 259
- General ledger, 42, 59**
  - and accounts payable subsidiary ledger, 253
- Generally accepted accounting principles (GAAP), 12**
- Goal/vision, 777**
- Going concern, 87**
- Goods flow, 265**
- Goodwill, 177, 387, 390**
- Governmental Accounting Standards Board (GASB), 14**

- Governmental and not-for-profit organizations, 16
- Graphic breakeven analysis, 932
- Gross margin, 209**  
effects of inventory costing methods on, 272
- Gross profit method, 278**  
of inventory estimation, 278
- Gross sales, 209**
- Group depreciation, 379**
- Group purchases, 373
- H**
- High-low method, 928**
- Horizontal analysis, 664**  
comparative balance sheets with, 665  
comparative income statements, 666
- I**
- Ideal capacity, 924
- Imprest systems, 312**  
*In balance, 57*
- Income (cash flow) approach, 426
- Income from operations (operating income), 211**
- Income measurement, 86  
assumptions, 87  
effects of inventory misstatements on, 282
- Income statement(s), 8, 607, 715**  
accounting for inventories and, 771  
multistep, 208  
under the periodic inventory system, 221  
under the perpetual inventory system, 215
- Income Summary account, 132**
- Income taxes**  
effects of FIFO and LIFO on, 273  
payable, 420
- Incorporation, advantages and disadvantages, 493
- Incremental analysis, 1090, 1091  
outsourcing decisions, 1093  
sales mix decisions, 1098, 1100  
segment profitability decisions, 1096  
sell-or-process-further decisions, 1101, 1102  
special order decisions, 1094, 1095
- Incremental cost, 1091**
- Incremental revenue, 1101**
- Indefinite useful life, 388
- Independence, 14**
- Independent accountant's audit of internal control, 318
- Independent contractor, 416**
- Index number, 666**
- Indirect costs, 762**
- Indirect labor costs, 763**
- Indirect materials costs, 763**
- Indirect method, 606**  
of determining net cash flows from operating activities, 609
- Industry norms, 661
- Information and communication, 303**
- Initial public offering (IPO), 491**
- Inspection time, 891**
- Institute of Management Accountants (IMA), 14**
- Intangible assets, 177, 368, 386**
- Integrity, 14**
- Interest, 346, 426**  
amortization table, 561, 564  
coverage ratio, 580, 676  
expense for bond issued at discount, 557  
expense for bond issued at premium, 562  
income, 313  
payment for bonds issued between interest payment dates, 569
- Interest receivable, 339**
- Interim financial statements, 662**
- Interim periods, 87**
- Internal control, 302**  
achieving control objectives, 304  
components of, 303  
financial statements and, 317  
independent accountant's audit of, 318  
limitations, 305  
management issues related to, 318  
need for, 302  
over merchandising transactions, 306  
plan for purchases and cash disbursements, 309  
separation of duties and documentation, 308
- Internal Revenue Service (IRS), 14**
- International Accounting Standards Board (IASB), 13**
- International Financial Reporting Standards (IFRS), 13**
- Inventory, 263  
days' on hand, 281  
evaluating the level of, 280  
financial statements and, 278  
management choices, 267  
management issues related to, 280  
merchandise, 206  
periodic system, 206  
perpetual system, 206  
physical, 206  
valuation of, 279
- Inventory accounting, 264**
- Inventory accounts in manufacturing organizations, 766
- Inventory cost, 264**  
under the periodic inventory system, 268  
under the perpetual inventory system, 274
- Inventory costing methods  
effects on gross margin, 272  
summary of, 276
- Inventory decisions, impact of, 272
- Inventory estimation  
gross profit method of, 278  
retail method of, 278
- Inventory management, 281
- Inventory misstatements  
and fraud, 282  
effects on income measurement, 282  
illustrated, 282
- Inventory turnover, 280, 677
- Investing activities, 17, 603, 626**
- Investment center, 1008**
- Investments, 177, 615**
- Investors, 16**
- Invoice, 310**
- Issued shares, 497**
- Issuing no-par stock, 502
- Issuing stock above par value, 501
- J**
- JIT costing method, 894
- JIT (just-in-time) operating environment, 281
- Job order and process costing systems, 804
- Job order cost card, 804**  
computation of unit cost and, 810  
for manufacturing company, 811  
for service organization, 812
- Job order costing**  
management process and, 819  
in manufacturing company, 805  
in service organization, 811  
**system, 804**
- Job order, 804**
- Joint costs, 1101**
- Joint products, 1101**
- Joint ventures, 474**
- Journal, 47**
- Journal entry, 47**
- Journal form, 48**
- Just-in-time (JIT), 889  
**operating environment, 281**  
**operating philosophy, 889**
- K**
- Kaizen, 891**
- L**
- Labor, 807
- Labor unions, 16
- Land, 372
- Land improvements, 373
- Last-in, first-out (LIFO) method, 270
- LCM rule, lower-of-cost-or-market, 266
- Lean operation, 889**
- Leasehold, 387**
- Leasehold improvements, 373**
- Ledger, 42
- Ledger account form, 59**
- Legal capital, 494**
- Letter to the shareholders, 715
- Liabilities, 6, 177**  
changes in, 611  
current, 177  
long-term, 178
- License, 387**
- LIFO, effects on  
cash flows, 273  
financial statements, 272  
income taxes, 273
- LIFO liquidation, 273**
- LIFO method, 276**
- Limitations on internal control, 305
- Limited liability, 5**
- Limited liability company (LLC), 475**
- Limited life, 452**
- Limited partnership (LP), 474**



- Line of credit, 411**
  - Liquidating dividend, 510**
  - Liquidation, 467**
    - of a partnership, 467
    - where loss is greater than a partners' capital balance, 471
    - where partners share the loss, 472
  - Liquidity, 10, 17, 180**
  - Long-term assets, 368, 367**
    - acquiring and financing, 392
    - classification of and methods of accounting for, 369
    - ethics in acquiring and financing, 393
    - financial statements and, 390
    - issues in accounting for, 393
    - management decisions relating to, 392
    - as a percentage of total assets for selected industries, 368
    - recognition of the acquisition cost of, 370
    - relationship to financial statements, 391
  - Long-term debt**
    - evaluating, 579
    - evaluating the decision to issue, 578
  - Long-term leases, 572**
  - Long-term liabilities, 178, 410, 545, 546**
    - on balance sheet, 577
    - classification, 546
    - disclosure, 546
    - financial statements and, 576
    - recognition, 546
    - valuation, 546
  - Loss on sale of assets, 470**
  - Lower-of-cost-or-market (LCM) rule, 266**
    - and conservatism, 265
- M**
- Make-or-buy decisions, 1093**
  - Management, 15, 493**
    - choices in accounting for inventories, 267
    - compensation, 687
    - decisions relating to long-term assets, 392
    - decisions using accrual-based information, 103
    - discussion and analysis, 715
    - inventory, 281
    - responsibility for internal control, 318
    - supply-chain, 281
    - tools for continuous improvement, 896
  - Management information systems (MIS), 2**
  - Management issues related to**
    - internal control, 318
    - inventory, 280
    - long-term debt financing, 578
  - Management process, 780, 819**
    - job order costing, 819
    - and the process costing system, 861, 862
  - Managerial accounting, 2, 3, 760**
    - cost concepts, 759
    - and financial accounting, 760
    - the management process, 777
    - role of, 760
  - Managerial performance report using variance analysis, 1068**
  - Managing for value and controlling costs, 898**
    - Manufacturer's income statement, cost of goods sold, 774
    - Manufacturer's job order cost card, 810
    - Manufacturing company, 208**
      - job order cost card for a, 811
      - job order costing in a, 805
    - Manufacturing cost flow, 768**
    - Margin of safety, 931**
    - Market, 266**
    - Market approach, 425
    - Market interest rate, 549**
    - Market rate above face rate, 556
    - Marketable securities, 602**
    - Master budget, 958**
      - preparation of, 960, 961
    - Matching rule, *see* accrual accounting, 87
    - Material, 171**
    - Materiality, 171**
    - Materials, 805
    - Materials inventory, 768**
    - Maturity date, 346**
    - Maturity value, 347**
    - Measurement of product costs, 775
    - Medical insurance, 417
    - Medicare tax, 417
    - Merchandise**
      - in transit, 265
      - inventory, 206**
        - not included in inventory, 265
        - purchases of, 215, 222
    - Merchandising accounting, 206
    - Merchandising company, 206, 208**
    - Merchandising transactions**
      - financial statements and, 227
      - internal control over, 306
    - Minimum rate of return on investment, 1104**
    - Miscellaneous debits and credits, 313
    - Mission statement, 777**
    - Mixed cost, 925**
      - behavior patterns, 925
      - contribution margin income statement and, 927
      - formula, 925**
    - Money measure, 2, 3**
    - Monitoring, 303**
    - Mortgage, 547**
    - Mortgages payable, 547
    - Moving time, 891**
    - Multistep income statement, 208**
    - Mutual agency, 452**

**N**

    - Natural resources, 368, 384**
    - Nature of bonds, 549
    - Need for internal controls, 302
    - Net assets, 7**
    - Net cost of purchases, 221**
    - Net income (net earnings), 7, 86, 211**
      - concepts underlying, 86
      - ethical measurement and cash flows, 102
    - Net loss, 7, 86**
    - Net present value method, 1104**
      - advantages, 1104
      - illustrated, 1105
    - Net revenue, 209
    - Net sales (net revenue), 209**
    - Neutral information, 172**
    - Nominal accounts, 132
    - Noncash investing and financing transactions, 606**
    - Noncompetete covenant, 387**
    - Noncumulative preferred stock, 498**
    - Noninventoriable costs, 763
    - Nonoperating items, 686
    - Nonoperating revenues and expenses, 211
    - Non-value-adding activity, 884**
    - Non-value-adding cost, 765**
    - No-par stock, 501, 502**
    - Normal balance, 45**
    - Normal capacity, 924**
    - Normal costing method, 776**
    - Normal operating cycle, 175**
    - Notes and accounts receivable, 336
    - Notes payable, 412, 547**
    - Notes receivable, 337**
      - common calculations, 345
    - Notes to the financial statements, 720
    - Not-for-profit organizations, and governmental, 16
    - NSF (nonsufficient funds) checks, 312**

**O**

    - Objective of financial reporting, 170
    - Objectivity, 14**
    - Obsolescence, 374**
    - Off-balance-sheet financing, 580**
    - One-time items, 685
    - Operating activities, 17, 603**
      - determining cash flows, 649
      - direct method of determining net cash flow, 649
    - Operating budgets, 958, 962**
    - Operating capacity, 923**
    - Operating cycle, 206, 228, 677**
    - Operating expenses, 210**
    - Operating income, 211
    - Operating lease, 573**
    - Operating objectives, 777**
    - Operations costing system, 804**
    - Opportunity costs, 1092**
    - Ordinary annuity, 429**
    - Organization chart, 1009**
    - Organization costs and start-up, 495
    - Outsourcing, 882, 1093**
    - Outstanding checks, 312**
    - Outstanding shares, 497**
    - Overapplied overhead costs, 814**
    - Overhead, 808**
      - account, closing, 815
      - budget, 966, 967**
      - costs, 763**
        - costs incurred for production, 808
    - Owner's equity, 7, 178**
      - accounts, 45
      - relationships of, 46
    - Owner's investment, 7, 48**

- P**
- Par value, 494**
  - Participation in partnership income, 453
  - Participative budgeting, 977**
  - Partner
    - admission of new, 461
    - bonus to new, 464
    - bonus to old, 463
    - death of, 467
    - purchasing an interest from, 461, 462
    - withdrawal, 465
  - Partner's equity, 178, 454**
    - and balance sheet, 472
  - Partnership, 4, 178, 452**
    - advantages and disadvantages, 453
    - agreement, 452**
    - balance sheet, 472
    - characteristics of, 452
    - companies that look like, 475
    - distribution of income and losses, 455
    - liquidation of, 467
  - Partnership-type entities, alternate forms of, 474
  - Past performance, 661
  - Patent, 387**
  - Payables turnover, 433, 678
  - Payback period method, 1106**
  - Payment date, 511**
  - Payroll liabilities, 415
  - Pension contributions, 417
  - Pension fund, 576**
  - Pension liabilities, 576
  - Pension plan, 576**
  - Percentage gross margin, 210**
  - Percentage net sales method, 340**
  - Performance analysis, 1006
    - cost centers and profit centers, 1011
    - investment centers, 1014
    - management process, 1021
  - Performance incentives and goals, 1022
  - Performance management and evaluation system, 1006**
  - Performance measures, 18, 1006, 1018**
  - Performance report based on using data from a flexible or static budget, 1052
  - Performance-based pay, 1022**
  - Performing, 777, 818
  - Period costs, 763**
  - Periodic independent verification, 304**
  - Periodic inventory system, 206, 221**
    - recording sales transactions, 225
  - Periodicity, 87**
  - Permanent accounts, 132**
  - Perpetual inventory system, 206, 215**
  - Petty cash fund, 314**
    - establishing, 314
    - making disbursements from, 315
    - reimbursing the, 315
  - Petty cash voucher, 315**
  - Physical controls, 304**
  - Physical deterioration, 374**
  - Physical inventory, 206, 302**
  - Planning, 777, 818
  - Plant assets, 615
    - sold for cash, 381
  - Post-closing trial balance, 140
  - Posting, 59**
    - formatting guidelines, 60
  - Posting from general journal to ledger, 60
  - Posting procedure, relationship of sales journal, general ledger, and accounts receivable subsidiary ledger, 251
  - Practical capacity, 924**
  - Predetermined overhead rate, 814**
  - Predictive value, 171**
  - Preferred stock, 497**
    - characteristics of, 498
  - Premium, 550**
  - Prepaid expenses, 91**
    - adjustment for, 92
  - Present value of
    - \$1 to be received at the end of a given number of periods, 428
    - asset, 431
    - deferred payment, 431
    - ordinary \$1 annuity received in each period for a given number of periods, 429
    - ordinary annuity, 429
    - single sum due in the future, 428
    - when compounding period is less than one year, 430
  - Present value, 427**
    - applications using, 430
    - valuing an asset at, 431
  - Price/earnings (P/E) ratio, 521**
  - Primary processes, 882**
  - Prime costs, 764**
  - Process cost report, 804, 845**
    - average costing method, 857
    - FIFO costing method, 850
    - preparing using the FIFO costing method, 849
  - Process costing system, 804, 844**
  - Process value analysis (PVA), 883**
  - Processing time, 891**
  - Product cost, 763**
    - measurement methods, 775
  - Product costing system, 804**
  - Product flows in a process costing environment, 845
  - Product liability and service, recording, 421
  - Product unit cost, 763**
    - information and the management process, 818
  - Product warranty liability, 420
  - Production budget, 963**
  - Production method, 376**
  - Production of goods, 766
  - Product-level activities, 886**
  - Professional conduct, 14
  - Profit center, 1008**
  - Profit margin, 181, 671
  - Profitability, 17, 181**
  - Profitability ratio relationships, 673
  - Proforma financial statements, 959**
  - Promissory note, 337, 412**
  - Promotional costs, 420
  - Property, plant, and equipment, 177, 368**
    - acquisition cost of, 372
  - Property taxes payable, 420
  - Public Company Accounting Oversight Board (PCAOB), 13**
  - Pull-through production, 890**
  - Purchase discounts, 213**
  - Purchase**
    - cash disbursements, control of, 307
    - materials, 766
    - merchandise, 215, 222
    - treasury stock, 505
  - Purchase journal, 252**
  - Purchase of an asset
    - on credit, 49
    - partly in cash and partly on credit, 49
  - Purchase order, 310**
  - Purchase returns and allowances account, 223**
  - Purchase requisition, 310**
  - Purchases account, 222**
  - Push-through production, 890**
- Q**
- Qualitative characteristics, 171**
  - Quality of earnings, 683**
  - Queue time, 891**
  - Quick ratio, 680**
  - Quick setup and flexible work cells, 890
- R**
- Rate variance, 1054
  - Real accounts, 132
  - Receivables, 335
    - financial statements and, 348
    - turnover, 349, 678
  - Receiving report, 310**
  - Recognition, 40, 62, 410**
    - of the acquisition cost of long-term assets, 370
    - point, 62
  - Recognizing
    - accrual interest expense, 414
    - expenses, 89
    - revenues, 88
    - unearned revenues that are now earned, 419
  - Record date, 511**
  - Recording transactions, 58, 303
  - Registered bonds, 551**
  - Registrars, 494**
  - Regression analysis, 929**
  - Regulatory agencies, 16
  - Reimbursing the petty cash fund, 315
  - Relevance, 171**
    - of the statement of cash flows, 602
  - Relevant range, 924**
    - linear approximation, 926
  - Research and development costs, 389
  - Residual income (RI), 1016**
  - Residual value, 375**
  - Responsibility accounting, 1006**
  - Responsibility center, 1006**
  - Restructuring, 686**
  - Retail method, 277, 278**
  - Retained earnings, 179, 496, 619**
  - Retirement
    - bonds, 566
    - and conversion of bonds, 566
    - treasury stock, 508



- Return on assets, 183, 672
- Return on equity, 186, 520, 676
- Return on investment (ROI), 1014
- Revenues, 7, 86**
  - in cash, 51
  - center, 1008
  - collected in advance, 52
  - on credit, 51
- Revenue expenditure, 370**
- Revenue recognition, 88**
- Reversing entries, 141**
- Risk assessment, 303**
- Rule-of-thumb measures, 661
  
- S**
- S corporations, 475**
- Salaries, 415**
  - interest, and stated ratios, 458
- Sales
  - on credit, 217
  - excise taxes payable and, 414
  - journal and related ledger accounts, 250
  - journal procedure, summary, 250
  - mix analysis, 1099
  - merchandise, 217, 224
  - purchases discounts and, 212
  - transfer of production costs to cost of goods sold and, 809
- Sales budget, 962**
- Sales discount, 212**
- Sales forecast, 963**
- Sales journal, 249**
- Sales mix, 934**
- Sales mix decision, 1098**
- Sales returns and allowances account, 209, 218**
- Sales taxes column, sales journal, 252
- Sarbanes-Oxley Act, 13, 19**
- Scatter diagram method, 927**
- Schedule of cash flows from operating activities, 613
  - direct method, 649
  - indirect method, 609
- Schedule of expected cash collections from customers, 972
- Schedule of expected cash payments for direct materials, 972
- Secured bonds, 550**
- Securities and Exchange Commission (SEC), 13, 14**
- Securitization, 351**
- Segment
  - income statement, 1095
  - profitability analysis, 1096
- Segment margin, 1096**
- Selling and administrative expenses budget, 967, 968**
- Selling expenses, 210**
- Sell-or-process-further decision, 1101**
- Separate entity, 4**
- Separation of duties, 304**
  - and documentation, internal controls in a large company, 308
- Serial bonds, 550**
- Service charges (SC), 312
- Service unit cost, 763**
- Share of stock, 492**
- Shares, 497
- Short-run decision analysis, 1090**
  - capital budgeting, 1089
- Short-term notes payable, 412**
- Simple interest, 426**
- Single-step income statement, 211**
- Social security (FICA) tax, 416
- Software, 387**
- Sold units, 809
- Sole proprietorship, 4, 178**
- Source documents, 47**
- Southwest Airlines Co.'s 2011 Annual report, excerpts from, 747–757
- Special order analysis
  - minimum bid price for special order, 1096
  - price and relevant cost comparison, 1095
- Special order decisions, 1094**
- Special rules for tax purposes, 379
- Special-purpose entities (SPEs), 475**
- Special-purpose journals, 249**
- Specific identification method, 268, 274**
- Split-off point, 1101**
- Standard costing, 1048**
- Standard costing and variance analysis, 1047
- Standard costing method, 776, 1048**
- Standard costs, 1048**
- Standard direct labor cost, 1050**
- Standard direct materials cost, 1049**
- Standard fixed overhead rate, 1050**
- Standard overhead cost, 1050**
- Standard variable overhead rate, 1050**
- Standards of comparison, 661
- Standards of ethical conduct, 780
- Start-up and organization costs, 495**
- State and local income taxes, 416
- State unemployment insurance tax, 417
- Stated ratios, 456
  - distributed income, 456
- Statement of cash flows, 10, 602**
  - asking the right questions, 625
  - compiling, 652
  - direct method, 653
  - direct method of preparing, 649
  - ethical considerations in analyzing, 626
- Statement of cost of goods manufactured, 773**
- Statement of Ethical Professional Practice, 781
- Statement of financial position, 8
- Statement of owner's equity, 8**
- Statement of stockholders' equity, 516, 517**
- Statement of management's responsibilities, 722
- Static budgets, 977**
- Statistical methods, 929
- Step cost, 924**
- Stock, 497
  - issuance of common, 500
  - issuance of for noncash assets, 503
  - issuance of stock for noncash assets when market value for the stock exists, 504
  - issuing above par value, 501
  - issuing stock for noncash assets when no market value for the stock exists, 503
  - no-par, 501
- Stock dividend, 513**
  - effect on stockholders' equity, 514
  - and stock splits, 513
  - transactions, 513
- Stock option plans, 522**
- Stock splits, 515**
- Stockholders, 2, 5, 492**
- Stockholders' equity, 178, 496**
- Storage time, 891**
- Straight-line method, 375, 558**
- Strategic objectives, 777**
- Strategic planning, 976**
- Subsidiary ledger, 249**
- Successful efforts accounting, 385**
- Summary of transactions, 54
- Sunk cost, 1091**
- Supply chain, 777, 882**
- Supply network, 777
- Supply-chain management, 281**
- Support services, 882**
  
- T**
- T account, 44**
- Tactical objectives, 777
- Tax authorities, 16
- Taxes, 416, 417
- Temporary accounts, 132**
- Term and serial bonds, 550
- Term bonds, 550**
- Terms of debit and credit card sales, 214
- Terms of sale, 212
- Theoretical capacity, 924**
- Theory of constraints (TOC), 896**
- Throughput time, 891**
- Time value of money, 426**
- Timeliness, 172**
- Trial balance, 56**
- Trade credit, 336**
- Total direct labor cost variance, 1057**
- Total direct materials cost variance, 1054**
- Total fixed overhead cost variance, 1062**
- Total manufacturing costs, 769**
- Total overhead cost variance, 1060**
- Total quality management (TQM), 896**
- Total standard unit cost, 1051
- Total variable overhead cost variance, 1061**
- Trade discount, 212**
- Trademark, 387**
- Trading securities, 603
- Traditional costing method, 893
- Transaction effects on accounting equation, 61
- Transfer agents, 494**
- Transparency, 173**
- Transportation costs, 213
- Treasury shares, 506, 507, 508
- Treasury stock, 496, 505, 619**
  - purchase of, 505
  - retirement of, 508
  - sale of, 506
- Trend analysis, 666**
  - graph, 667
- Trial balance, 56**
  - finding errors, 57
  - preparation and use of, 56

- U**
- Uncollectible accounts, 337, 340**
    - allowance method, 338
    - percentage of net sales method, 340
  - Underapplied overhead, 815**
  - Understandability, 172**
  - Underwriter, 494**
  - Unearned revenues, 96, 418**
  - Unequal annual net cash inflows, 1107**
  - Unit-level activities, 886**
  - Unlimited liability, 452**
  - Unsecured bonds (debenture bonds), 550**
  - Usage variance, 1054, 1057**
- V**
- Vacation pay, 422**
  - Valuation, 40, 410**
    - accounts receivable on the balance sheet, 348
    - approaches to fair value accounting, 425
    - and disclosure of long-term assets, 369
    - inventory on the balance sheet, 279
  - Value chain, 882**
    - analysis, 882
    - in a furniture company, 883
  - Value-adding activity, 883**
    - non-value-adding activities, 883
    - versus non-value-adding costs, 765
  - Value-adding cost, 764**
  - Value-based systems, 882**
    - activity-based costing and lean accounting, 881
  - Valuing**
    - asset at present value, 431
    - inventory by estimation, 277
  - Variable and fixed overhead variances, summary, 1064**
  - Variable budget, 1011**
  - Variable cost, 764, 922**
    - formula, 923
  - Variable costing, 1012**
    - income statement, 929
    - versus traditional income statement, 1013
  - Variable overhead**
    - rate variance, 1062
    - variance analysis, diagram, 1061
    - variances, 1061
  - Variable overhead efficiency variance, 1062**
  - Variable overhead spending variance, 1062**
  - Variance, 1048**
    - analysis, 1049
    - four-step approach to controlling costs, 1053
    - the management process, 1067
  - Verifiability, 172**
  - Vertical analysis, 667**
- W**
- Wages, 415**
  - Weighted average method, 269**
- Withdrawal(s), 7, 54**
  - by removing assets, 466
  - by selling interest, 466
  - of a partner, 465
- Work cell, 890**
- Work in progress inventory, 768**
- Work sheet, 143**
  - adjustments from, entered in the general journal, 146
  - importance of and closing entries for managers, 148
  - preparing, 143
  - using, 148
- Working capital, 180**
  - and the current ratio, 433
- Working papers, 143**
- Write-down, 686**
  - and restructurings, 686
- Write-off, 686**
- Writing off uncollectible accounts, 344**
- Y**
- Year-end accrual of bond interest expense, 570**
- Z**
- Zero coupon bonds, 558**
  - Zero-based budgeting, 978**