GLEIM®

2018 EDITION

CMA Review

Part 1
Financial Reporting, Planning, Performance, and Control

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by

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and

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TABLE OF CONTENTS

DETAILED TABLE OF CONTENTS

PREFACE FOR CMA PART 1 CANDIDATES

The purpose of this book is to help **you** prepare **yourself** to pass Part 1 of the two-part CMA examination. The overriding consideration is to provide an inexpensive, effective, and easy-to-use study program. This manual

- Defines the subject matter tested on Part 1 of the CMA exam.
- Covers all topics on Part 1 of the CMA exam in a concise manner to help you pass.
- Presents multiple-choice and essay questions from past CMA examinations to prepare you for questions in future CMA exams. Our signature detailed answer explanations are presented to the immediate right of each question for your convenience. Use a piece of paper to cover our explanations as you study the questions.
- Suggests exam-taking and question-answering techniques to help you maximize your exam score.

The outline format, the spacing, and the question-and-answer formats in this book are designed to facilitate readability, learning, understanding, and success on the CMA exam. Our most successful candidates use the Gleim Premium Review System*, which includes CMA Gleim Instruct, the largest test bank of multiple-choice and essay questions, expertly authored books, and the Gleim Access Until You Pass guarantee; or a group study CMA review program. This review book and all Gleim CMA Review materials are compatible with other CMA review materials and courses that are based on the ICMA's Content Specification Outlines.

To maximize the efficiency and effectiveness of your CMA review program, augment your studying with the *CMA Exam Guide* (available at www.gleim.com/PassCMA). This booklet has been carefully written and organized to provide important information to assist you in passing the CMA examination.

Thank you for your interest in our materials. We deeply appreciate all the feedback we have received from CIA, CMA, CPA, and EA candidates; accounting students; and faculty during the past 5 decades.

If you use Gleim materials, we want YOUR feedback immediately after the exam and as soon as you have received your grades. The CMA exam is NONDISCLOSED, and you must maintain its confidentiality and agree not to divulge the nature or content of any CMA question or answer under any circumstances. We ask only for information about our materials, i.e., the topics that need to be added, expanded, etc.

Please go to www.gleim.com/feedbackCMA1 to share your suggestions on how we can improve this edition.

Good Luck on the Exam,

Irvin N. Gleim
Dale L. Flesher

October 2017

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PREPARING FOR AND TAKING THE CMA EXAM

READ THE GLEIM *CMA EXAM GUIDE*

Obtain a free copy of the Gleim ***CMA Exam Guide*** by visiting www.gleim.com/PassCMA. Then, continue to reference it throughout your studies to obtain a deeper understanding of the CMA exam and exam strategies.

OVERVIEW OF THE CMA EXAMINATION

The total exam is 8 hours of testing. It is divided into two parts, as follows:

Part 1 – Financial Reporting, Planning, Performance, and Control
Part 2 – Financial Decision Making

Each part consists of 100 multiple-choice questions and 2 essay scenarios, and testing lasts 4 hours (3 hours for the multiple-choice questions plus 1 hour for the essays). The exams are only offered during the following three testing windows: January/February, May/June, and September/October.

The CMA exam is computerized and offered at hundreds of Prometric testing centers worldwide. The suite of Gleim products, including the Gleim CMA Review Course, CMA Mega Test Bank, and CMA Exam Rehearsal provide exact exam emulations of the Prometric computer screens and procedures so you are totally comfortable and prepared to PASS on exam day.

SUBJECT MATTER FOR PART 1

Below, we have provided the ICMA's abbreviated Content Specification Outline (CSO) for Part 1. The percentage coverage of each topic is indicated to its right. We constantly update our materials for any changes in the CSO.

Candidates for the CMA designation are expected to have a minimum level of business knowledge that transcends both examination parts. This minimum level includes knowledge of basic financial statements, time value of money concepts, and elementary statistics. Specific discussion of the ICMA's Levels of Performance (A, B, and C) is provided in Appendix D, which is a reprint of the ICMA's discussion of "Types and Levels of Exam Questions."

Part 1: Financial Reporting, Planning, Performance, and Control

External Financial Reporting Decisions	15%
Planning, Budgeting, and Forecasting	30%
Performance Management	20%
Cost Management	20%
Internal Controls	15%

Appendix D contains the CSOs in their entirety as well as cross-references to the subunits in Gleim CMA Review where topics are covered. We have studied the CSOs while developing our materials and can assure you they are aligned with the most current CSOs. Accordingly, you do not need to spend time with Appendix D. Rather, it should give you confidence that Gleim CMA Review is the best review source available to help you pass the CMA exam.

LEARNING OUTCOME STATEMENTS

In addition to the CSOs, the ICMA provides Learning Outcome Statements (LOSs). The LOSs are more specific and describe in greater detail what candidates need to know and the skills they are expected to have as a CMA. Gleim materials cover these LOSs thoroughly. For your convenience, Appendix D provides a complete reproduction of the LOSs along with cross-references to the subunits in Gleim CMA Review where they are covered.

WHICH PRONOUNCEMENTS ARE TESTED?

New pronouncements are eligible to be tested on the CMA exam in the testing window beginning 1 year after a pronouncement's effective date. Rest assured that Gleim updates our materials as appropriate when any new standard is testable and will only cover what candidates need for the current CMA exam.

HOW ETHICS ARE TESTED

Ethical issues and considerations are tested from the perspectives of both the individual and the organization in Part 2. Candidates will be expected to evaluate the issues involved and make recommendations for the resolution of the situation in both the multiple-choice section and the essay section of Part 2 of the exam.

STUDY UNIT TWO
MEASUREMENT, VALUATION, AND DISCLOSURE: INVESTMENTS AND SHORT-TERM ITEMS

(24 pages of outline)

This study unit is the **second of three** on **external financial reporting decisions**. The relative weight assigned to this major topic in Part 1 of the exam is **15%**. The three study units are

Study Unit 1: External Financial Statements and Revenue Recognition
Study Unit 2: Measurement, Valuation, and Disclosure: Investments and Short-Term Items
Study Unit 3: Measurement, Valuation, and Disclosure: Long-Term Items

If you are interested in reviewing more introductory or background material, go to www.gleim.com/CMAIntroVideos for a list of suggested third-party overviews of this topic. The following Gleim outline material is more than sufficient to help you pass the CMA exam; any additional introductory or background material is for your own personal enrichment.

2.1 ACCOUNTS RECEIVABLE

1. **Overview**
   a. Accounts receivable, often called trade receivables, are the amounts owed to an entity by its customers.
   b. The recording of a receivable, which often coincides with revenue recognition, is consistent with the accrual method of accounting.
   c. Receivables should be separated into **current and noncurrent** portions. Most of the entity's accounts receivable are classified as current assets because they are expected to be collected within 1 year or the entity's normal operating cycle.
      1) **Current** accounts receivable are reported in the balance sheet at **net realizable value (NRV)**, i.e., net of allowance for uncollectible accounts, allowance for sales returns, and billing adjustments.

         Gross accounts receivable – Allowance for uncollectible accounts = NRV of accounts receivable

      2) **Noncurrent** receivables are measured at net present value of future cash flows expected to be collected.
   d. The direct write-off method expenses bad debts when they are determined to be uncollectible. It is **not acceptable under GAAP** because it does not match revenue and expense when the receivable and the write-off are recorded in different periods. But this method is used for tax purposes.
2. **Allowance for Customers' Right of Sales Return**
   a. A provision must be made for the return of merchandise because of product defects, customer dissatisfaction, etc.

b. To be consistent with the matching principle (recognition of revenue and related expense in the same accounting period), the revenue from the sale of goods and the expense for the estimated sales returns must be recognized on the same date.

1) Accordingly, an **allowance** for sales returns should be established.

EXAMPLE

A company has $500,000 of sales in July, its first month of operations. Management estimates that total returns will be 1% of sales.

Recognition of revenue from sale		
Cash/accounts receivable	$500,000	
Sales		$500,000

Recognition of allowance for sales returns		
Sales returns (contra revenue)	$5,000	
Allowance for sales returns (contra asset)		$5,000

3. **Allowance for Uncollectible Accounts and Bad Debt Expense**

a. Because collection in full of all accounts receivable is unlikely, the allowance for uncollectible accounts must be recognized. This method attempts to match bad debt expense with the related revenue.

b. The principal measurement issue for accounts receivable is the estimation of net realizable value for balance sheet reporting and the related **uncollectible accounts expense** (bad debt expense) for the income statement.

c. The bad debt expense recognized for the period increases the allowance for uncollectible accounts. The allowance for uncollectible accounts is a contra account to accounts receivable. Thus, the recognition of bad debt expense decreases the balance of accounts receivable.

d. The two most common methods of measuring bad debt expense and the allowance for uncollectible accounts are the **percentage-of-sales method** (an **income statement approach**) and the **percentage-of-receivables method** (a **balance sheet approach**). Both approaches have the goal of measuring accounts receivable at net realizable value.

1) Note, the direct write-off method (i.e., expense bad debts only when they are determined to be uncollectible) is **not acceptable under GAAP**. This method does not match revenues and expenses. Occasionally, a small company will use the direct write-off method under the assumption that the difference between it and the allowance method is immaterial. In other words, the materiality principle is used as an excuse to violate the matching principle.

4. **Income Statement Approach (Percentage of Sales)**

a. The **income statement approach** calculates bad debt expense as a percentage of credit sales reported on the income statement.

EXAMPLE

A company's year-end unadjusted trial balance reports the following amounts:

Gross accounts receivable	$100,000	Dr
Allowance for uncollectible accounts (year-beginning balance)	1,000	Cr
Sales on credit	250,000	Cr

According to past experience, 1% of the company's credit sales have been uncollectible. The company uses the income statement approach to calculate bad debt expense. The bad debt expense recognized for the year is $2,500 ($250,000 × 1%). The company records the following adjusting journal entry:

Bad debt expense	$2,500	
Allowance for uncollectible accounts		$2,500

The total adjusted balances of allowance for uncollectible accounts and bad debt expense are $3,500 ($1,000 + $2,500) and $2,500, respectively. The company reports **net accounts receivable** of **$96,500** ($100,000 – $3,500) in its balance sheet and **bad debt expense** of **$2,500** in its statement of income.

Balance sheet presentation:

Accounts receivable, net of allowance for uncollectible accounts of $3,500 **$96,500**

5. **Balance Sheet Approach (Percentage of Receivables)**

   a. The **balance sheet approach** estimates the balance that should be recorded in the allowance based on the collectibility of ending gross accounts receivable. Bad debt expense is the amount necessary to adjust the allowance.

EXAMPLE

Using the data from the previous example, assume that the company uses the balance sheet approach and that based on the company's experience, 6% of accounts receivable are determined to be uncollectible.

Thus, the ending balance of the allowance for uncollectible accounts is $6,000 ($100,000 × 6%). Because the allowance currently has a balance of $1,000, the following journal entry is required:

Bad debt expense ($6,000 – $1,000)	$5,000	
Allowance for uncollectible accounts		$5,000

Balance sheet presentation:

Accounts receivable, net of allowance for uncollectible accounts of $6,000 **$94,000**

   b. An entity rarely has a single rate of uncollectibility for all accounts. Thus, an entity using the balance sheet approach generally prepares an **aging schedule** for accounts receivable.

EXAMPLE

Using the data from the previous example, assume that the company uses the following aging schedule to determine the ending balance of the allowance for uncollectible accounts:

Aging Interval	Balance	Estimated Uncollectible	Ending Allowance
Less than 30 days	$ 70,000	2%	$1,400
30-60 days	18,000	5%	900
61-90 days	10,000	13%	1,300
Over 90 days	2,000	20%	400
Total	**$100,000**		**$4,000**

Thus, the ending balance of the allowance for uncollectible accounts is $4,000. Because the allowance currently has a balance of $1,000, the following journal entry is required:

Bad debt expense ($4,000 – $1,000)	$3,000	
Allowance for uncollectible accounts		$3,000

Balance sheet presentation:

Accounts receivable, net of allowance for uncollectible accounts of $4,000 **$96,000**

6. **Write-Off of Accounts Receivable**

   a. Some customers are unwilling or unable to satisfy their debts. A write-off of a specific debt is recorded as follows:

Allowance for uncollectible accounts	$XXX	
Accounts receivable		$XXX

      1) Thus, the write-off of a particular bad debt has no effect on expenses.
      2) Write-offs do not affect the carrying amount of net accounts receivable because the reductions of gross accounts receivable and the allowance are the same. Thus, they also have no effect on working capital.

   b. Occasionally, a customer pays on an account previously written off.

Cash	$XXX	
Allowance for uncollectible accounts		$XXX

      1) Bad debt expense is not affected when an account receivable is written off or when an account previously written off becomes collectible.

The following equation illustrates the reconciliation of the beginning and ending balances of gross accounts receivable (accounts receivable before adjustment for allowance for uncollectible accounts):

Beginning accounts receivable
Plus: Credit sales during the period
Less: Cash collected on credit sales during the period
Less: Accounts receivable written-off during the period
Ending accounts receivable

The following equation illustrates the reconciliation of the beginning and ending balances of the allowance for uncollectible accounts:

Beginning allowance for uncollectible accounts
Plus: Bad debt expense recognized for the period
Less: Accounts receivable written off
Plus: Collection of accounts receivable previously written off
Ending allowance for uncollectible accounts

Under the income statement approach, bad debt expense is a percentage of sales on credit, and the ending balance of the allowance is calculated using the equation above.

Under the balance sheet approach, the ending balance of the allowance is a percentage of the ending balance of accounts receivable, and bad debt expense is calculated using the equation above.

7. **Factoring of Accounts Receivable**

a. **Factoring** is a transfer of receivables to a third party (a factor) who assumes the responsibility of collection.

b. Factoring discounts receivables on a **nonrecourse**, notification basis. Thus, payments by the debtors on the transferred assets are made to the factor. If the transferor (seller) surrenders control, **the transaction is a sale**.

1) If a sale is **without recourse**, the transferee (credit agency) assumes the risks and receives the rewards of collection. This sale is final, and the seller has no further liabilities to the transferee. Accordingly, the receivables are no longer reported on the seller's books.

2) If a sale is **with recourse**, the transferor (seller) may be required to make payments to the transferee or to buy back receivables in specified circumstances. In this circumstance the transfer might not qualify as a sale. The parties account for the transaction as a secured borrowing with a pledge of noncash collateral. Accordingly, the receivables are still on the seller's books and it must recognize a liability for the amount of cash received.

EXAMPLE

A factor charges a 2% fee plus an interest rate of 18% on all cash advanced to a transferor of accounts receivable. Monthly sales are $100,000, and the factor advances 90% of the receivables submitted after deducting the 2% fee and the interest. Credit terms are net 60 days. What is the cost to the transferor of this arrangement?

Amount of receivables submitted	$100,000	
Minus: 10% reserve	(10,000)	
Minus: 2% factor's fee	(2,000)	
Amount accruing to the transferor	$ 88,000	
Minus: 18% interest for 60 days	(2,640)	[$88,000 × 18% × (60 ÷ 360)]
Amount to be received immediately	$ 85,360	

-- Continued on the next page --