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CMA REVIEW

PART 1: FINANCIAL PLANNING, PERFORMANCE, AND ANALYTICS

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by

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and

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PREFACE FOR CMA PART 1 CANDIDATES

The purpose of this book is to help **you** prepare to pass Part 1 of the two-part CMA examination. Our goal is to provide an affordable, effective, and easy-to-use study program. This book

1. Explains how to optimize your score through learning techniques perfected by Gleim CMA.
2. Defines the subject matter tested on Part 1 of the CMA exam.
3. Outlines all of the subject matter tested on Part 1 in 16 easy-to-use study units, including all relevant authoritative pronouncements.
4. Presents multiple-choice and essay questions from past CMA examinations to prepare you for the types of questions you will find on your CMA exam. Our answer explanations are presented to the immediate right of each multiple-choice question for your convenience. Use a piece of paper to cover our explanations as you study the questions. You also should practice answering these questions on your exam-emulating review course practice exams. The review course provides detailed answer explanations of both the correct and incorrect answer choices.
5. 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 CMA Review System*, which includes our innovative SmartAdapt technology, first-of-their-kind Gleim Instruct video lectures, the Gleim Access Until You Pass guarantee, and comprehensive exam-emulating test questions. This review book and all Gleim CMA Review materials are compatible with other CMA review materials and courses that comprehensively cover the ICMA's Content Specification Outlines and Learning Outcome Statements.

To maximize the efficiency and effectiveness of your CMA review program, augment your studying with *CMA Exam Guide: A System for Success*. 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 thousands of CMA, CIA, CPA, and EA candidates; accounting students; and faculty since releasing the first Gleim publication in 1974.

If you use Gleim materials, we want your feedback immediately after the exam upon receipt of your exam scores. The CMA exam is nondisclosed, and you must maintain the 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.

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Good Luck on the Exam,

Irvin N. Gleim
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STUDY UNIT TWO

MEASUREMENT, VALUATION, AND DISCLOSURE: INVESTMENTS AND SHORT-TERM ITEMS

(36 pages of outline)

2.1	*Accounts Receivable*	*57*
2.2	*Inventory -- Fundamentals*	*62*
2.3	*Inventory -- Cost Flow Methods*	*67*
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2.8	*Business Combinations and Consolidated Financial Statements*	*86*
2.9	*Different Types of Expenses and Liabilities*	*89*
2.10	*Essay Questions*	*107*

This study unit is the **second of four** on **external financial reporting decisions**. The relative weight assigned to this major topic in Part 1 of the exam is **15%**. The four 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
Study Unit 4: Integrated Reporting

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 personal enrichment.

2.1 ACCOUNTS RECEIVABLE

1. **Overview**
   a. Accounts receivable **(trade receivables)** are amounts owed to an entity by its customers resulting from credit sales in the ordinary course of business that are due in customary trade terms.
      1) All other receivables are non-trade receivables.
   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 credit losses (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.

1) 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.

2) But this method is used for tax purposes.

2. **Allowance for Customers' Right of Sales Return**

a. When a right of return exists, an entity may recognize revenue from a sale of goods at the time of sale only if the amount of future returns can be reliably estimated. 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 2-1 Allowance for Sales Returns

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			Recognition of allowance for sales returns		
Cash/accounts receivable	$500,000		Sales returns (contra revenue)	$5,000	
Sales		$500,000	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.

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 2-2 Income Statement Approval

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 2-3 Balance Sheet Approach (Percentage of Receivables)

Using the data from Example 2-2, 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 2-4 Balance Sheet Approach (Aging Schedule)

Using the data from the Example 2-3, 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.

   c. 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
      Minus: Cash collected on credit sales during the period
      Minus: Accounts receivable written-off during the period
      Ending accounts receivable

   d. 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
      Minus: Accounts receivable written off
      Plus: Collection of accounts receivable previously written off
      Ending allowance for uncollectible accounts

      1) 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.
      2) 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.

   a) 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.

   b) Accordingly, the receivables are still on the seller's books and it must recognize a liability for the amount of cash received.

EXAMPLE 2-5 Factoring of Accounts Receivable

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	

The transferor also will receive the $10,000 reserve at the end of the 60-day period if it has not been absorbed by sales returns and allowances. Thus, the total cost to the transferor to factor the receivables for the month is $4,640 ($2,000 factor fee + interest of $2,640). Assuming that the factor has approved the customers' credit in advance (the sale is without recourse), the transferor will not absorb any bad debts.

The journal entry to record the transaction is

Cash	$85,360	
Due from factor	10,000	
Loss on sale of receivables	2,000	
Prepaid interest	2,640	
Accounts receivable		$100,000

c. The main reasons for factoring transactions are as follows:

   1) A factor usually receives a high financing fee plus a fee for collection. Furthermore, the factor often operates more efficiently than its clients because of the specialized nature of its services.

   2) An entity (seller) that uses a factor tries to speed up its collections. Also, it can eliminate its credit department and accounts receivable staff. In addition, bad debts are eliminated from the financial statements.

      a) These reductions in costs can offset the fee charged by the factor.

d. Credit card sales are a common form of factoring. The retailer benefits by prompt receipt of cash and avoidance of bad debts and other costs. In return, the credit card company charges a fee.

STOP AND REVIEW! **You have completed the outline for this subunit. Study multiple-choice questions 1 through 5 beginning on page 93.**