



CMA REVIEW

Part 1 | Financial Planning, Performance, and Analytics

2024 EDITION



by

Irvin N. Gleim, Ph.D., CPA, CIA, CMA, CFM

and

Dale L. Flesher, Ph.D., CPA, CIA, CMA, CFM

Gleim Publications, Inc.

PO Box 12848
Gainesville, Florida 32604

(800) 874-5346
(352) 375-0772

www.gleim.com/cma
CMA@gleim.com

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About the Authors

Irvin N. Gleim, who authored the first edition of the Gleim CMA Review over 40 years ago, was Professor Emeritus in the Fisher School of Accounting at the University of Florida and a member of the American Accounting Association, Academy of Legal Studies in Business, American Institute of Certified Public Accountants, Association of Government Accountants, Florida Institute of Certified Public Accountants, The Institute of Internal Auditors, and the Institute of Management Accountants. The late Dr. Gleim published articles in the *Journal of Accountancy*, *The Accounting Review*, and the *American Business Law Journal* and authored numerous accounting books, aviation books, and CPE courses.

Dale L. Flesher is a professor, Ph.D., CPA, CIA, CMA, CFM, and holder of the Roland and Sheryl Burns Chair in the School of Accountancy at the University of Mississippi and has written over 300 articles for business and professional journals, including *Management Accounting*, *Journal of Accountancy*, and *The Accounting Review*, as well as numerous books. He is a member of the IMA, AICPA, The IIA, American Accounting Association, and American Taxation Association. He is a past editor of *The Accounting Historians' Journal* and is a trustee and past president of the Academy of Accounting Historians. He is a former vice president of finance for the American Accounting Association. In 2011, he received the AICPA's highest award for educators, The Distinguished Achievement in Accounting Education Award, which is a lifetime achievement award. Previously, in 1990, he received The Institute of Internal Auditors Radde Award as the Outstanding Auditing Educator worldwide.

Reviewers and Contributors

Garrett W. Gleim, CPA, CIA, CGMA, leads production of the Gleim CPA, CMA, CIA, and EA exam review systems. He is a member of the American Institute of Certified Public Accountants and the Florida Institute of Certified Public Accountants and holds a Bachelor of Science in Economics with a Concentration in Accounting from The Wharton School, University of Pennsylvania. Mr. Gleim is coauthor of numerous accounting and aviation books and the inventor of multiple patents with educational applications. He is also an avid pilot who holds a commercial pilot rating and is a flight instructor. In addition, as an active supporter of the local business community, Mr. Gleim serves as an advisor to several start-ups with ties to the University of Florida.

Brigitte de Graaff, Ph.D., LL.M., CMA, CSCA, is an assistant professor of accounting at Vrije Universiteit Amsterdam, the Netherlands, where she earned her Ph.D. in Integrated Reporting and master's degrees in Accounting & Control and Dutch Criminal Law. She is also the program director of the CMA program at VU Amsterdam. Ms. de Graaff is one of the CMA Gleim Instruct lecturers, and she provided substantial editorial assistance throughout the project.

Amy Ford, CMA, CPA, is a senior instructor of accounting at Western Illinois University. She has more than 15 years' experience teaching business and accounting students with a specialty in managerial and cost accounting. Prior to teaching, she worked in public accounting. Professor Ford is the lead CMA Gleim Instruct lecturer. Professor Ford provided substantial editorial assistance throughout the project.

Mark S. Modas, M.S.T., CPA, holds a Bachelor of Arts in Accounting from Florida Atlantic University and a Master of Science in Taxation from Nova Southeastern University. He is currently an Assistant Professor of Accounting at Santa Fe College and was formerly the head of the Internal Audit department of Perry Ellis International and the Director of Accounting and Financial Reporting for the School Board of Broward County, Florida. Additionally, he worked as the corporate tax compliance supervisor for Ryder Systems, Inc., and has worked as a tax practitioner for more than 25 years. Mr. Modas provided substantial editorial assistance throughout the project.

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Accounting Titles from Gleim Publications

CMA Review:

- Part 1: Financial Planning, Performance, and Analytics
- Part 2: Strategic Financial Management

CIA Review:

- Part 1: Essentials of Internal Auditing
- Part 2: Practice of Internal Auditing
- Part 3: Business Knowledge for Internal Auditing
- CIA Challenge Exam

CPA Review:

- Auditing and Attestation (AUD)
- Financial Accounting and Reporting (FAR)
- Taxation and Regulation (REG)
- Business Analysis and Reporting (BAR)
- Information Systems and Controls (ISC)
- Tax Compliance and Planning (TCP)

EA Review:

- Part 1: Individuals
- Part 2: Businesses
- Part 3: Representation, Practices and Procedures

Exam Questions and Explanations (EQE) Series:

- Auditing & Systems
- Business Law & Legal Studies
- Cost/Managerial Accounting
- Federal Tax
- Financial Accounting

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A Message from Our Authors

In 1981, we set out with one mission: to help you prepare to pass the CMA exam. We were **the first** CMA Review course, and our mission was and continues to be to provide an affordable, effective, and easy-to-use study program. While the delivery and technology have changed over the years, our mission and the core learning techniques that we have perfected over the last 40+ years remain the same. The outline presentation, the spacing, and the question-and-answer formats in this book are designed to facilitate readability, learning, understanding, and your 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.

Our course

- ✓ Teaches how to maximize your score through learning strategies and exam-taking techniques.
- ✓ Defines the subject matter tested on Part 1 of the CMA exam.
- ✓ Outlines all of the Part 1 subject matter tested in 20 easy-to-use study units, including all relevant authoritative pronouncements.
- ✓ Presents multiple-choice and essay questions taken or modeled from CMA examinations to prepare you for the types of questions you will find on your CMA exam.
 - In our book, 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 detailed explanations as you answer the question and then review all answer choices to learn why the correct one is correct and why the other choices are incorrect.
 - You also should practice answering these questions through our online platform, which mimics Prometric's user interface, so you are comfortable answering questions online like you will do on test day. Our adaptive course will focus and target your weak areas.

All Gleim CMA Review materials comprehensively cover the ICMA's Content Specification Outlines and Learning Outcome Statements. Note that, with over 40 years of experience, we teach CSO Section D, Cost Management, before Section B, Planning, Budgeting, and Forecasting, and Section C, Performance Management, because there is foundational knowledge that needs to be acquired in cost accounting before tackling other topics. Also, we cover Integrated Reporting at the end, rather than in the middle, of Section A, External Financial Reporting Decisions.

Thank you for trusting us with your CMA studies. Gleim continues to celebrate 40+ years of being the leading CMA Review course. We want to thank, on behalf of our entire team, every candidate who has trusted us to help them pass the CMA exam and achieve career success.

We appreciate any and all feedback from candidates like you. Please go to www.gleim.com/feedbackCMA1 to share suggestions on how we can improve this edition.

Please reach out to us immediately after the exam upon receipt of your exam scores. While the CMA exam is nondisclosed, and you must maintain confidentiality of any CMA questions or answers and agree not to divulge the nature of its content, we ask for you to provide information about our materials, such as the topics that need to be added or expanded, so that we are providing the best review materials possible.

Good Luck on the Exam,

Irvin N. Gleim

Dale L. Flesher

Preparing for and Taking the CMA Exam

| | |
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Read the *CMA Exam Guide: A System for Success*

Access the free **Gleim CMA Exam Guide** at www.gleim.com/PassCMA and reference it as needed throughout your studying process to obtain a deeper understanding of the CMA exam. This booklet is your system for success.

Overview of the CMA Examination

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

- Part 1 Financial Planning, Performance, and Analytics
- Part 2 Strategic Financial Management

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 online components of Gleim CMA Review provide exact exam emulations of the Prometric computer screens and procedures so you feel comfortable at the testing center 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 adjust the content of 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 Coverage (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 Planning, Performance, and Analytics | |
|--|-----|
| External Financial Reporting Decisions | 15% |
| Planning, Budgeting, and Forecasting | 20% |
| Performance Management | 20% |
| Cost Management | 15% |
| Internal Controls | 15% |
| Technology and Analytics | 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. Remember that we have studied the CSOs in developing our CMA Review materials. Accordingly, you do not need to spend time with Appendix D. Rather, it should give you confidence that Gleim CMA Review is the best and most comprehensive review course 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 CMAs. 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. Like the CSOs, this does not need to be studied. Rather, it should give you confidence in your choice of using Gleim CMA.

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.

Nondisclosed Exam

The CMA is a nondisclosed exam, which means that exam questions are not released to review providers or the public while they are still testable. As part of the ICMA's nondisclosure policy and to prove each candidate's willingness to adhere to this policy, a confidentiality agreement must be accepted by each candidate before each part is taken. This statement is reproduced here to remind all CMA candidates about the ICMA's strict policy of nondisclosure, which Gleim consistently supports and upholds.

I hereby attest that I will not divulge the content of this examination, nor will I remove any examination materials, notes, or other unauthorized materials from the examination room. I understand that failure to comply with this attestation may result in invalidation of my grades and disqualification from future examinations. For those already certified by the Institute of Certified Management Accountants, failure to comply with the statement will be considered a violation of the standards of Ethical Conduct for Practitioners of Management Accounting and Financial Management and could result in revocation of the certification.

The ICMA's Requirements for CMA Designations

The CMA designation is granted only by the ICMA. Candidates must complete the following steps to become a CMA:

1. Become a member of the IMA, enter the certification program, and register for the part(s) you are going to take.
 - The Gleim *CMA Exam Guide* contains helpful guidelines on the membership and certification application and registration processes.
 - A useful checklist to help you keep track of your process and organize what you need for exam day can be found within the Gleim Study Planner of the CMA Review Course.
2. Pass both parts of the exam within 3 years.
3. Satisfy the education requirement within 7 years.
4. Satisfy the experience requirement within 7 years.
5. Comply with the *IMA Statement of Ethical Professional Practice*.

Eligibility Period

Once candidates are admitted into the Certification Program, they are required to pass both parts of the exam within 3 years. If a candidate is not able to pass both parts within this time period, the Certification Entrance Fee will have to be repaid and the passed part will have to be retaken.

Maintaining Your CMA Designation

When you have completed all requirements, you will be issued a numbered CMA certificate. This certificate is the property of the ICMA and must be returned upon request. To maintain your certificate, membership in the IMA is required. CMAs must pay the CMA Annual Fee, which covers active IMA membership and the CMA Maintenance Fee. You are also required to comply with the *IMA Statement of Ethical Professional Practice* and all applicable state laws. The final requirement is continuing professional education (CPE).

Beginning the calendar year after successful completion of the CMA exams, 30 hours of CPE must be completed, which is about 4 days per year. Qualifying topics include management accounting, corporate taxation, statistics, computer science, systems analysis, management skills, marketing, business law, and insurance. All CMAs are required to complete 2 hours of CPE on the subject of ethics as part of their 30-hour annual requirement. Contact Gleim for all of your CPE needs at www.gleim.com/CPE.

Gleim Premium CMA Review with SmartAdapt

Gleim Premium CMA Review features the most comprehensive coverage of exam content and employs learning techniques to help you study smarter and prepare for the CMA exam with confidence. The Gleim Premium CMA Review System is powered by SmartAdapt technology, an innovative platform that continually identifies areas you should focus on and guides you through the learning process. Follow these steps for an optimized CMA review:

Step 1: Complete a Diagnostic Quiz.

This quiz sets a baseline that our SmartAdapt technology will use to create a custom learning track. Immediately after you complete the quiz, you will see your results broken down by topic and then be able to review the detailed answer explanations to facilitate learning.

Step 2: Read, watch, or listen based on your weak areas.

Study identified areas. Learn concepts from our streamlined outlines with detailed examples and success tips. Watch selections identified from our highly acclaimed Gleim Instruct videos. This will ensure you master the required skills.

Step 3: Practice answering multiple-choice and essay questions.

Practice and perfect your question-answering techniques by taking the adaptive quizzes and essays that SmartAdapt has created for you to optimize your learning.

Final Review: Complete Mock Exams to complete your final review leading up to your exam.

After completing all study units, take the first Mock Exam, a full-length practice exam. Then, SmartAdapt will guide you through a Final Review based on your results. Finally, a few days before your exam date, take the second Mock Exam. SmartAdapt will tell you when you are ready so you can pass with confidence.

To facilitate your studies, the Gleim Premium CMA Review System uses the most comprehensive test bank of exam-quality CMA questions on the market. Our system's content and presentation are the most realistic representation of the whole exam environment so you feel completely at ease on exam day.

Gleim Knowledge Transfer Outlines

This edition of the CMA Part 1 Review book has the following features to make studying easier:

Examples

We use illustrative examples, set off in shaded, bordered boxes, to make the concepts more relatable.

Example 1-6 Issuance of Stock

A company issued 50,000 shares of its \$1 par value common stock. The market price of the stock was \$17 per share on the day of issue.

| Assets | = | Liabilities | + | Stockholders' Equity |
|------------------|---|-------------|---|---|
| Cash \$850,000 ↑ | | | | Common stock \$50,000 ↑ Additional paid-in capital \$800,000 ↑ |

Cash: 50,000 shares × \$17 market price = \$850,000

Common stock: 50,000 shares × \$1 par value = \$50,000

Additional paid-in capital: \$850,000 cash – \$50,000 common stock = \$800,000

Gleim Success Tips

These tips supplement the core exam material by suggesting how certain topics might be presented on the exam or how you should prepare for an issue.



Success Tip

CMA candidates will be expected to understand the proper accounting procedure for normal and abnormal spoilage under both job-order costing and process costing. In job-order costing, normal spoilage is treated as a product cost while abnormal spoilage is treated as a period cost. It is important to understand not only that they are treated differently, but why. When answering questions pertaining to spoilage, pay attention to the question stem, what system is being used, and whether the product can be sold or not.

Author's Notes

Our authors use these to call your attention to specific points of content and give more context.



Author's Note

Under the **cash basis**, revenues are recognized when cash is received and expenses are recognized when cash is paid. Under GAAP, financial statements cannot be prepared under the cash basis of accounting.

Flowcharts and Visuals

These images help to conceptualize ideas and make procedures clear.

The Value-Creation Process Described by the <IR> Framework

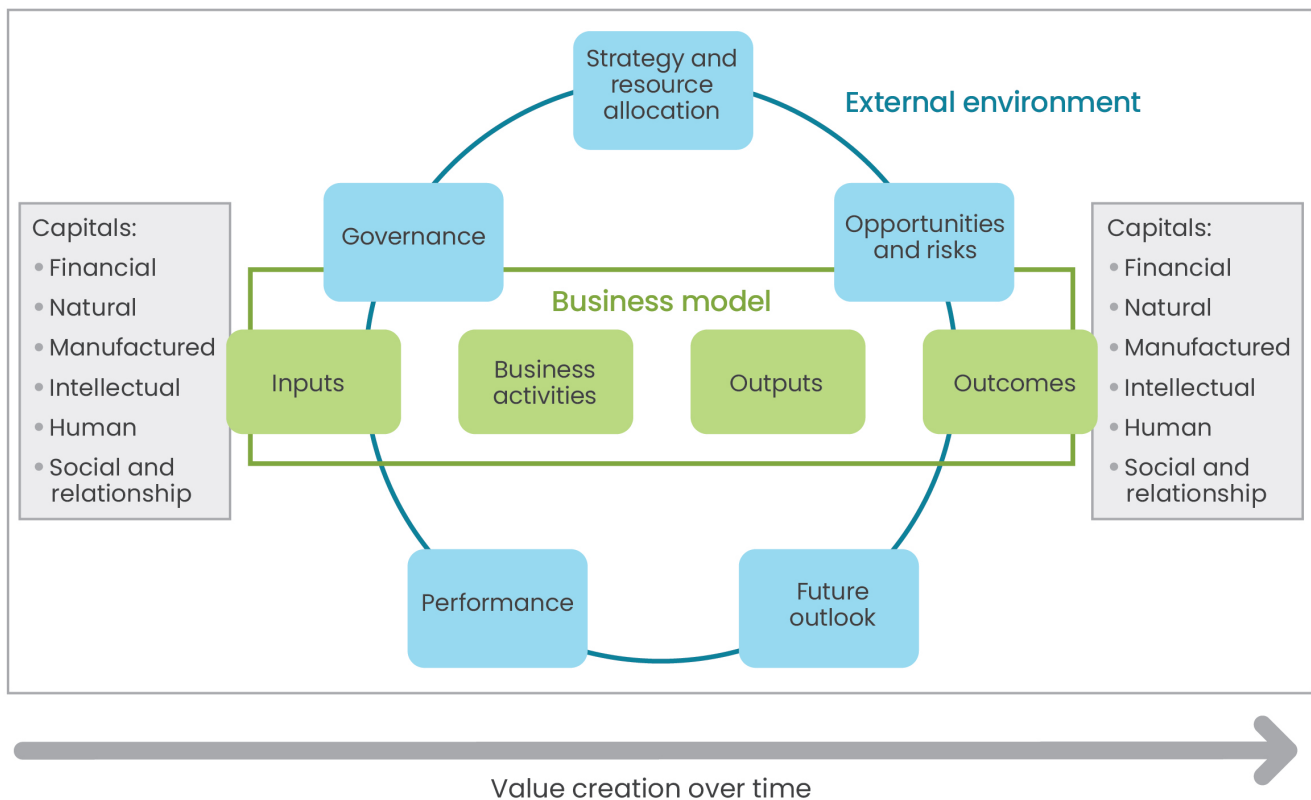


Figure 6-2

Time-Budgeting and Question-Answering Techniques for the Exam

Having a solid multiple-choice answering technique will help you maximize your score on each part of the CMA exam. Remember, knowing how to take the exam and how to answer individual questions is as important as studying/reviewing the subject matter tested on the exam. Competency in both will reduce your stress and the number of surprises you experience on exam day.

- **Budget your time so you can finish before time expires.**
 - Spend about 1.5 minutes per question. This would result in completing 100 questions in 150 minutes to give you 30 minutes to review your answers and questions that you have marked.
- **Read the question carefully to discover exactly what is being asked.**
 - Focusing on what is required allows you to
 - ✓ Reject extraneous information
 - ✓ Concentrate on relevant facts
 - ✓ Proceed directly to determining the best answer
 - Be careful! The requirement may be an **exception** that features a negative word.
- **Decide the correct answer before looking at the answer choices.**
- **Read the answer choices, paying attention to small details.**
 - Only one answer option is best. In the MCQs, four answer choices are presented, and you know one of them is correct. The remaining choices are distractors and are meant to appear correct at first glance. *They are called distractors for a reason.* Eliminate them as quickly as you can.
 - In computational items, the distractors are carefully calculated to be the result of common mistakes. Be careful and double-check your computations if time permits.
 - Even if an answer choice appears to be correct, do not skip the remaining answer choices. Each choice requires consideration because you are looking for the best answer provided.
 - Tip: Treat each answer choice like a true/false question as you analyze it.
- **Click on the best answer.**
 - You have a 25% chance of answering the question correctly by guessing blindly, but you can improve your odds with an educated guess.
 - For many MCQs, you can eliminate two answer choices with minimal effort and increase your educated guess to a 50/50 proposition.

- **Answer the questions in consecutive order.**
 - Do **not** agonize over any one item or question. Stay within your time budget.
 - Never leave a multiple-choice question (MCQ) unanswered. Your score is based on the number of correct responses. You will not be penalized for answering incorrectly. If you are unsure about a question,
 - ✓ Make an educated guess,
 - ✓ Mark it for review at the bottom of the screen, and
 - ✓ Return to it before you submit the testlet as time allows. Remember, once you have selected the “End” button, you will no longer be able to review or change any answers in the MCQ section.

Learning from Your Mistakes

Learning from questions you answer incorrectly is very important. Each question you answer incorrectly is an **opportunity** to avoid missing actual test questions on your CMA exam. Thus, you should carefully study the answer explanations provided until you understand why the original answer you chose is wrong, as well as why the correct answer indicated is correct. This study technique is the difference between passing and failing for many CMA candidates.

Also, you **must** determine why you answered questions incorrectly to learn how to avoid the same errors in the future. Reasons for missing questions include

- ⊗ Misreading the requirement (stem)
- ⊗ Not understanding what is required
- ⊗ Making a math error
- ⊗ Applying the wrong rule or concept
- ⊗ Being distracted by one or more of the answers
- ⊗ Incorrectly eliminating answers from consideration
- ⊗ Not having any knowledge of the topic tested
- ⊗ Employing bad intuition when guessing

It is also important to verify that you answered correctly for the right reasons. Otherwise, if the material is tested on the CMA exam in a different manner, you may not answer it correctly.

How to Be in Control While Taking the Exam

You have to be in control to be successful during exam preparation and execution. Control can also contribute greatly to your personal and other professional goals. Control is a process whereby you

- ✓ Develop expectations, standards, budgets, and plans
- ✓ Undertake activity, production, study, and learning
- ✓ Measure the activity, production, output, and knowledge
- ✓ Compare actual activity with expected and budgeted activity
- ✓ Modify the activity, behavior, or study to better achieve the desired outcome
- ✓ Revise expectations and standards in light of actual experience
- ✓ Continue the process or restart the process in the future

Exercising control will ultimately develop the confidence you need to outperform other CMA candidates and PASS the CMA exam! Obtain our *CMA Exam Guide* for a more detailed discussion of control and other exam tactics.

Gleim outlines cover everything in the ICMA Learning Outcome Statements and Content Specification Outlines and are more than sufficient to help you pass the CMA exam. However, some candidates may wish to review certain topics on a more fundamental level. For these candidates, Gleim has created our **CMA Fundamentals video series**. Contact accountingteam@gleim.com if you would like access to these supplementary videos.

If You Have Questions about Gleim Materials

Gleim has an efficient and effective way for candidates who have purchased the Premium CMA Review System to submit an inquiry and receive a response regarding Gleim materials directly through their course. This system also allows you to view your Q&A session in your Gleim Personal Classroom.

Questions regarding the **information in this introduction and/or the Gleim CMA Exam Guide (study suggestions, study plans, exam specifics)** may be emailed to personalcounselor@gleim.com.

Questions concerning **orders, prices, shipments, or payments** should be sent via email to customerservice@gleim.com and will be promptly handled by our competent and courteous customer service staff.

For **technical support**, you may use our automated technical support service at www.gleim.com/support, email us at support@gleim.com, or call us at (800) 874-5346.

Feedback

Please fill out our online feedback form (www.gleim.com/feedbackCMA1) immediately after you take the CMA exam so we can adapt to changes in the exam. Our approach has been approved by the ICMA.

Study Unit One

External Financial Statements

(36 pages of outline)

| | | |
|-----|--|----|
| 1.1 | Concepts of Financial Accounting | 14 |
| 1.2 | Statement of Financial Position (Balance Sheet) | 18 |
| 1.3 | Income Statement and Statement of Comprehensive Income | 24 |
| 1.4 | Statement of Changes in Equity and Equity Transactions | 31 |
| 1.5 | Statement of Cash Flows | 40 |
| 1.6 | Essay Questions | 56 |

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

- **Study Unit 1: External Financial Statements**
- Study Unit 2: Measurement, Valuation, and Disclosure: Assets -- Short-Term Items
- Study Unit 3: Measurement, Valuation, and Disclosure: Assets -- Long-Term Items
- Study Unit 4: Measurement, Valuation, and Disclosure: Liabilities
- Study Unit 5: Revenue and Impairment Recognition
- Study Unit 6: Integrated Reporting

This study unit discusses the basic concepts underlying financial accounting, which are important to understand before moving on to Study Units 2 through 5. Topics covered in this study unit include

- Users of accounting
- Accrual accounting
- Basic financial statements
- The accounting equation and transaction analysis
- Equity transactions

1.1 Concepts of Financial Accounting

The Objective of General-Purpose Financial Reporting

The objective of general-purpose financial reporting is to report financial information that is **useful in making decisions** about providing resources to the reporting entity.

The information reported relates to the entity's economic resources and claims to them (financial position) and to changes in those resources and claims. Information about economic resources and claims helps to evaluate liquidity, solvency, financing needs, and the probability of obtaining financing.

Users need to differentiate between changes in economic resources and claims arising from the entity's performance (income statement) and other events and transactions, such as issuing debt and equity (balance sheet). Information about financial performance is useful for

- Understanding the return on economic resources, its variability, and its components
- Evaluating management
- Predicting future returns

For general-purpose financial statements to be useful to external parties, they **must be prepared in conformity with accounting principles that are generally accepted in the United States (GAAP)**.



The CMA exam also tests some knowledge of International Financial Reporting Standards (IFRS). Significant differences between international standards and U.S. GAAP are detailed in Appendix B. If an exam question does not distinguish between GAAP and IFRS, use GAAP.

Financial accounting differs from management accounting. Management accounting assists management decision making, planning, and control. Management accounting information is therefore primarily directed to specific internal users. Management accounting topics are covered in Study Units 7 through 16.

Users of Financial Statements

External users are the primary users of financial statements. External users use financial statements to determine whether doing business with the firm will be beneficial.

- Investors need information to decide whether to increase, decrease, or obtain an investment in a firm.
- Creditors need information to determine whether to extend credit and under what terms.
- Financial advisors and analysts need financial statements to help investors evaluate particular investments.
- Stock exchanges need financial statements to evaluate whether to accept a firm's stock for listing or whether to suspend the stock's trading.
- Regulatory agencies may need financial statements to evaluate the firm's conformity with regulations and to determine price levels in regulated industries.

Internal users also use financial statements to make decisions affecting the operations of the business. These users include management, employees, and the board of directors.

Features of Financial Statements

Financial statements are the primary means of communicating financial information to external parties. Additional information is provided by financial statement notes, supplementary information (such as management's discussion and analysis), and other disclosures. Information typically disclosed in notes is essential to understanding the financial statements.

- The notes are considered part of the basic financial statements. They amplify or explain information recognized in the statements and are an integral part of statements prepared in accordance with GAAP.
 - The first footnote accompanying any set of complete financial statements is generally one describing significant accounting policies, such as the use of estimates and assumptions, and policies relating to, among others, revenue recognition and allocation of asset (tangible and intangible) costs to current and future periods.

A full set of financial statements includes the following statements:

- Statement of financial position (also called a balance sheet)
- Income statement
- Statement of comprehensive income
- Statement of changes in equity
- Statement of cash flows

To be useful, information presented in the financial statements must be relevant and faithfully represented.

- Usefulness is enhanced when the information is comparable with similar information for other entities and the same entity for another period or date. **Comparability** allows users to understand similarities and differences.

Financial statements are prepared under the **going-concern assumption**, which means that the entity is assumed to continue operating indefinitely and that it will not be liquidated in the near future.

Financial Statement Relationships

Financial statements complement each other. They describe different aspects of the same transactions, and more than one statement is necessary to provide information for a specific economic decision.

The components (elements) of one statement relate to those of other statements. Among the relationships are:

- Net income or loss from the statement of income is reported and accumulated in the retained earnings account, a component of the equity section of the statement of financial position.
- The components of cash and equivalents from the statement of financial position are reconciled with the corresponding items in the statement of cash flows.
- Items of equity from the statement of financial position are reconciled with the balances on the statement of changes in equity.
- Ending inventories are reported in current assets on the statement of financial position and are reflected in the calculation of cost of goods sold on the statement of income.
- Amortization and depreciation reported in the statement of income also are reflected in asset and liability balances in the statement of financial position.

Accrual Basis of Accounting

Financial statements are prepared under the accrual basis of accounting. Accrual accounting records the financial effects of transactions and other events and circumstances when they occur rather than when their associated cash is paid or received.

- Revenues are recognized in the period in which they were earned even if the cash will be received in a future period. This is referred to as the **revenue recognition principle**.
- Expenses are recognized in the period in which they were incurred even if the cash will be paid in a future period.
 - Under the **matching principle**, expenses are recognized in the same period as the related revenue.
 - Expense recognition principles associate cause and effect, systematic and rational allocation, and immediate recognition.



Author's Note

Under the **cash basis**, revenues are recognized when cash is received and expenses are recognized when cash is paid. Under GAAP, financial statements cannot be prepared under the cash basis of accounting.



Stop & Review

You have completed the outline for this subunit.
Study multiple-choice questions 1 and 2 on page 48.

1.2 Statement of Financial Position (Balance Sheet)

The statement of financial position, also called the balance sheet, reports the amounts of assets (items of value), liabilities (debt), and equity (net worth) and their relationships at a moment in time, such as at the end of the fiscal year. It helps users assess liquidity, financial flexibility, the efficiency with which assets are used, capital structure, and risk.

The **basic accounting equation** presents a perfect balance between the entity's resources and its capital structure.

- The entity's resources consist of the assets used in its attempts to earn a return.
- The capital structure consists of the amounts contributed by creditors (liabilities) and investors (stockholders' equity).

$$\text{Assets} = \text{Liabilities} + \text{Stockholders' Equity}$$

- The equation is based on the **fund theory**.
 - The basic equation can be derived to form the proprietary theory:

$$\text{Assets} - \text{Liabilities} = \text{Stockholders' Equity}$$

- ▶ According to this theory, equity in an enterprise is what remains after the economic obligations of the enterprise are deducted from its economic resources.

Transaction Analysis

Using the basic accounting equation, all transactions of the entity can be illustrated based on the impact of the transaction to the accounting equation. Every transaction will have a dual effect, impacting at least two elements of the equation.

- The accounting equation must remain in balance with each accounting transaction.



Author's Note

Although financial accounting typically uses debits and credits to record transactions in journal entries, the CMA exam has traditionally used increases and decreases to refer to a transaction's impact on the elements of the accounting equation. This text therefore presents transactions with increases and decreases.

Example 1-1 Transaction Analysis

Examples of transaction analysis include the following:

- Borrowing cash from a bank with a note payable

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|-----------------|---|----------------------|
| Cash ↑ | | Notes payable ↑ | | |

- Receiving cash when providing services for customers

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|-------------|---|----------------------|
| Cash ↑ | | | | Service revenue ↑ |

- Paying a supplier an amount owed on account

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|--------------------|---|----------------------|
| Cash ↓ | | Accounts payable ↓ | | |

- Purchasing inventory on account from a supplier

| Assets | = | Liabilities | + | Stockholders' Equity |
|-------------|---|--------------------|---|----------------------|
| Inventory ↑ | | Accounts payable ↑ | | |

- Purchasing equipment with cash

| Assets | = | Liabilities | + | Stockholders' Equity |
|-----------------------|---|-------------|---|----------------------|
| Cash ↓ Equipment ↑ | | | | |

Elements of the Balance Sheet

Assets are resources controlled by the entity as a result of past events. They represent probable future economic benefits to the entity.

- Examples include inventory; accounts receivable; investments; and property, plant, and equipment.

Liabilities are present obligations of the entity arising from past events. Their settlement is expected to result in an outflow of economic benefits from the entity.

- Examples include loans payable, bonds issued by the entity, and accounts payable.

Equity is the residual interest in the assets of the entity after subtracting all its liabilities.

- Examples include a company's common stock, preferred stock, and retained earnings.
- Equity is affected not only by operations but also by transactions with owners, such as dividends and contributions.

Assets and liabilities are separated in the statement of financial position into **current** and **noncurrent** categories. Assets are generally reported in order of liquidity, which means the order in which the assets are expected to be converted to cash.

NOTE: In some parts of the world, assets are listed in the order of reverse liquidity with intangibles and property, plant, and equipment listed first. This is known as the "production order." This method is not used in the United States.

Some variation of the following classifications is used by most entities:

Assets

Current assets:

Cash
Certain investments
Accounts receivable
Inventories
Prepaid expenses

Noncurrent assets:

Certain investments and funds
Property, plant, and equipment (PPE)
Intangible assets
Other noncurrent assets

Liabilities

Current liabilities:

Accounts payable
Current notes payable
Current maturities of noncurrent liabilities

Noncurrent liabilities:

Noncurrent notes payable
Bonds payable

Equity

Common stock
Retained earnings

Current and Noncurrent Assets

An asset is classified as **current** on the statement of financial position if it is expected to be realized in cash or sold or consumed within the entity's operating cycle or 1 year, **whichever period is longer**.

- The following are the major categories of current assets:
 - Cash and cash equivalents
 - Certain individual trading, available-for-sale, and held-to-maturity debt securities
 - Receivables
 - Inventories
 - Prepaid expenses
 - Certain individual investments in equity securities

Noncurrent assets (long term assets) are those not qualifying as current. The following are the major categories of noncurrent assets:

- **Investments and funds** include nonoperating items intended to be held beyond the longer of 1 year or the operating cycle. The following assets are typically included:
 - Investments in equity securities made to control or influence another entity and other noncurrent securities.
 - Certain available-for-sale and held-to-maturity debt securities may be noncurrent.
- **Property, plant, and equipment (PPE)** are tangible operating items recorded at cost and reported net of any accumulated depreciation. They include
 - Land and natural resources subject to depletion, e.g., oil and gas
 - Buildings, equipment, furniture, fixtures, leasehold improvements, land improvements, a lessee's right-of-use assets held under finance and operating leases, noncurrent assets under construction, and other depreciable assets
- **Intangible assets** are nonfinancial assets without physical substance. Examples are patents and goodwill.

Current and Noncurrent Liabilities

Current liabilities are expected to be settled or liquidated in the ordinary course of business during the longer of the next year or the operating cycle. Generally speaking, current liabilities are expected to be settled or liquidated within 1 year from the balance sheet date.

The following are the major categories of current liabilities:

- **Accounts (or trade) payables** for items entering into the operating cycle, e.g., for materials and supplies used in producing goods or services for sale.
- **Other payables** arising from operations, such as accrued wages, salaries, rentals, royalties, and taxes.
- **Unearned revenues** arising from collections in advance of delivering goods or performing services, e.g., ticket sales revenue.
- **Other obligations** expected to be liquidated in the ordinary course of business during the longer of the next year or the operating cycle. These include
 - Short-term notes given to acquire capital assets
 - Payments on the current portion of serial bonds or other noncurrent debt
 - Long-term obligations that are or will become callable by the creditor because of the debtor's violation of a provision of the debt agreement at the balance sheet date
 - Possible obligations for warranties (guarantees) and estimated returns

Current liabilities **do not include** short-term debt if an entity intends to refinance them on a noncurrent basis and demonstrates an ability to do so.

- The ability to refinance may be demonstrated by entering into a **refinancing agreement** before the balance sheet is issued.

Noncurrent liabilities (long term liabilities) are those not qualifying as current. The noncurrent portions of the following items are reported in this section of the balance sheet:

- Noncurrent notes and bonds
- A lessee's liabilities under finance and operating leases
- Deferred tax liabilities arising from interperiod tax allocation
- Obligations under product or service warranty agreements
- Deferred revenue
- Advances for noncurrent commitments to provide goods or services

Equity

Equity represents ownership interest in a firm. Owners of corporations are referred to as stockholders or shareholders. The following are the major items of equity:

- **Capital contributions by owners** (par value of common and preferred stock issued and additional paid-in capital).
 - Additional paid-in (contributed) capital (APIC) is the amount received in excess of par value at the time stock was sold.
- **Retained earnings** is the accumulated net income not yet distributed to owners. Dividends can be paid when retained earnings has a balance. A payment in excess of this balance is a return of capital, not a dividend.
 - Occasionally, the board of directors restricts retained earnings to prevent payment of dividends. The usual reason is that the board plans to reinvest the earnings in the business.
- **Treasury stock** is the firm's own stock that has been repurchased.
 - It is reflected in shareholders' equity as a contra account (which reduces the balance of a related account).
- **Accumulated other comprehensive income** (all comprehensive income items not included in net income).

Detailed equity transactions are covered in Subunit 1.4.

Limitations of the Balance Sheet

Limitations of using the balance sheet for decision making include the following:

- The balance sheet shows a company's financial position at a single point in time. Accounts may vary significantly a few days before or after the publication of the balance sheet.
- Many balance sheet items, such as property, plant, and equipment, are recorded at historical costs, which may not equal their fair value.
- The preparation of the balance sheet requires estimates and management judgment.
- The balance sheet omits many items that cannot be recorded objectively but have financial value to the company.



Stop & Review

You have completed the outline for this subunit.
Study multiple-choice questions 3 through 6 beginning on page 49.

1.3 Income Statement and Statement of Comprehensive Income

Income Statement Elements

The income statement reports the results of an entity's operations over a period of time, such as a year.

The Income Equation

$$\text{Income (Loss)} = \text{Revenues} + \text{Gains} - \text{Expenses} - \text{Losses}$$

The following are the elements of an income statement:

- **Revenues** are inflows or other enhancements of assets or settlements of liabilities (or both) from delivering or producing goods, providing services, or other activities that qualify as ongoing major or central operations.
- **Gains** are increases in equity (or net assets) other than from revenues or investments by owners.
- **Expenses** are outflows or other usage of assets or incurrences of liabilities (or both) from delivering or producing goods, providing services, or other activities that qualify as ongoing major or central operations.
- **Losses** are decreases in equity (or net assets) other than from expenses or distributions to owners.
- All transactions affecting the net change in equity during the period are included in income except
 - Transactions with owners
 - Prior-period adjustments (such as error correction or a change in accounting principle, which are covered in Subunit 1.4)
 - Items reported initially in other comprehensive income
 - Transfers to and from appropriated retained earnings

Cost of Goods Sold and Cost of Goods Manufactured

Cost of goods sold is an expense account reported on the income statement.

- For a **retailer**, cost of goods sold represents the cost of the items being sold to customers and is calculated based on changes in inventory:

| | |
|--------------------------|------------------------|
| Beginning inventory | \$10,000 |
| Plus: Net purchases | 14,000 |
| Plus: Freight-in | <u>1,000</u> |
| Goods available for sale | \$25,000 |
| Minus: Ending inventory | <u>(5,000)</u> |
| Cost of goods sold | <u><u>\$20,000</u></u> |

- For a **manufacturer**, cost of goods sold represents the cost of items that were produced (manufactured) by the firm and are being sold to customers.
 - Manufacturers must calculate the cost of goods manufactured in order to calculate the cost of goods sold. The **cost of goods manufactured** is the cost of goods completed during the current year. It represents the cost of goods transferred out of work-in-process inventory to finished goods inventory.
 - Manufacturers calculate cost of goods sold as follows:

| | | |
|--|----------------|------------------------|
| Beginning direct materials inventory | \$3,000 | |
| Purchases during the period | 3,000 | |
| Ending direct materials inventory | <u>(1,000)</u> | |
| Direct materials used in production | | \$5,000 |
| Direct labor costs | | 5,000 |
| Manufacturing overhead costs* (Fixed + Variable) | | <u>4,000</u> |
| Total manufacturing costs | | \$14,000 |
| Beginning work-in-process inventory | | 5,000 |
| Ending work-in-process inventory | | <u>(4,000)</u> |
| Cost of goods manufactured | | \$15,000 |
| Beginning finished goods inventory | | 6,000 |
| Ending finished goods inventory | | <u>(11,000)</u> |
| Cost of goods sold | | <u><u>\$10,000</u></u> |

*Study Unit 7, Subunit 1, has details about what is included in manufacturing overhead.

- Cost of goods sold is recognized at the time the goods are sold, which follows the matching principle.

Gross profit is the net difference between sales revenue and cost of goods sold.

- Gross profit margin as a percentage of sales is calculated as follows:

$$\text{Gross profit margin (\%)} = \text{Gross profit} \div \text{Sales}$$

Example 1-2 Cost of Goods Sold and Cost of Goods Manufactured

The following information was taken from the accounting records of Amy's Manufacturing.

| <u>Inventory</u> | <u>January 1</u> | <u>December 31</u> |
|---------------------------|------------------|--------------------|
| Raw materials | \$ 65,000 | \$ 58,000 |
| Work-in-process (WIP) | 100,000 | 120,000 |
| Finished goods | 30,000 | 26,000 |
| <u>Other Information</u> | | |
| Purchase of raw materials | \$240,000 | |
| Direct labor | 300,000 | |
| Factory rent | 80,000 | |
| Factory utilities | 25,000 | |
| Advertising expense | 40,000 | |
| Administrative salaries | 200,000 | |

1. Find the direct materials used in production.

| | |
|-------------------------------------|-------------------------|
| Beginning raw materials | \$ 65,000 |
| Add: Purchases during the period | 240,000 |
| Materials available | <u>\$305,000</u> |
| Less: Ending raw materials | (58,000) |
| Materials used in production | <u>\$247,000</u> |

2. Find the total manufacturing cost.

| | |
|----------------------------------|-------------------------|
| Materials used in production | \$247,000 |
| Direct labor | 300,000 |
| Manufacturing overhead | |
| Factory rent | \$80,000 |
| Factory utilities | <u>25,000</u> |
| Total manufacturing overhead | 105,000 |
| Total manufacturing costs | <u>\$652,000</u> |

3. Calculate the cost of goods manufactured.

| | |
|-----------------------------------|-------------------------|
| Total manufacturing costs | \$652,000 |
| Add: Beginning WIP inventory | 100,000 |
| Less: Ending WIP inventory | <u>(120,000)</u> |
| Cost of goods manufactured | <u>\$632,000</u> |

4. Calculate the cost of goods sold.

| | |
|---|-------------------------|
| Cost of goods manufactured | \$632,000 |
| Add: Beginning finished goods inventory | 30,000 |
| Less: Ending finished goods inventory | <u>(26,000)</u> |
| Cost of goods sold | <u>\$636,000</u> |



IFRS Difference

Share-based payment differences between U.S. GAAP and IFRS are covered in Appendix B.

Other Expenses

General and administrative expenses are incurred for the benefit of the enterprise as a whole and are not related wholly to a specific function, e.g., selling or manufacturing.

- They include accounting, legal, and other fees for professional services; officers' salaries; insurance; wages of office staff; miscellaneous supplies; and office occupancy costs.

Selling expenses are those incurred in selling or marketing.

- Examples include sales representatives' salaries, commissions, and traveling expenses; sales department salaries and expenses, including rent; advertising; and credit and collection costs.
- Shipping costs are also often classified as selling expenses.

Interest expense is recognized based on the passage of time. In the case of bonds, notes, and finance leases, the effective interest method is used.

Income Statement Formats

The **single-step** income statement provides one grouping for revenue items and one for expense items. The single step is the one subtraction necessary to arrive at net income.

The **multiple-step** income statement presents operating revenues and expenses in a section separate from nonoperating items.

- The most common way to present the income statement is the condensed format of the multiple-step income statement, which includes only the section totals.

Example 1-3 Multiple-Step Income Statement

| | |
|---------------------------|-------------------------|
| Net sales | \$ 200,000 |
| Cost of goods sold | <u>(150,000)</u> |
| Gross profit | \$ 50,000 |
| Selling expenses | (6,000) |
| Administrative expenses | <u>(5,000)</u> |
| Income from operations | \$ 39,000 |
| Other revenues and gains | 3,500 |
| Other expenses and losses | <u>(2,500)</u> |
| Income before taxes | \$ 40,000 |
| Income taxes | <u>(16,000)</u> |
| Net income | <u><u>\$ 24,000</u></u> |

Discontinued Operations

When an entity reports a **discontinued operation**, it must be presented in a separate section between **income from continuing operations and net income**.

- Because these items are reported after the presentation of income taxes, they must be shown net of tax.
- The term “continuing operations” is used only when a discontinued operation is reported.

Discontinued operations, if reported, may have two components:

1. Gain or loss from operations of the component that has been disposed of or is classified as held for sale from the first day of the reporting period until the date of disposal (or the end of the reporting period if it is classified as held for sale)
2. Gain or loss on the disposal of this component

Example 1-4 Discontinued Operations

| | | |
|--|----------|------------|
| Net sales | | \$ 200,000 |
| Cost of goods sold | | (150,000) |
| Gross profit | | \$ 50,000 |
| Selling expenses | | (6,000) |
| Administrative expenses | | (5,000) |
| Income from operations | | \$ 39,000 |
| Other revenues and gains | | 3,500 |
| Other expenses and losses | | (2,500) |
| Income before taxes | | \$ 40,000 |
| Income taxes | | (16,000) |
| Income from continuing operations | | \$ 24,000 |
| Discontinued operations | | |
| Gain from operations of component (including loss on disposal of \$5,000) | \$10,000 | |
| Income taxes | (4,000) | |
| Gain from discontinued operations | | \$ 6,000 |
| Net income | | \$ 30,000 |

Statement of Comprehensive Income

Comprehensive income includes all changes in equity (net assets) of a business during a period except those from investments by and distributions to owners. It consists of

- **Net income or loss** (the bottom line of the income statement)
- **Other comprehensive income (OCI)**

Certain income items are excluded from the calculation of net income and instead are included in other comprehensive income. The following are the major items included in other comprehensive income:

- The effective portion of a gain or loss on a hedging instrument in a cash flow hedge
- Unrealized holding gains and losses due to changes in the fair value of available-for-sale debt securities
- Translation gains and losses for financial statements of foreign operations
- Certain amounts associated with accounting for defined benefit postretirement plans

All items of comprehensive income are recognized for the period in either

- **One continuous financial statement** that has two sections, net income and OCI, or
- **Two separate but consecutive statements.**
 - The first statement (the income statement) presents the components of net income and total net income.
 - The second statement (the statement of OCI) is presented immediately after the first. It presents a total of OCI with its components and a total of comprehensive income.

Example 1-5 Separate Statement of Comprehensive Income

| | | |
|--|----------------|-------------------------------|
| Net income | | \$70,000 |
| Other comprehensive income (net of tax): | | |
| Loss on defined benefit postretirement plans | \$(15,000) | |
| Gains on foreign currency translation | 6,000 | |
| Gains on remeasuring available-for-sale securities | 4,000 | |
| Effective portion of losses on cash flow hedges | <u>(3,000)</u> | |
| Other comprehensive income (loss) | | <u>(8,000)</u> |
| Total comprehensive income | | <u><u>\$62,000</u></u> |

Limitations of the Income Statement

The income statement does not always show all items of income and expense. Some of the items are reported on a statement of other comprehensive income and not included in the calculation of net income.

The financial statements report accrual-basis results for the period. The company may recognize revenue and report net income before any cash was actually received.

- For example, the data from the income statement itself is not sufficient enough for assessing liquidity. This statement must be viewed in conjunction with other financial statements, such as the balance sheet and statement of cash flows.

The preparation of the income statement requires estimates and management judgment.



Stop & Review

You have completed the outline for this subunit.
Study multiple-choice questions 7 through 9 on page 51.

1.4 Statement of Changes in Equity and Equity Transactions

Statement of Changes in Equity

A statement of changes in equity presents a reconciliation for the accounting period of the beginning balance for each component of equity to the ending balance.

Each change is disclosed separately in the statement. The following are the common changes in the equity component balances during the accounting period:

| Item | Equity Component and Direction |
|--|-------------------------------------|
| Net income | Retained earnings ↑ |
| Net loss | Retained earnings ↓ |
| Distributions to owners (dividends) | Retained earnings ↓ |
| Issuance of common stock | Common stock ↑ |
| Issuance of common stock – portion above par | Additional paid-in capital (APIC) ↑ |
| Total change in other comprehensive income (OCI) | Accumulated OCI ↑ or ↓ |
| Repurchase treasury stock | Total stockholders' equity ↓ |

Statement of Retained Earnings

A statement of retained earnings reconciles the beginning and ending balances of the account. This statement is reported as part of the statement of changes in equity in a separate column.

The following is a common example of retained earnings reconciliation:

| |
|---|
| Retained earnings beginning balance |
| + Net income (loss) for the period |
| – Dividends distributed during the period |
| + Positive (negative) prior-period adjustments |
| <u>Retained earnings ending balance</u> |

Prior-Period Adjustments

Prior-period adjustments include the cumulative effect on the income statement of the following two items:

1. **Changes in accounting principle** (e.g., change in inventory valuation method)
2. **Corrections of prior-period financial statement errors**
 - These items require **retrospective application** (i.e., adjustment of the carrying amounts of assets, liabilities, and retained earnings at the beginning of the first period reported for the cumulative effect of the new principle or the error on the prior periods).
 - Correction of prior-period errors and the cumulative effect of changes in accounting principle **must not** be included in the calculation of current-period net income.

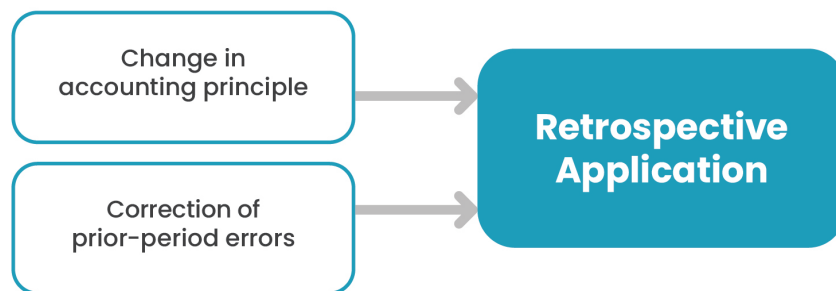


Figure 1-1

Changes in accounting estimate are not prior-period adjustments.

- Examples include a change in the percentage used for the estimation of credit losses or the change in the estimated remaining life of a depreciable asset.
- Changes in accounting estimate require **prospective application**. The effect of the change is accounted for only in the period of the change and any future periods



Figure 1-2

It may be **impracticable** to determine the cumulative effect of a new principle on any prior period. The new principle then must be applied as if the change had been made **prospectively** at the earliest date practicable.

Common and Preferred Stock

The most widely used classes of stock are common and preferred. If only one class of stock is issued, it is treated as common, and each shareholder must be treated equally. The following basic terminology is related to stock:

| Stock Term | Definition |
|-------------|---|
| Authorized | Maximum amount of stock that a corporation may issue |
| Issued | Stock that has been sold to stockholders by the corporation |
| Outstanding | Stock currently held by stockholders |

The **common shareholders** are the owners of the firm. They have voting rights, and they select the firm's board of directors and vote on resolutions. Common shareholders are not entitled to dividends unless declared by the board of directors. A firm may choose not to declare any.

- Common shareholders are entitled to receive **liquidating distributions** only after all other claims have been satisfied, including those of preferred shareholders.
- Common shareholders ordinarily have **preemptive rights**.
 - Preemptive rights give current common shareholders the right to purchase any additional stock issuances in proportion to their ownership percentages. This way the preemptive rights safeguard a common shareholder's proportionate interest in the firm.

Preferred stock has features of debt and equity. It is classified as an equity instrument and presented in the equity section of the firm's balance sheet.

- Preferred stock has a fixed charge, but payment of dividends is not an obligation.
- The payment of dividends is at the firm's discretion.
- Preferred shareholders tend not to have voting rights.
- Preferred shareholders have the right to receive
 - Dividends at a specified fixed rate before common shareholders may receive any
 - Distributions before common shareholders, but after creditors, in the event of firm bankruptcy (liquidation)
- The following are common features of preferred stock:
 - **Cumulative preferred stock** accumulates unpaid dividends (called dividends in arrears). Dividends in arrears must be paid before any common dividends can be paid.
 - Holders of **convertible preferred stock** have the right to convert the stock into shares of another class (usually common stock) at a predetermined ratio.

Treasury stock is the entity's own stock that was repurchased by the entity subsequent to its initial issuance to shareholders.

- Treasury stock reduces the shares outstanding, not the shares authorized.
- Dividends are never paid to these shares.

Equity Transactions

Issuance of Stock

The par value of stock is an arbitrary amount assigned by the issuer. Common and preferred stock are reported in the financial statements at par value. Additional paid-in capital (paid-in capital in excess of par) is increased for the difference between the cash received and the par value of the stock issuance.

Example 1-6 Issuance of Stock

A company issued 50,000 shares of its \$1 par value common stock. The market price of the stock was \$17 per share on the day of issue.

| Assets | = | Liabilities | + | Stockholders' Equity |
|------------------|---|-------------|---|---|
| Cash \$850,000 ↑ | | | | Common stock \$50,000 ↑ Additional paid-in capital \$800,000 ↑ |

Cash: 50,000 shares × \$17 market price = \$850,000

Common stock: 50,000 shares × \$1 par value = \$50,000

Additional paid-in capital: \$850,000 cash – \$50,000 common stock = \$800,000

Treasury Stock

Treasury stock is reported using one of two methods:

1. Under the **cost method**, treasury stock is recorded at the cost of the purchase.
 - Treasury stock is treated as a reduction to total stockholders' equity.
2. Under the **par value method**, treasury stock is recorded for the par value of the stock.
 - Treasury stock reduces total stockholders' equity.
 - Additional paid-in capital is reduced.
 - Retained earnings is decreased if the acquisition price is greater than the original issue price.

Treasury stock

- Has no voting rights
- Receives no distributions in liquidation
- Receives no dividends when the entity declares a dividend

Example 1-7 Treasury Stock -- Acquisition Price > Original Issue Price

Parvenu reacquired 5,000 shares of its \$1 par value common stock for \$20 per share. This stock had originally been issued at \$17 per share. Parvenu had no prior treasury stock transactions.

Cost method

| Assets | = | Liabilities | + | Stockholders' Equity |
|------------------|---|-------------|---|----------------------------|
| Cash \$100,000 ↓ | | | | Treasury stock \$100,000 ↓ |

5,000 shares × \$20 market price = \$100,000

Par value method

| Assets | = | Liabilities | + | Stockholders' Equity |
|------------------|---|-------------|---|---------------------------------------|
| Cash \$100,000 ↓ | | | | Treasury stock \$5,000 ↓ |
| | | | | Additional paid-in capital \$80,000 ↓ |
| | | | | Retained earnings \$15,000 ↓ |

Cash payment: 5,000 shares × \$20 market price = \$100,000

Treasury stock: 5,000 shares × \$1 par value = \$5,000

Additional paid-in capital: 5,000 shares × \$16 original issue excess = \$80,000

Retained earnings -- difference:

\$100,000 cash payment – \$5,000 treasury stock – \$80,000 additional paid-in capital = \$15,000

Example 1-8 Treasury Stock -- Acquisition Price < Issue Price

Parvenu reacquired 5,000 shares of its \$1 par value common stock for \$10 per share.

Cost method

| Assets | = | Liabilities | + | Stockholders' Equity |
|-----------------|---|-------------|---|---------------------------|
| Cash \$50,000 ↓ | | | | Treasury stock \$50,000 ↓ |

5,000 shares × \$10 market price = \$50,000

Par value method

| Assets | = | Liabilities | + | Stockholders' Equity |
|-----------------|---|-------------|---|---------------------------------------|
| Cash \$50,000 ↓ | | | | Treasury stock \$5,000 ↓ |
| | | | | Additional paid-in capital \$45,000 ↓ |

Cash payment: 5,000 shares × \$10 market price = \$50,000

Treasury stock: 5,000 shares × \$1 par value = \$5,000

Additional paid-in capital -- difference: \$50,000 cash payment – \$5,000 treasury stock = \$45,000

Cash Dividend

The most common form of dividend is a cash dividend. An entity declares a dividend based on a dollar amount per share. Each shareholder receives cash as the form of distribution.

- On the **declaration date**, the board of directors formally approves a dividend. A declaration of a dividend decreases the retained earnings account.
- All holders of the stock on the **record date** are legally entitled to receive the dividend. There is no impact on the firm's accounting equation on the record date.
- The **payment date** is the date on which the dividend is paid.

Example 1-9 Cash Dividend

On September 12, a company's board of directors declared a \$3 per-share dividend to be paid on October 15 to all holders of common stock. On the date of declaration, 40,000 shares of common stock were outstanding.

Declaration date

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|-------------|---|----------------------|
|--------|---|-------------|---|----------------------|

Dividends payable \$120,000 ↑ Retained earnings \$120,000 ↓

40,000 shares outstanding × \$3 per share = \$120,000

Payment date

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|-------------|---|----------------------|
|--------|---|-------------|---|----------------------|

Cash \$120,000 ↓ Dividends payable \$120,000 ↓

Property Dividend

When an entity declares a dividend consisting of tangible property,

1. First, the property is **remeasured to fair value** as of the date of declaration, and any gain or loss on the remeasurement is recognized in the statement of income.
2. Second, the carrying amount of retained earnings is decreased for the fair value of the property to be distributed.
3. Third, the property is distributed as a dividend.

Example 1-10 Property Dividend

On August 1, a company's board of directors declared a property dividend (land) to be distributed on December 1 to holders of common stock. On August 1, the carrying amount of the land to be distributed is \$50,000 and its fair value is \$80,000. The journal entries to record the declaration and distribution of the property dividend are as follows:

August 1 -- Declaration date

| Assets | = | Liabilities | + | Stockholders' Equity |
|-----------------|---|--------------------------------------|---|---|
| Land \$30,000 ↑ | | Property dividend payable \$80,000 ↑ | | Gain on land remeasurement \$30,000 ↑ Retained earnings \$80,000 ↓ |

December 1 -- Payment date

| Assets | = | Liabilities | + | Stockholders' Equity |
|-----------------|---|--------------------------------------|---|----------------------|
| Land \$80,000 ↓ | | Property dividend payable \$80,000 ↓ | | |

Stock Dividends and Stock Splits

A stock dividend involves no distribution of cash or other property. Stock dividends are accounted for as a reclassification of different equity accounts, not as liabilities.

The accounting for stock dividends depends on the percentage of new shares to be issued.

- **Small stock dividend:** An issuance of shares **less than 20% to 25%** of the previously outstanding common shares should be recognized as a **stock dividend**.
- **Large stock dividend:** An issuance of **more than 20% to 25%** of the previously outstanding common shares should be recognized as a **stock split in the form of a dividend**.

In accounting for a **stock dividend**, the **fair value** of the additional shares issued is reclassified from retained earnings to common stock (at par value) and the difference to additional paid-in capital.

Example 1-11 Small Stock Dividend

On May 1, a company's board of directors declared and paid a 10% stock dividend on the 45,000 shares of common stock outstanding (\$1 par value). The stock was trading for \$15 per share at the declaration date.

May 1 -- Declaration and payment date

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|-------------|---|----------------------|
|--------|---|-------------|---|----------------------|

| | | | | |
|--|--|--|--|------------------------------|
| | | | | Common stock \$4,500 ↑ |
| | | | | APIC \$63,000 ↑ |
| | | | | Retained earnings \$67,500 ↓ |

45,000 shares × 10% = 4,500 shares

Retained earnings: 4,500 shares × \$15 market price = \$67,500

Common stock: 4,500 shares × \$1 par value = \$4,500

Additional paid-in capital -- difference: \$67,500 retained earnings – \$4,500 common stock = \$63,000

For a stock dividend that is accounted for as a **stock split in the form of a dividend**, the **par value** of the additional shares issued is reclassified from retained earnings to common stock.

Example 1-12 Large Stock Dividend

Continuing from Example 1-11, assume that a 40% stock split in the form of a dividend was declared.

May 1 -- Declaration and payment date

| Assets | = | Liabilities | + | Stockholders' Equity |
|--------|---|-------------|---|----------------------|
|--------|---|-------------|---|----------------------|

| | | | | |
|--|--|--|--|------------------------------|
| | | | | Common stock \$18,000 ↑ |
| | | | | Retained earnings \$18,000 ↓ |

45,000 shares × 40% = 18,000 shares

18,000 shares × \$1 par value = \$18,000

Stock splits are issuances of shares that do not affect any aggregate par value of shares issued and outstanding or total equity. Stock split reduces the par value of each stock and increases the number of shares outstanding.

- No entry is made, and no transfer from retained earnings occurs.
- The primary purpose of a stock split is to improve the stock's marketability by reducing its market price and proportionally increasing the number of shares outstanding.

The following table summarizes the impact on the par value per share:

| Item | Par value per share |
|----------------------|---------------------|
| Small stock dividend | No change |
| Large stock dividend | No change |
| Stock split | Decrease |

The following table summarizes the impact on the elements of the accounting equation:

| Item | Common Stock | Additional Paid-In Capital | Retained Earnings | Total Stockholders' Equity |
|----------------------|--------------|----------------------------|-------------------|----------------------------|
| Small stock dividend | Increase | Increase | Decrease | No change |
| Large stock dividend | Increase | No change | Decrease | No change |
| Stock split | No change | No change | No change | No change |

Limitations of the Statement of Changes in Equity

The financial statements report accrual-basis results for the period. The company may recognize revenue and/or expense and report net income before any cash was actually received and/or paid.

- The data for retained earnings is not sufficient for assessing the amount actually available to be reinvested in the company or to pay debt.

The statement of changes in equity illustrates a company's equity based on a specific time period, which means equity may vary significantly a few days before or after publication of the statement.



Stop & Review

You have completed the outline for this subunit.

Study multiple-choice questions 10 through 14 beginning on page 52.

1.5 Statement of Cash Flows

The **primary purpose** of the statement of cash flows is to provide relevant information about the cash receipts and cash payments of an entity during the period.

- To achieve this purpose, the statement should provide information about cash inflows and outflows from the operating, investing, and financing activities of an entity. This is the accepted order of presentation.
- The statement of cash flows should help users assess the entity's ability to generate positive future net cash flows (liquidity), its ability to meet obligations (solvency), and its financial flexibility.

The statement of cash flows explains the change in cash and cash equivalents during the period. It reconciles the period's beginning balance of cash and cash equivalents with the ending balance.

Example 1-13 Summary of Cash Flow Statement

The following is an example of the summarized format of the statement of cash flows (only the headings). The amounts of cash and cash equivalents at the beginning and end of the year are taken from the balance sheet.

| Entity A's Statement of Cash Flows for the Year Ended December 31, Year 1 | |
|--|------------------------|
| Net cash provided by (used in) operating activities | \$20,000 |
| Net cash provided by (used in) investing activities | (5,000) |
| Net cash provided by (used in) financing activities | <u>9,000</u> |
| Net increase (decrease) in cash and cash equivalents during the year | \$24,000 |
| Cash and cash equivalents at beginning of year (January 1, Year 1) | <u>6,000</u> |
| Cash and cash equivalents at end of year (December 31, Year 1) | <u><u>\$30,000</u></u> |

Operating Activities

Operating activities are all transactions and other events that are not financing or investing activities.

- Cash flows from operating activities are primarily derived from the principal revenue-producing activities of the entity.
- They generally result from transactions and other events that enter into the determination of net income.

The following are examples of **cash inflows** from operating activities:

- Cash receipts from the sale of goods and services (including collections of accounts receivable)
- Cash receipts from royalties, fees, commissions, trading debt securities, and other revenue
- Cash received in the form of **interest** or **dividends**

The following are examples of **cash outflows** from operating activities:

- Cash payments to suppliers for goods and services
- Cash payments to employees
- Cash payments to government for taxes, duties, fines, and other fees or penalties
- Payments of **interest on debt**

Investing Activities

Cash flows from investing activities represent the extent to which expenditures have been made for resources intended to generate future income and cash flows.

The following are examples of **cash outflows (and inflows)** from investing activities:

- Cash payments to acquire (cash receipts from sale of) property, plant, and equipment; intangible assets; and other long-lived assets
- Cash payments to acquire (cash receipts from sale and maturity of) equity and debt instruments (such as held-to-maturity securities and available-for-sale debt securities) of other entities for investing purposes
- Cash advances and loans made to other parties (cash receipts from repayment of advances and loans made to other parties)

Financing Activities

Cash flows from financing activities generally involve the cash effects of transactions and other events that relate to the issuance, settlement, or reacquisition of the entity's debt and equity instruments.

The following are examples of **cash inflows** from financing activities:

- Cash proceeds from issuing shares and other equity instruments (obtaining resources from owners).
- Cash proceeds from issuing loans, notes, bonds, and other short-term or long-term borrowings.

The following are examples of **cash outflows** from financing activities:

- Cash repayments of amounts borrowed
 - Payments of cash dividends
 - Cash payments to acquire or redeem the entity's own shares
 - Cash payments by a lessee for a reduction of the outstanding liability relating to a finance lease
-

Major Statement of Cash Flows Note Disclosures

Information about all **noncash investing and financing activities** (i.e., investing and financing activities that affect recognized assets or liabilities **but not cash flows**) must be disclosed in the notes.

The following are examples of noncash investing and financing activities:

- Conversion of debt to equity
- Acquisition of assets either by assuming directly related liabilities or by a lessee's recognition of a finance or operating lease
- Exchange of a noncash asset or liability for another

Indirect Method of Presenting Operating Cash Flows

Under the indirect method (also called the reconciliation method), the net cash flow from operating activities is determined by adjusting the net income of a business for the effect of the following:

- **Noncash revenue and expenses** that were **included in net income**, such as depreciation and amortization expenses, impairment losses, undistributed earnings of equity-method investments, and amortization of discount and premium on bonds
- Items **included in net income** whose cash effects relate to **investing or financing cash flows**, such as gains or losses on sales of property and equipment (related to investing activities) and gain or losses on extinguishment of debt (related to financing activities)
- All **deferrals** of past operating cash flows, such as changes during the period in inventory and deferred income
- All **accruals** of expected future operating cash flows, such as changes during the period in accounts receivable and accounts payable



Author's Note

The net income for the period as it is reported in the income statement was calculated using the accrual method of accounting. Therefore, adjustments must be made to reach the amount of cash flow from operating activities.



Success Tip

The following rules will help reconcile net income to net cash flow from operating activities under the indirect method:

| | |
|---|----------------------------|
| Increase in current operating liabilities | Added to net income |
| Decrease in current operating assets | Added to net income |
| Increase in current operating assets | Subtracted from net income |
| Decrease in current operating liabilities | Subtracted from net income |
| Noncash losses and expenses included in net income | Added to net income |
| Losses and expenses whose cash effects are related to investing or financing cash flows | Added to net income |
| Noncash gains and revenues included in net income | Subtracted from net income |
| Gains and revenues whose cash effects are related to investing or financing cash flows | Subtracted from net income |

Example 1-14 Statement of Cash Flows -- Indirect Method

Dize Corp's consolidated balance sheet accounts as of December 31, Year 6 and Year 5, are presented below. Information relating to Year 6 activities is to the left.

Information Relating to Year 6 Activities

- Cash dividends of \$240,000 were declared and paid by Dize in Year 6.
- The accounts receivable balances at the beginning and end of Year 6 were net of allowances for credit losses of \$50,000 and \$60,000, respectively. Dize wrote off \$40,000 of accounts receivable during Year 6.
- Current investments consist of Treasury bills maturing on 6/30/Year 7. They were acquired for cash on December 31, Year 6.
- Equipment costing \$400,000 and having a carrying amount of \$140,000 was sold on January 1, Year 6, for \$150,000 in cash. Additional plant assets were purchased in Year 6 for cash.
- Dize accounts for its interest in Thrice Corp. under the equity method. Its equity in Thrice's Year 6 earnings was \$25,000. During Year 6, Dize received a \$10,000 cash dividend from Thrice. At the end of Year 6, Dize sold part of its investment in Thrice for \$135,000 in cash. Significant influence over Thrice was not lost as a result of the sale.
- The provision for Year 6 income taxes was \$210,000.
- 10,000 shares of common stock were issued in Year 6 for \$22 a share.

| | December 31 | |
|-------------------------------|--------------------|--------------------|
| | Year 6 | Year 5 |
| Assets | | |
| Cash | \$ 195,000 | \$ 100,000 |
| Current investments | 300,000 | 0 |
| Accounts receivable (net) | 480,000 | 510,000 |
| Inventory | 680,000 | 600,000 |
| Prepaid expenses | 15,000 | 20,000 |
| Equity method investment | 215,000 | 300,000 |
| Plant assets | 1,730,000 | 1,000,000 |
| Accumulated depreciation | (480,000) | (450,000) |
| Goodwill | 90,000 | 100,000 |
| Total assets | <u>\$3,225,000</u> | <u>\$2,180,000</u> |
| Liabilities and Equity | | |
| Accounts payable | \$ 825,000 | \$ 720,000 |
| Interest payable | 15,000 | 10,000 |
| Income tax payable | 20,000 | 30,000 |
| Current debt | 325,000 | 0 |
| Deferred taxes | 250,000 | 300,000 |
| Common stock, \$10 par | 800,000 | 700,000 |
| Additional paid-in capital | 370,000 | 250,000 |
| Retained earnings | 620,000 | 170,000 |
| Total liabilities and equity | <u>\$3,225,000</u> | <u>\$2,180,000</u> |

The following computations are necessary to determine the net cash flows from operating, investing, and financing activities:

- **Net income.** The starting point for presenting the net cash flow from operating activities is net income (loss) for the period. Net income can be calculated as follows:

| | |
|-----------------------------|------------------|
| Ending retained earnings | \$620,000 |
| Dividends declared | 240,000 |
| Beginning retained earnings | (170,000) |
| Year 6, net income | <u>\$690,000</u> |

- The \$240,000 of cash dividends paid in Year 6 are a cash outflow from financing activities.

-- Continued on next page --

Example 1-14 -- Continued

- **Accounts receivable.** The easiest way to determine the reconciling adjustment for accounts receivable is to calculate the change in their net amount (Accounts receivable – Allowance for credit losses). Net accounts receivable are current operating assets. A decrease in net accounts receivable of **\$30,000** (\$510,000 – \$480,000) is **added** to net income to determine the net cash flow from operating activities.
- **Plant assets.** The items that affect the presentation of cash flow from operating activities are depreciation expense, gain or loss on disposal, and impairment loss.

- **Depreciation expense** for Year 6 can be calculated as follows:

| | |
|--|-------------------------|
| Ending accumulated depreciation | \$480,000 |
| Accumulated depreciation on items sold | 260,000 |
| Beginning accumulated depreciation | <u>(450,000)</u> |
| Depreciation expense | <u>\$290,000</u> |

Depreciation expense is a noncash expense included in net income. Thus, **\$290,000** is **added** to net income in determining the net cash flows from operating activities.

- The **gain on disposal** of the equipment is **\$10,000** (\$150,000 cash received – \$140,000 carrying amount). The cash effect is related to investing activities. Thus, it is **subtracted** from net income to determine the net cash flow from operating activities.
- The \$150,000 of cash proceeds from sale of equipment is a cash inflow from investing activities.
- Plant assets purchased in Year 6 (cash outflow from investing activities) can be calculated as follows:

| | |
|--------------------------------|---------------------------|
| Ending plant assets at cost | \$1,730,000 |
| Plant assets sold at cost | 400,000 |
| Beginning plant assets at cost | <u>(1,000,000)</u> |
| Plant assets purchased | <u>\$1,130,000</u> |

NOTE: The following equation may be useful for deriving the required information if the data given in the question are for the carrying amount (Cost – Accumulated depreciation) of the PPE item.

| | |
|-----------------------------|---------------------|
| Beginning carrying amount | \$XXX |
| Purchases during the period | XXX |
| Depreciation expense | (XXX) |
| Disposals during the period | <u>(XXX)</u> |
| Ending carrying amount | <u>\$XXX</u> |

- **Equity-method investment.** The carrying amount of the equity-method investment sold can be calculated as follows:

| | |
|--|-------------------------|
| Beginning carrying amount | \$300,000 |
| Equity in Thrice's current year earnings | 25,000 |
| Dividends received from Thrice | (10,000) |
| Ending carrying amount | <u>(215,000)</u> |
| Carrying amount of investment sold | <u>\$100,000</u> |

-- Continued on next page --

Example 1-14 -- Continued

NOTE: Accounting for equity method investments is covered in detail in Study Unit 3, Subunit 2.

- **The gain on sale of the investment is \$35,000** (\$135,000 cash received – \$100,000 carrying amount). The cash effect is related to investing activities. Thus, it is **subtracted** from net income in determining the net cash flows from operating activities.
 - **Undistributed earnings on equity-method investment.** Under the equity method, the investor's share of the investee's earnings is recorded to the investment account and reported as income. A cash dividend from the investee is a return of an investment that results in an increase to cash and a decrease to the investment. The undistributed earnings on the equity-method investments equal **\$15,000** (\$25,000 share in earnings – \$10,000 dividends received). This amount is a noncash revenue included in net income. Thus, it is **subtracted** from net income in determining the net cash flow from operating activities.
 - The cash received on the sale of the investment of \$135,000 is a cash inflow from investing activities.
- **Goodwill.** Goodwill is not amortized. Thus, the **\$10,000** decrease in the amount of goodwill (\$100,000 beginning balance – \$90,000 ending balance) must be a result of impairment. A loss on impairment of goodwill is a noncash loss included in net income. Thus, it is **added** to net income in determining the net cash flow from operating activities. Goodwill is covered in detail in Study Unit 3, Subunit 5.
 - **Current investments.** The purchase of current investments for \$300,000 is a cash outflow from investing activities.
 - **Common stock.** The proceeds from issuing common stock were \$220,000 (10,000 × \$22). This cash inflow from financing activities equals the sum of the increases in the common stock and additional paid-in capital accounts.
 - **Inventory** is a current operating asset. Inventory increased by **\$80,000** (\$680,000 – \$600,000). This amount is **subtracted** from net income in determining the net cash flow from operating activities.
 - **Prepaid expenses** are current operating assets. Prepaid expenses decreased by **\$5,000** (\$15,000 – \$20,000). This amount is **added** to net income in determining the net cash flow from operating activities.
 - **Accounts payable** is a current operating liability. Accounts payable increased by **\$105,000** (\$825,000 – \$720,000). This amount is **added** to net income in determining the net cash flow from operating activities.
 - **Interest payable** is a current operating liability. Interest payable increased by **\$5,000** (\$15,000 – \$10,000). This amount is **added** to net income in determining the net cash flow from operating activities.
 - **Income tax payable** is a current operating liability. Income tax payable decreased by **\$10,000** (\$20,000 – \$30,000). This amount is **subtracted** from net income in determining the net cash flow from operating activities.
 - **Current debt.** The issuance of \$325,000 of current debt (\$325,000 – \$0) is a cash inflow from financing activities.
 - The **deferred tax liability** decreased by **\$50,000** (\$250,000 – \$300,000). The decrease in the deferred tax liability increases net income by decreasing income tax expense. This decrease is a noncash item included in net income. Thus, it is **subtracted** from net income in determining the net cash flow from operating activities. Deferred taxes are covered in Study Unit 4, Subunit 3.

-- Continued on next page --

Example 1-14 -- Continued

Dize Corp.
Consolidated Statement of Cash Flows -- Indirect Method
for the Year Ended December 31, Year 6

Cash flows from operating activities:

| | | |
|--|------------|--------------------------|
| Net income for Year 6 | \$ 690,000 | |
| Decrease in accounts receivable | 30,000 | |
| Depreciation expense | 290,000 | |
| Gain on disposal of equipment | (10,000) | |
| Gain on sale of investment | (35,000) | |
| Undistributed earnings of equity-method investment | (15,000) | |
| Loss on impairment of goodwill | 10,000 | |
| Increase in inventories | (80,000) | |
| Decrease in prepaid expenses | 5,000 | |
| Increase in accounts payable | 105,000 | |
| Increase in interest payable | 5,000 | |
| Decrease in income tax payable | (10,000) | |
| Decrease in deferred tax liability | (50,000) | |
| Net cash provided by operating activities | | <u>\$ 935,000</u> |

Cash flows from investing activities:

| | | |
|--|-------------|-----------------------------|
| Proceeds from sale of equipment | \$ 150,000 | |
| Purchases of plant assets | (1,130,000) | |
| Proceeds from sale of equity-method investment | 135,000 | |
| Purchases of current investments | (300,000) | |
| Net cash used in investing activities | | <u>\$(1,145,000)</u> |

Cash flows from financing activities:

| | | |
|--|--------------|--------------------------|
| Dividends paid | \$ (240,000) | |
| Proceeds from issuing common stock | 220,000 | |
| Proceeds from current debt | 325,000 | |
| Net cash provided by financing activities | | <u>\$ 305,000</u> |

| | |
|--------------------------|---------------------------------|
| Net increase in cash | \$ 95,000 |
| Cash, beginning of year | 100,000 |
| Cash, end of year | <u><u>\$ 195,000</u></u> |

Limitations of the Statement of Cash Flows

A cash flow statement is not sufficient for forecasting the profitability of a firm as noncash items are not included in the calculation of cash flow from operating activities.

A cash flow statement may not represent the true liquid position of an entity.

- Decisions regarding large expenditures could be based on misconceived information when decisions are based only on the statement of cash flows.
- This statement must be viewed in conjunction with other financial statements, such as the balance sheet and the income statement.

Information can be manipulated in the statement of cash flows.

- For instance, management can schedule vendor payments to occur after year end to increase net cash flows reported on the statement of cash flows.