

## Chapter7: Planning for Profit and Cost Control

---

### Questions

---

1. Budgets are useful only for small companies that can estimate sales with accuracy. Do you agree with this statement?
2. Why does preparing the master budget require a committee?
3. What are the three levels of planning? Explain each briefly.
4. What is the primary factor that distinguishes the three different levels of planning from each other?
5. What is the advantage of using a perpetual budget instead of the traditional annual budget?
6. What are the advantages of budgeting?
7. How may budgets be used as a measure of performance?
8. Ken Shilov, manager of the marketing department, tells you that "budgeting simply does not work." He says that he made budgets for his employees and when he reprimanded them for failing to accomplish budget goals, he got unfounded excuses. Suggest how Mr. Shilov could encourage employee cooperation.
9. What is a master budget?
10. What is the normal starting point in developing the master budget?
11. How does the level of inventory affect the production budget? Why is it important to manage the level of inventory?
12. What are the components of the cash budget? Describe each.
13. The primary reason for preparing a cash budget is to determine the amount of cash to include on the budgeted balance sheet. Do you agree or disagree with this statement? Explain.
14. What information does the pro forma income statement provide? How does its preparation depend on the operating budgets?
15. How does the pro forma statement of cash flows differ from the cash budget?

2011 McGraw-Hill Higher Education  
Any use is subject to the [Terms of Use](#) and [Privacy Notice](#).  
[McGraw-Hill Higher Education](#) is one of the many fine businesses of [The McGraw-Hill Companies](#).

## Chapter 7: Planning for Profit and Cost Control

### Exercises-Series A

All applicable Exercises in Series A are available with McGraw-Hill's *Connect Accounting*.



#### Exercise 7-1A *Budget responsibility*

Sonya Huffman, the accountant, is a perfectionist. No one can do the job as well as she can. Indeed, she has found budget information provided by the various departments to be worthless. She must change everything they give her. She has to admit that her estimates have not always been accurate, but she shudders to think of what would happen if she used the information supplied by the marketing and operating departments. No one seems to care about accuracy. Indeed, some of the marketing staff have even become insulting. When Ms. Huffman confronted one of the salesmen with the fact that he was behind in meeting his budgeted sales forecast, he responded by saying, "They're your numbers. Why don't you go out and make the sales? It's a heck of a lot easier to sit there in your office and make up numbers than it is to get out and get the real work done." Ms. Huffman reported the incident, but, of course, nothing was done about it.

#### Required

Write a short report suggesting how the budgeting process could be improved.

#### Exercise 7-2A *Preparing a sales budget*

[LO 3, 7](#)

Welch Company, which expects to start operations on January 1, 2011, will sell digital cameras in shopping malls. Welch has budgeted sales as indicated in the following table. The company expects a 10 percent increase in sales per month for February and March. The ratio of cash sales to sales on account will remain stable from January through March.

Sales	January	February	March
Cash sales	\$ 40,000	?	?
Sales on account	100,000	?	?
Total budgeted sales	\$140,000	?	?

#### Required

- Complete the sales budget by filling in the missing amounts.
- Determine the amount of sales revenue Welch will report on its first quarter pro forma income statement.

#### Exercise 7-3A *Preparing a schedule of cash receipts*

[LO 3, 7](#)

The budget director of Ginger's Florist has prepared the following sales budget. The company had \$300,000 in accounts receivable on July 1. Ginger's Florist normally collects 100 percent of accounts receivable in the month following the month of sale.

	July	August	September
<b>Sales Budget</b>			
Cash sales	\$ 70,000	\$ 75,000	\$ 80,000
Sales on account	90,000	108,000	129,600
Total budgeted sales	\$160,000	\$183,000	\$209,600
<b>Schedule of Cash Receipts</b>			
Current cash sales	?	?	?
Plus: Collections from accounts receivable	?	?	?
Total budgeted collections	\$370,000	\$165,000	\$188,000

#### Required

p. 324

- Complete the schedule of cash receipts by filling in the missing amounts.
- Determine the amount of accounts receivable the company will report on its third quarter pro forma balance sheet.

#### Exercise 7-4A *Preparing sales budgets with different assumptions*

[LO 3](#)

Applebaum Corporation, which has three divisions, is preparing its sales budget. Each division expects a different growth rate because economic conditions vary in different regions of the country. The growth expectations per quarter are 4 percent for East Division, 2 percent for West Division, and 6 percent for South Division.

Division	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
East Division	\$100,000	?	?	?
West Division	300,000	?	?	?
South Division	200,000	?	?	?

**Required**

- Complete the sales budget by filling in the missing amounts. (Round figures to the nearest dollar.)
- Determine the amount of sales revenue that the company will report on its quarterly pro forma income statements.

**Exercise 7-5A** *Determining cash receipts from accounts receivable*

LO 3

Janice's Dress Delivery operates a mail-order business that sells clothes designed for frequent travelers. It had sales of \$560,000 in December. Because Janice's Dress Delivery is in the mail-order business, all sales are made on account. The company expects a 30 percent drop in sales for January. The balance in the Accounts Receivable account on December 31 was \$96,400 and is budgeted to be \$73,600 as of January 31. Janice's Dress Delivery normally collects accounts receivable in the month following the month of sale.

**Required**

- Determine the amount of cash Janice's Dress Delivery expects to collect from accounts receivable during January.
- Is it reasonable to assume that sales will decline in January for this type of business? Why or why not?

**Exercise 7-6A** *Using judgment in making a sales forecast*

LO 3



Contrell Company operates a candy store located in a large shopping mall.

**Required**

Write a brief memo describing the sales pattern that you would expect Contrell to experience during the year. In which months will sales likely be high? In which months will sales likely be low? Explain why.

**Exercise 7-7A** *Preparing an inventory purchases budget*

LO 4

Naftel Company sells lamps and other lighting fixtures. The purchasing department manager prepared the following inventory purchases budget. Naftel's policy is to maintain an ending inventory balance equal to 10 percent of the following month's cost of goods sold. April's budgeted cost of goods sold is \$75,000.

	January	February	March
Budgeted cost of goods sold	\$50,000	\$54,000	\$60,000
Plus: Desired ending inventory	5,400	?	?
Inventory needed	55,400	?	?
Less: Beginning inventory	5,000	?	?
Required purchases (on account)	\$50,400	?	?

p. 325

**Required**

- Complete the inventory purchases budget by filling in the missing amounts.
- Determine the amount of cost of goods sold the company will report on its first quarter pro forma income statement.
- Determine the amount of ending inventory the company will report on its pro forma balance sheet at the end of the first quarter.

**Exercise 7-8A** *Preparing a schedule of cash payments for inventory purchases*

LO 4

Sciara Books buys books and magazines directly from publishers and distributes them to grocery stores. The wholesaler expects to purchase the following inventory.

	April	May	June
Required purchases (on account)	\$100,000	\$120,000	\$132,000

Sciara Books' accountant prepared the following schedule of cash payments for inventory purchases. Sciara Books' suppliers require that 90 percent of purchases on account be paid in the month of purchase; the remaining 10 percent are paid in the month following the month of purchase.

Schedule of Cash Payments for Inventory Purchases			
	April	May	June

Payment for current accounts payable	\$90,000	?	?
Payment for previous accounts payable	8,000	?	?
Total budgeted payments for inventory	\$98,000	?	?

**Required**

- Complete the schedule of cash payments for inventory purchases by filling in the missing amounts.
- Determine the amount of accounts payable the company will report on its pro forma balance sheet at the end of the second quarter.

**Exercise 7-9A** *Determining the amount of expected inventory purchases and cash payments* LO 4

Tobert Company, which sells electric razors, had \$300,000 of cost of goods sold during the month of June. The company projects a 5 percent increase in cost of goods sold during July. The inventory balance as of June 30 is \$28,000, and the desired ending inventory balance for July is \$29,000. Tobert pays cash to settle 70 percent of its purchases on account during the month of purchase and pays the remaining 30 percent in the month following the purchase. The accounts payable balance as of June 30 was \$35,000.

**Required**

- Determine the amount of purchases budgeted for July.
- Determine the amount of cash payments budgeted for inventory purchases in July.

**Exercise 7-10A** *Preparing a schedule of cash payments for selling and administrative expenses* LO 5

The budget director for Metro Cleaning Services prepared the following list of expected selling and administrative expenses. All expenses requiring cash payments are paid for in the month incurred except salary expense and insurance. Salary is paid in the month following the month in which it is incurred. The insurance premium for six months is paid on October 1. October is the first month of operations; accordingly, there are no beginning account balances.

	October	November	December
<b>Budgeted S&amp;A Expenses</b>			
Equipment lease expense	\$ 6,000	\$ 6,000	\$ 6,000
Salary expense	6,100	6,600	7,000
Cleaning supplies	2,800	2,730	3,066
Insurance expense	1,200	1,200	1,200
Depreciation on computer	1,800	1,800	1,800
Rent	1,700	1,700	1,700
Miscellaneous expenses	700	700	700
Total operating expenses	\$20,300	\$20,730	\$21,466
<b>Schedule of Cash Payments for S&amp;A Expenses</b>			
Equipment lease expense	?	?	?
Prior month's salary expense, 100%	?	?	?
Cleaning supplies	?	?	?
Insurance premium	?	?	?
Depreciation on computer	?	?	?
Rent	?	?	?
Miscellaneous expenses	?	?	?
Total disbursements for operating expenses	\$18,400	\$17,230	\$18,066

p. 326 **Required**

- Complete the schedule of cash payments for S&A expenses by filling in the missing amounts.
- Determine the amount of salaries payable the company will report on its pro forma balance sheet at the end of the fourth quarter.
- Determine the amount of prepaid insurance the company will report on its pro forma balance sheet at the end of the fourth quarter.

**Exercise 7-11A** *Preparing inventory purchases budgets with different assumptions* LO 4

Executive officers of Dominick Company are wrestling with their budget for the next year. The following are two different sales estimates provided by two different sources.

Source of Estimate	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Sales manager	\$380,000	\$310,000	\$280,000	\$480,000
Marketing consultant	520,000	460,000	410,000	650,000

Dominick's past experience indicates that cost of goods sold is about 60 percent of sales revenue. The company tries to maintain 10 percent of the next quarter's expected cost of goods sold as the current quarter's ending inventory. This year's ending inventory is \$29,000. Next year's ending inventory is budgeted to be \$30,000.

**Required**

- Prepare an inventory purchases budget using the sales manager's estimate.

- b. Prepare an inventory purchases budget using the marketing consultant's estimate.

**Exercise 7-12A** *Determining the amount of cash payments and pro forma statement data for selling and administrative expenses* LO 5, 7

January budgeted selling and administrative expenses for the retail shoe store that Kathy Sibley plans to open on January 1, 2011, are as follows: sales commissions, \$25,000; rent, \$16,000; utilities, \$5,000; depreciation, \$4,000; and miscellaneous, \$2,000. Utilities are paid in the month after incurrence. Other expenses are expected to be paid in cash in the month in which they are incurred.

p. 327 **Required**

- a. Determine the amount of budgeted cash payments for January selling and administrative expenses.
- b. Determine the amount of utilities payable the store will report on the January 31st pro forma balance sheet.
- c. Determine the amount of depreciation expense the store will report on the income statement for the year 2011, assuming that monthly depreciation remains the same for the entire year.

**Exercise 7-13A** *Preparing a cash budget* LO 6, 7

The accountant for Teresa's Dress Shop prepared the following cash budget. Teresa's desires to maintain a cash cushion of \$14,000 at the end of each month. Funds are assumed to be borrowed and repaid on the last day of each month. Interest is charged at the rate of 2 percent per month.

Cash Budget	July	August	September
<b>Section 1: Cash receipts</b>			
Beginning cash balance	\$ 42,500	\$ ?	\$ ?
Add cash receipts	180,000	200,000	240,600
Total cash available (a)	<u>222,500</u>	?	?
<b>Section 2: Cash payments</b>			
For inventory purchases	165,526	140,230	174,152
For S&A expenses	54,500	60,560	61,432
For interest expense	0	?	?
Total budgeted disbursements (b)	<u>220,026</u>	?	?
<b>Section 3: Financing activities</b>			
Surplus (shortage)	2,474	?	?
Borrowing (repayments) (c)	<u>11,526</u>	?	?
Ending cash balance (a - b + c)	<u>\$ 14,000</u>	<u>\$ 14,000</u>	<u>\$ 14,000</u>

**Required**

- a. Complete the cash budget by filling in the missing amounts. Round all computations to the nearest whole dollar.
- b. Determine the amount of net cash flows from operating activities Teresa's will report on the third quarter pro forma statement of cash flows.
- c. Determine the amount of net cash flows from financing activities Teresa's will report on the third quarter pro forma statement of cash flows.

**Exercise 7-14A** *Determining amount to borrow and pro forma statement balances* LO 6, 7

Athena Sudsberry owns a small restaurant in New York City. Ms. Sudsberry provided her accountant with the following summary information regarding expectations for the month of June. The balance in accounts receivable as of May 31 is \$60,000. Budgeted cash and credit sales for June are \$150,000 and \$600,000, respectively. Credit sales are made through Visa and MasterCard and are collected rapidly. Eighty percent of credit sales is collected in the month of sale, and the remainder is collected in the following month. Ms. Sudsberry's suppliers do not extend credit. Consequently, she pays suppliers on the last day of the month. Cash payments for June are expected to be \$700,000. Ms. Sudsberry has a line of credit that enables the restaurant to borrow funds on demand; however, they must be borrowed on the last day of the month. Interest is paid in cash also on the last day of the month. Ms. Sudsberry desires to maintain a \$30,000 cash balance before the interest payment. Her annual interest rate is 9 percent.

**Required**

- a. Compute the amount of funds Ms. Sudsberry needs to borrow for June.
- b. Determine the amount of interest expense the restaurant will report on the June pro forma income statement.
- c. What amount will the restaurant report as interest expense on the July pro forma income statement?

p. 328 **Exercise 7-15A** *Preparing pro forma income statements with different assumptions* LO 7



Norman Jelen, the controller of Wing Corporation, is trying to prepare a sales budget for the coming year. The income statements for the last four quarters follow.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Sales revenue	\$170,000	\$200,000	\$210,000	\$260,000	\$840,000
Cost of goods sold	<u>102,000</u>	<u>120,000</u>	<u>126,000</u>	<u>156,000</u>	<u>504,000</u>

Gross profit	68,000	80,000	84,000	104,000	336,000
Selling & admin. expenses	<u>17,000</u>	<u>20,000</u>	<u>21,000</u>	<u>26,000</u>	<u>84,000</u>
Net income	<u>\$ 51,000</u>	<u>\$ 60,000</u>	<u>\$ 63,000</u>	<u>\$ 78,000</u>	<u>\$252,000</u>

Historically, cost of goods sold is about 60 percent of sales revenue. Selling and administrative expenses are about 10 percent of sales revenue.

Sam Wing, the chief executive officer, told Mr. Jelen that he expected sales next year to be 10 percent for each respective quarter above last year's level. However, Glenda Sullivan, the vice president of sales, told Mr. Jelen that she believed sales growth would be only 5 percent.

**Required**

- Prepare a pro forma income statement including quarterly budgets for the coming year using Mr. Wing's estimate.
- Prepare a pro forma income statement including quarterly budgets for the coming year using Ms. Sullivan's estimate.
- Explain why two executive officers in the same company could have different estimates of future growth.

2011 McGraw-Hill Higher Education  
Any use is subject to the [Terms of Use](#) and [Privacy Notice](#).  
[McGraw-Hill Higher Education](#) is one of the many fine businesses of [The McGraw-Hill Companies](#).

## Chapter7: Planning for Profit and Cost Control

## Problems-Series A

All applicable Problems in Series A are available with McGraw-Hill's *Connect Accounting*.



Problem 7-16A

*Preparing a sales budget and schedule of cash receipts*

LO 3



CHECK FIGURES

c. Feb: \$194,000

March \$233,400

McCarty Pointers Corporation expects to begin operations on January 1, 2012; it will operate as a specialty sales company that sells laser pointers over the Internet. McCarty expects sales in January 2012 to total \$200,000 and to increase 10 percent per month in February and March. All sales are on account. McCarty expects to collect 70 percent of accounts receivable in the month of sale, 20 percent in the month following the sale, and 10 percent in the second month following the sale.

## Required

- Prepare a sales budget for the first quarter of 2012.
- Determine the amount of sales revenue McCarty will report on the first 2012 quarterly pro forma income statement.
- Prepare a cash receipts schedule for the first quarter of 2012.
- Determine the amount of accounts receivable as of March 31, 2012.

Problem 7-17A

*Preparing an inventory purchases budget and schedule of cash payments*

LO 4, 7

CHECK FIGURES

May: \$71,000

c. June: \$76,760

Spratt, Inc., sells fireworks. The company's marketing director developed the following cost of goods sold budget for April, May, June, and July.

	April	May	June	July
Budgeted cost of goods sold	\$60,000	\$70,000	\$90,000	\$86,000

Spratt had a beginning inventory balance of \$3,600 on April 1 and a beginning balance in accounts payable of \$14,800. The company desires to maintain an ending inventory balance equal to 10 percent of the next period's cost of goods sold. Spratt makes all purchases on account. The company pays 60 percent of accounts payable in the month of purchase and the remaining 40 percent in the month following purchase.

p. 329

## Required

- Prepare an inventory purchases budget for April, May, and June.
- Determine the amount of ending inventory Spratt will report on the end-of-quarter pro forma balance sheet.
- Prepare a schedule of cash payments for inventory for April, May, and June.
- Determine the balance in accounts payable Spratt will report on the end-of-quarter pro forma balance sheet.

Problem 7-18A

*Preparing pro forma income statements with different assumptions*

LO 7

CHECK FIGURE

a. 12.75%

Top executive officers of Zottoli Company, a merchandising firm, are preparing the next year's budget. The controller has provided everyone with the current year's projected income statement.

	Current Year
Sales revenue	\$2,000,000

Cost of goods sold	1,400,000
Gross profit	600,000
Selling & admin. expenses	260,000
Net income	<u>\$ 340,000</u>

Cost of goods sold is usually 70 percent of sales revenue, and selling and administrative expenses are usually 10 percent of sales plus a fixed cost of \$60,000. The president has announced that the company's goal is to increase net income by 15 percent.

**Required**

The following items are independent of each other.

- What percentage increase in sales would enable the company to reach its goal? Support your answer with a pro forma income statement.
- The market may become stagnant next year, and the company does not expect an increase in sales revenue. The production manager believes that an improved production procedure can cut cost of goods sold by 2 percent. What else can the company do to reach its goal? Prepare a pro forma income statement illustrating your proposal.
- The company decides to escalate its advertising campaign to boost consumer recognition, which will increase selling and administrative expenses to \$340,000. With the increased advertising, the company expects sales revenue to increase by 15 percent. Assume that cost of goods sold remains a constant proportion of sales. Can the company reach its goal?

**Problem 7-19A****Preparing a schedule of cash payments for selling and administrative expenses**[LO 5, 6](#)**CHECK FIGURE**

a. Sept: \$28,510

Prestia is a retail company specializing in men's hats. Its budget director prepared the list of expected operating expenses that follows. All items are paid when incurred except sales commissions and utilities, which are paid in the month following their incurrence. July is the first month of operations, so there are no beginning account balances.

	July	August	September
Salary expense	\$18,000	\$18,000	\$18,000
Sales commissions (4 percent of sales)	1,700	1,700	1,700
Supplies expense	360	390	420
Utilities	1,100	1,100	1,100
Depreciation on store equipment	3,000	3,000	3,000
Rent	6,600	6,600	6,600
Miscellaneous	690	690	690
Total S&A expenses before interest	<u>\$31,450</u>	<u>\$31,480</u>	<u>\$31,510</u>

p. 330

**Required**

- Prepare a schedule of cash payments for selling and administrative expenses.
- Determine the amount of utilities payable as of September 30.
- Determine the amount of sales commissions payable as of September 30.

**Problem 7-20A****Preparing a cash budget**[LO 6](#)**CHECK FIGURE**

Feb. cash surplus before financing activities: \$7,010

Kinnion Medical Clinic has budgeted the following cash flows.

	January	February	March
Cash receipts	\$100,000	\$106,000	\$126,000
Cash payments			
For inventory purchases	90,000	72,000	85,000
For S&A expenses	31,000	32,000	27,000

Kinnion Medical had a cash balance of \$8,000 on January 1. The company desires to maintain a cash cushion of \$5,000. Funds are assumed to be borrowed, in increments of \$1,000, and repaid on the last day of each month; the interest rate is 1 percent per month. Repayments may be made in any amount available. Kinnion pays its vendors on the last day of the month also. The company had a monthly \$40,000 beginning balance in its line of credit liability account from this year's quarterly results.

**Required**

Prepare a cash budget. (Round all computations to the nearest whole dollar.)

**Problem 7-21A****Preparing budgets with multiple products**[LO 3, 4, 5](#)





## CHECK FIGURES

c. 1st QTR purchases for peaches: \$141,120

2nd QTR purchases for oranges: \$312,840

Hammond Fruits Corporation wholesales peaches and oranges. Lashanda King is working with the company's accountant to prepare next year's budget. Ms. King estimates that sales will increase 5 percent for peaches and 10 percent for oranges. The current year's sales revenue data follow.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Peaches	\$220,000	\$240,000	\$300,000	\$240,000	\$1,000,000
Oranges	400,000	450,000	570,000	380,000	1,800,000
Total	\$620,000	\$690,000	\$870,000	\$620,000	\$2,800,000

Based on the company's past experience, cost of goods sold is usually 60 percent of sales revenue. Company policy is to keep 10 percent of the next period's estimated cost of goods sold as the current period's ending inventory. (*Hint: Use the cost of goods sold for the first quarter to determine the beginning inventory for the first quarter.*)

## Required

- Prepare the company's sales budget for the next year for each quarter by individual product.
- If the selling and administrative expenses are estimated to be \$700,000, prepare the company's budgeted annual income statement.
- Ms. King estimates next year's ending inventory will be \$34,000 for peaches and \$56,000 for oranges. Prepare the company's inventory purchases budgets for the next year showing quarterly figures by product.

## Problem 7-22A

Preparing a master budget for retail company with no beginning [LO 3, 4, 5](#)  
account balances



## CHECK FIGURES

c. Dec. purchases: \$113,250

g. Nov. surplus before financing activities:  
\$19,505

Patel Company is a retail company that specializes in selling outdoor camping equipment. The company is considering opening a new store on October 1, 2012. The company president formed a planning committee to prepare a master budget for the first three months of operation. As budget coordinator, you have been assigned the following tasks.

p. 331

## Required

- October sales are estimated to be \$120,000 of which 40 percent will be cash and 60 percent will be credit. The company expects sales to increase at the rate of 25 percent per month. Prepare a sales budget.
- The company expects to collect 100 percent of the accounts receivable generated by credit sales in the month following the sale. Prepare a schedule of cash receipts.
- The cost of goods sold is 60 percent of sales. The company desires to maintain a minimum ending inventory equal to 10 percent of the next month's cost of goods sold. However, ending inventory of December is expected to be \$12,000. Assume that all purchases are made on account. Prepare an inventory purchases budget.
- The company pays 70 percent of accounts payable in the month of purchase and the remaining 30 percent in the following month. Prepare a cash payments budget for inventory purchases.
- Budgeted selling and administrative expenses per month follow.

Salary expense (fixed)	\$18,000
Sales commissions	5 percent of Sales
Supplies expense	2 percent of Sales
Utilities (fixed)	\$1,400
Depreciation on store fixtures (fixed)*	\$4,000
Rent (fixed)	\$4,800
Miscellaneous (fixed)	\$1,200

\*The capital expenditures budget indicates that Patel will spend \$164,000 on October 1 for store fixtures, which are expected to have a \$20,000 salvage value and a three-year (36-month) useful life.

Use this information to prepare a selling and administrative expenses budget.

- f. Utilities and sales commissions are paid the month after they are incurred; all other expenses are paid in the month in which they are incurred. Prepare a cash payments budget for selling and administrative expenses.
- g. Patel borrows funds, in increments of \$1,000, and repays them on the last day of the month. Repayments may be made in any amount available. The company also pays its vendors on the last day of the month. It pays interest of 1 percent per month in cash on the last day of the month. To be prudent, the company desires to maintain a \$12,000 cash cushion. Prepare a cash budget.
- h. Prepare a pro forma income statement for the quarter.
- i. Prepare a pro forma balance sheet at the end of the quarter.
- j. Prepare a pro forma statement of cash flows for the quarter.

**Problem 7-23A*****Behavioral impact of budgeting*****LO 2****CHECK FIGURES**

a. NI: \$630,000

c. NI: \$690,000

Shahid Corporation has three divisions, each operating as a responsibility center. To provide an incentive for divisional executive officers, the company gives divisional management a bonus equal to 15 percent of the excess of actual net income over budgeted net income. The following is Chaudhry Division's current year's performance.

	Current Year
Sales revenue	\$4,000,000
Cost of goods sold	<u>2,500,000</u>
Gross profit	1,500,000
Selling & admin. expenses	<u>900,000</u>
Net income	<u>\$ 600,000</u>

The president has just received next year's budget proposal from the vice president in charge of Chaudhry Division. The proposal budgets a 5 percent increase in sales revenue with an extensive explanation about stiff market competition. The president is puzzled. Chaudhry has enjoyed revenue growth of around 10 percent for each of the past five years. The president had consistently approved the division's budget proposals based on 5 percent growth in the past. This time, the president wants to show that he is not a fool. "I will impose a 15 percent revenue increase to teach them a lesson!" the president says to himself smugly.

- p. 332 Assume that cost of goods sold and selling and administrative expenses remain stable in proportion to sales.

**Required**

- a. Prepare the budgeted income statement based on Chaudhry Division's proposal of a 5 percent increase.
- b. If growth is actually 10 percent as usual, how much bonus would Chaudhry Division's executive officers receive if the president had approved the division's proposal?
- c. Prepare the budgeted income statement based on the 15 percent increase the president imposed.
- d. If the actual results turn out to be a 10 percent increase as usual, how much bonus would Chaudhry Division's executive officers receive since the president imposed a 15 percent increase?
- e. Propose a better budgeting procedure for Shahid.

2011 McGraw-Hill Higher Education  
Any use is subject to the [Terms of Use](#) and [Privacy Notice](#).  
[McGraw-Hill Higher Education](#) is one of the many fine businesses of [The McGraw-Hill Companies](#).