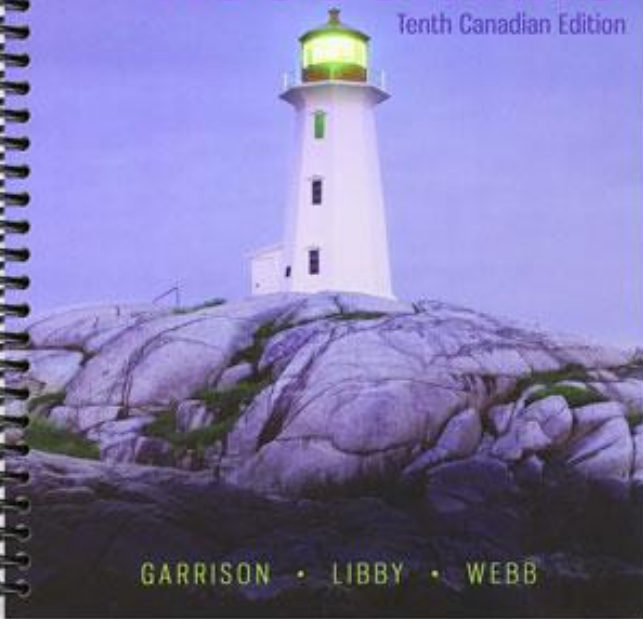


SOLUTIONS MANUAL



**MANAGERIAL
ACCOUNTING**

Tenth Canadian Edition



GARRISON • LIBBY • WEBB

Chapter 2

Cost Terms, Concepts, and Classifications

Solution to Discussion Case

Possible reasons for disagreeing with the statement:

- Distinguishing between product and period costs will still be important, even for small single-product companies. For companies in competitive markets knowing product costs will help them manage profitability more successfully. Knowing product costs is also important for companies that are able to set their own prices as it will provide an indication of the price needed to cover the costs of production.
- Understanding how costs behave (variable versus fixed) is still important even for small companies as it will help them predict how costs will change in response to changes in activity levels. This knowledge will be helpful when developing budgets (more on this in chapter 9).
- Understanding concepts such as opportunity costs and sunk costs is still important in smaller companies because they will still arise. For example a company that devotes its production equipment to producing one product is still incurring an opportunity cost that is equal to the benefits that would arise from using the invested capital in something else. Periodically owners of small companies should still evaluate whether the benefits of the status quo exceed the opportunity costs being incurred related to the next best alternative for using the company's resources. Sunk costs also arise in small companies and should be ignored.

Possible reasons for agreeing with the statement:

- Students who agree will likely take the view that, as per the question wording, many of the concepts in Chapter 2 take on more importance as the complexity of operations increases. For example, understanding product versus period costs is arguably more important in a multi-product setting where managers have to allocate resources across multiple products in an effort to maximize profitability.

Solutions to Questions

2-1 No. Only costs related to operating the production facilities are included as manufacturing overhead. Costs related to the administrative building would be an administrative expense.

2-2

a. Direct materials are an integral part of a finished product and their costs can be conveniently traced to it.

b. Indirect materials are generally small items of material such as glue and nails. They may be an integral part of a finished product but their costs can be traced to the product only at great cost or inconvenience. Indirect materials are ordinarily classified as manufacturing overhead.

c. Direct labour includes those labour costs that can be easily traced to individual units of products. Direct labour is also called "touch labour."

d. Indirect labour includes the labour costs of janitors, supervisors, materials handlers, and other factory workers that cannot be conveniently traced directly to particular products. These labour costs are incurred to support production, but the workers involved do not directly work on the product.

e. Manufacturing overhead includes all manufacturing costs except direct materials and direct labour.

2-3 Not always. Product costs are expensed in the same period in which the related products are sold. For example, if product costs were incurred in December but the products weren't sold until January, the costs would not be expensed as part of cost of goods sold until January. In this example, the product costs would be included on the December balance sheet as finished goods inventory.

2-4 Marketing or selling costs are those costs incurred to secure customer orders and to deliver the finished product or service into the hands of the customer. They are always treated as period costs on the income statement. As a result, they are expensed in the period incurred.

2-5 The schedule of cost of goods manufactured lists the manufacturing costs that have been incurred during the period. These costs are

organized under the three major categories of direct materials, direct labour, and manufacturing overhead. The total costs incurred are adjusted for any change in the Work in Process inventory to determine the cost of goods manufactured (i.e. finished) during the period.

The schedule of cost of goods manufactured ties into the income statement through the Cost of Goods Sold section. The cost of goods manufactured is added to the beginning Finished Goods inventory to determine the goods available for sale. In effect, the cost of goods manufactured takes the place of the "Purchases" account in a merchandising firm.

2-6 Prime costs consist of direct materials and direct labour. Conversion costs consist of manufacturing overhead and direct labour.

2-7 Total manufacturing costs are the total costs of direct materials, direct labour and manufacturing overhead incurred in the current period for products that are both complete and partially complete at the end of the period. Cost of goods manufactured represents the direct materials, direct labour and manufacturing overhead costs for goods completed during the period.
$$\text{Cost of goods manufactured} = \text{Total manufacturing costs} + \text{beginning WIP} - \text{ending WIP}.$$

2-8 Yes, costs such as salaries and depreciation can end up as assets on the balance sheet if these are manufacturing costs. Manufacturing costs are inventoried until the associated finished goods are sold. Thus, if some units are still in inventory, such costs may be part of either Work in Process inventory or Finished Goods inventory at the end of a period.

2-9 A mixed cost contains both variable and fixed cost elements.

2-10 As activity levels increase, variable costs per unit do not change within the relevant range. However, as activity levels increase, fixed costs per unit decrease. This decrease happens because total fixed costs remain unchanged (the numerator in the calculation of fixed costs per unit) even though the activity levels are increasing (the denominator in the calculation of fixed costs per unit).

2-11 The relevant range is the range of activity within which assumptions about variable and fixed costs are valid. The relevant range is important when predicting costs because cost behaviour may change when activity levels are well below or well above the normal range of activity. For example, if the relevant range of production activity is 10,000 to 20,000 units and next year, 30,000 units of production are expected, both variable and fixed costs may change. Fixed costs will likely increase as the result of needing to expand production capacity; depreciation, insurance, rent, taxes and so on will rise. Variable costs per unit may also change as production volume increases to 30,000 units. Buying raw materials in larger quantities may drive down unit costs but hiring additional employees could result in higher hourly wages if there is a shortage of available labour. Thus, managers will have to estimate the effects of production exceeding the relevant range on both variable and fixed cost behaviour.

2-12 Manufacturing overhead is an indirect cost since these costs cannot be easily and conveniently traced to particular units of products.

2-13 No. The original cost of the existing machine is a sunk cost that is not relevant to the decision as to whether the new machine should be purchased. The original cost has already been incurred and cannot be undone at this point. Thus it is irrelevant for decision-making purposes.

2-14 No; differential costs can be either variable or fixed. For example, the alternatives might consist of purchasing one machine rather than another to make a product. The difference in the fixed costs of purchasing the two machines would be a differential cost.

2-15

Direct labour cost	\$828
(46 hours × \$18 per hour)	
Manufacturing overhead cost	
(6 hours × \$9 per hour)	<u>54</u>
Total wages earned.....	<u>\$882</u>

2-16

Direct labour cost	\$910
(35 hours × \$26 per hour)	
Manufacturing overhead cost	
(5 hours × \$26 per hour)	<u>130</u>
Total wages earned.....	<u>\$1,040</u>

Exercise 2-1 (15 minutes)

1. Manufacturing overhead cost.
2. Administrative and marketing and selling costs. The rent would be allocated based on the amount of space in the building used by the administrative (accounting, human resources) and marketing and selling activities.
3. Direct labour cost.
4. Manufacturing overhead cost. Because the cost of glue would likely be very low per speaker, it would be considered an indirect material and thus included with manufacturing overhead.
5. Marketing and selling cost.
6. Administrative cost.
7. Manufacturing overhead.
8. Direct material cost.
9. Marketing and selling cost.
10. Administrative cost.

Exercise 2-2 (15 minutes)

	<i>Product (Invento- riable) Cost</i>	<i>Period Cost</i>
1. Depreciation on salespersons' cars		X
2. Rent on equipment used in the factory	X	
3. Lubricants used for machine maintenance	X	
4. Salaries of personnel who work in the finished goods warehouse.....		X
5. Soap and paper towels used by factory workers at the end of a shift	X	
6. Factory supervisors' salaries.....	X	
7. Heat, water, and power consumed in the factory	X	
8. Materials used for boxing products for shipment overseas (units are not normally boxed).....		X
9. Advertising costs.....		X
10 Workers' compensation insurance for factory employees	X	
11 Depreciation on chairs and tables in the factory lunchroom.....	X	
12 The wages of the receptionist in the administrative offices.....		X
13 Cost of leasing the corporate jet used by the company's executives		X
14 The cost of renting rooms at a British Columbia resort for the annual sales conference		X
15 The cost of packaging the company's product.....	X	

Exercise 2-3 (15 minutes)

Home Entertainment
Income Statement
For the month ended xxx

Sales.....		\$150,000
Cost of goods sold:		
Beginning merchandise inventory	\$ 12,000	
Add: Purchases	<u>90,000</u>	
Goods available for sale	102,000	
Deduct: Ending merchandise inventory.....	<u>22,000</u>	<u>80,000</u>
Gross margin		70,000
Selling and administrative expenses:		
Selling expense	40,000	
Administrative expense	<u>25,000</u>	<u>65,000</u>
Operating income		<u>\$ 5,000</u>

Exercise 2-4 (15 minutes)

Acromould Fabrication
Schedule of Cost of Goods Manufactured
For the month ended xxx

Direct materials:

Beginning raw materials inventory.....	\$ 66,000	
Add: Purchases of raw materials	<u>528,000</u>	
Raw materials available for use	594,000	
Deduct: Ending raw materials inventory....	<u>78,000</u>	
Raw materials used in production.....		\$ 516,000
Direct labour		258,000
Manufacturing overhead.....		<u>456,000</u>
Total manufacturing costs		1,230,000
Add: Beginning work in process inventory....		<u>228,000</u>
		1,458,000
Deduct: Ending work in process inventory ...		<u>264,000</u>
Cost of goods manufactured.....		<u>\$1,194,000</u>

Exercise 2-5 (30 minutes)

1. Per unit amounts:

Item			
	<u>Amount</u>	<u>July Activity</u>	<u>Per Unit</u>
Variable expenses:			
Direct materials	\$200,000	1,000	\$200
Direct labour	\$30,000	1,000	\$30
Indirect materials	\$10,000	1,000	\$10
Fixed expenses:			
Installation supervisor's wages	\$4,000	1,000	\$4
Installation scheduler's wages	\$2,000	1,000	\$2
Warehouse expenses	\$5,000	1,000	\$5

2. a & b

Item	(1)	(2)	(3)	(3) ÷ (1)
	<u>August Activity</u>	<u>July Per Unit</u>	<u>August Total Cost</u>	<u>August Per Unit</u>
Variable expenses:				
Direct materials	1,200	\$200	\$240,000	\$200
Direct labour	1,200	\$30	\$36,000	\$30
Indirect materials	1,200	\$10	\$12,000	\$10
Fixed expenses:				
Installation supervisor's wages	1,200	n/a	\$4,000	\$3.33
Installation scheduler's wages	1,200	n/a	\$2,000	\$1.67
Warehouse expenses	1,200	n/a	\$5,000	\$4.17

- Variable expenses per unit do not change within the relevant range of activity so the July and August amounts should not differ.
- Fixed expenses per unit decrease in August because the total fixed expenses are being spread over a higher activity base (1,200 installations versus 1,000).

Exercise 2-5 continued

3. Factors that could cause variable costs per unit to change when activity levels fall outside the relevant range:
- Direct material costs per unit could decrease if quantity discounts are received from the manufacturer for larger order quantities.
 - Direct material costs could increase if quantity discounts currently being received are lost if order quantities decrease significantly.
 - Direct labour costs per unit could increase if activity levels increase and installations have to be completed using more expensive overtime hours.
 - Direct labour costs per unit could increase if activity levels decrease and less experienced, and lower paid, installers are laid off.
 - Direct labour costs per unit could decrease as the number of installations increases due to the effects of learning (i.e., the time required for each installation may decrease with experience).

Note: requirement three may be a stretch for many students given that the factors affecting cost behaviour outside the relevant range are not discussed in detail in Chapter 2. Accordingly, providing some hints to generate ideas may be warranted.

Exercise 2-6 (15 minutes)

Some possibilities:

	Direct Costs	Indirect Costs**
Hotel Guests*	<ol style="list-style-type: none"> 1. Newspaper provided for the guest in the morning. 2. Room repairs resulting from damage caused by guests. 	<ol style="list-style-type: none"> 1. Cleaning supplies for the guest's room. 2. Concierge wages.
Hotel Restaurant	<ol style="list-style-type: none"> 1. Salary of the head chef. 2. Cleaning supplies used in the restaurant. 	<ol style="list-style-type: none"> 1. Fire insurance on the hotel. 2. Salary of the hotel's general manager.
Hotel Fitness Centre	<ol style="list-style-type: none"> 1. Fitness equipment maintenance. 2. Personal trainers/lifeguards who work in the fitness centre/pool. 	<ol style="list-style-type: none"> 1. Hotel utilities. 2. Property taxes on the hotel.
Hotel Business Centre.	<ol style="list-style-type: none"> 1. Computer equipment. 2. Printer suppliers (e.g., toner, paper, etc.) 	<ol style="list-style-type: none"> 1. Internet charges for the hotel. 2. Hotel cleaning staff wages.

*Students will struggle to identify direct costs that would pass the cost/benefit test of separate identification with individual guests. However, this provides a good example of a cost object that direct costs *could* be accumulated for, but would rarely occur in practice. In service industries such as hospitality, calculating profitability at the customer-level typically involves assigning indirect costs with very few direct costs identified.

**Encourage students to identify two unique indirect costs for each cost object rather than reusing the sample examples.

Exercise 2-7 (15 minutes)

<i>Item</i>	<i>Differential Cost</i>	<i>Opportunity Cost</i>	<i>Sunk Cost</i>
1. Cost of the new flat-panel displays.....	X		
2. Cost of the old computer terminals.....			X
3. Rent on the space occupied by the registration desk			
4. Wages of registration desk personnel			
5. Benefits from a new freezer		X	
6. Costs of maintaining the old computer terminals	X		
7. Cost of removing the old computer terminals	X		
8. Cost of existing registration desk wiring.....			X

Note: The costs of the rent on the space occupied by the registration desk and the wages of registration desk personnel are neither differential costs, opportunity costs, nor sunk costs. These are costs that do not differ between the alternatives and are therefore irrelevant in the decision, but they are not sunk costs since they occur in the future.

Exercise 2-8 (15 minutes)

Opportunity versus Sunk Costs:

Opportunity Costs

The \$1,000,000 offered for the building, land and equipment is an opportunity cost since it represents a benefit that the company would give up if it continues to manufacture the product.

The \$20,000 is also an opportunity cost since it represents another benefit that the company would have to forego if it continues to manufacture the product.

Sunk Costs The original cost of the land (\$500,000), building (\$1,500,000), and manufacturing equipment (\$300,000), the net book value of the building (\$1,375,000) and equipment (\$150,000), and the insurance and taxes recently paid on the building (\$30,000), are all sunk costs. In each case they have already been incurred and there is nothing management can do at this point to change that fact. Note: students could argue that some portion of the insurance and taxes may be recoverable if the building is sold and thus are not sunk cost.

Exercise 2-9 (30 minutes)

1. a. USB flash drives purchased	22,000
USB flash drives drawn from inventory	<u>19,500</u>
USB flash drives remaining in inventory	2,500
Cost per USB flash drive	<u>× \$6</u>
Cost in Raw Materials Inventory at May 31	<u>\$15,000</u>
b. USB flash drives used in production (19,500 – 500)	19,000
Units completed and transferred to Finished Goods (95% × 19,000)	<u>18,050</u>
Units still in Work in Process at May 31	950
Cost per flash drive	<u>× \$6</u>
Cost in Work in Process Inventory at May 31	<u>\$ 5,700</u>
c. Units completed and transferred to Finished Goods (above)	18,050
Units sold during the month (80% × 18,050)	<u>14,440</u>
Units still in Finished Goods at May 31	3,610
Cost per USB flash drive	<u>× \$6</u>
Cost in Finished Goods Inventory at May 31	<u>\$21,660</u>
d. Units sold during the month (above)	14,440
Cost per USB flash drive	<u>× \$6</u>
Cost in Cost of Goods Sold at May 31	<u>\$86,640</u>
e. USB flash drives used in advertising	500
Cost per USB flash drive	<u>× \$6</u>
Cost in Advertising Expense at May 31	<u>\$ 3,000</u>
2. Raw Materials Inventory—balance sheet	\$15,000
Work in Process Inventory—balance sheet	5,700
Finished Goods Inventory—balance sheet	21,660
Cost of Goods Sold—income statement	86,640
Advertising Expense—income statement	<u>3,000</u>
	<u>\$132,000</u>

Note: the \$132,000 above reconciles to the total amount spent on the flash drives on May 1: 22,000 × \$6 per unit = \$132,000.

Exercise 2-10 (30 minutes)

1.

Tiessen Limited
Schedule of Cost of Goods Manufactured
For the year ended December 31

Direct materials:	
Raw materials inventory, beginning.....	\$ 24,000
Add: Purchases of raw materials	<u>396,000</u>
Raw materials available for use.....	420,000
Deduct: Raw materials inventory, ending	<u>30,000</u>
Raw materials used in production	\$390,000
Direct labour	270,000
Manufacturing overhead:	
Rent, manufacturing building.....	\$ 240,000
Indirect labour.....	168,900
Utilities, manufacturing	27,000
Depreciation, manufacturing equipment.....	72,000
Supplies, manufacturing	2,100
Repairs, manufacturing equipment.....	<u>120,000</u>
Total manufacturing overhead costs.....	<u>630,000</u>
Total manufacturing costs.....	1,290,000
Add: Work in process, beginning	<u>15,000</u>
	1,305,000
Deduct: Work in process, ending	<u>60,000</u>
Cost of goods manufactured	<u>\$1,245,000</u>

2. The cost of goods sold section would be:

Finished goods inventory, beginning	\$ 210,000
Add: Cost of goods manufactured	<u>1,245,000</u>
Goods available for sale	1,455,000
Deduct: Finished goods inventory, ending.....	<u>75,000</u>
Cost of goods sold	<u>\$1,380,000</u>

Exercise 2-11 (15 minutes)

<i>Cost Item</i>	<i>Cost Behaviour</i>		<i>Selling and Administrative Cost</i>	<i>Product Cost</i>
	<i>Variable</i>	<i>Fixed</i>		
1. The costs of turn signal switches used at a General Motors plant.....	X			X
2. Salary of production manager at Blackberry		X		X
3. Salesperson's commissions at Avon Products	X		X	
4. Insurance on one of Bombardier's factory buildings.....		X		X
5. The costs of shipping brass fittings to customers in California.....	X		X	
6. Depreciation on the bookshelves at Reston Bookstore.....		X	X	
7. The costs of X-ray film at the Toronto General's radiology lab.....	X			X
8. The cost of leasing a toll-free telephone number at Staples Canada		X	X	
9. The depreciation on the playground equipment at a McDonald's outlet		X	X	
10. The cost of the mozzarella cheese used at a Pizza Hut outlet.....	X			X

Exercise 2-12 (15 minutes)

- | | |
|--|--------------|
| 1. Direct labour cost: 35 hours × \$14 per hour | \$490 |
| Manufacturing overhead cost: 5 hours × \$14 per hour | <u>70</u> |
| Total cost | <u>\$560</u> |
| 2. Direct labour cost: 49 hours × \$14 per hour | \$686 |
| Manufacturing overhead cost: 9 hours × \$7 per hour | <u>63</u> |
| Total cost | <u>\$749</u> |
3. The company could treat the cost of employee benefits relating to direct labour workers as part of manufacturing overhead. This approach spreads the cost of such benefits over all units of output. Alternatively, the company could treat the cost of employee benefits relating to direct labour workers as additional direct labour cost. This latter approach charges the costs of employee benefits to specific jobs rather than to all units of output.

Problem 2-13 (30 minutes)

1. a-e

Item	Behaviour	Type	Direct/ Indirect
Leather used for the bicycle seats	Variable	Manufacturing	Direct
Production manager's salary	Fixed	Manufacturing	Indirect
Life insurance for the company president		Administrative	
Electricity used in the production facilities*	Variable/fixed	Manufacturing	Indirect
Sales commissions		Selling	
Internet advertising		Selling	
Employee benefits for the production workers	Variable	Manufacturing	Indirect
Property taxes on the production facilities	Fixed	Manufacturing	Indirect
Shipping costs		Administrative	
Salary of the chief financial officer		Administrative	

*There is a fixed and variable component to this cost. The base charge of \$100 represents a fixed cost with the remainder varying with the level of production activity.

Problem 2-13 continued

2. Unit costs for variable manufacturing expenses based on November (October) amounts:

Leather used in seats: $\$30,000 (\$27,000) \div 1,000 (900) = \$30/\text{bike}$

Electricity: $\$1,000^* (\$900^*) \div 1,000 (900) = \$1/\text{bike}$

Employee benefits: $\$20,000 (\$18,000) \div 1,000 (900) = \$20/\text{bike}$

* $\$1,100 (\$1,000) - \$100 \text{ basic charge} = \$1,000 (\$900)$.

December manufacturing costs:

Item	Per unit Amount	Activity	Cost
Leather in seats (variable)	\$30	1,200	\$36,000
Electricity (variable)	\$1	1,200	\$1,200
Employee benefits (variable)	\$20	1,200	\$24,000
Production manager's salary (fixed)	n/a	1,200	\$6,000
Electricity (fixed)	n/a	1,200	\$100
Property taxes (fixed)	n/a	1,200	\$1,000

Problem 2-14 (30 minutes)

1. Total wages for the week:		
Regular time: 40 hours × \$30 per hour	\$	1,200
Overtime: 10 hours × \$45 per hour		<u>450</u>
Total wages		<u>\$1,650</u>
Allocation of total wages:		
Direct labour: 50 hours × \$30 per hour		\$1,500
Manufacturing overhead: 10 hours × \$15 per hour		<u>150</u>
Total wages		<u>\$1,650</u>
2. Total wages for the week:		
Regular time: 40 hours × \$30 per hour	\$	1,200
Overtime: 5 hours × \$45 per hour		<u>225</u>
Total wages		<u>\$1,425</u>
Allocation of total wages:		
Direct labour: 42 hours × \$30 per hour		\$1,260
Manufacturing overhead:		
Idle time: 3 hours × \$30 per hour	\$	90
Overtime premium: 5 hours × \$15 per hour		<u>75</u>
Total wages		<u>165</u>
Total wages		<u>\$1,425</u>
3. Total wages and employee benefits for the week:		
Regular time: 40 hours × \$30 per hour	\$	1,200
Overtime: 12 hours × \$45 per hour		540
Fringe benefits: 52 hours × \$9 per hour		<u>468</u>
Total wages and fringe benefits		<u>\$2,208</u>
Allocation of wages and employee benefits:		
Direct labour: 46 hours × \$30 per hour		\$1,380
Manufacturing overhead:		
Idle time: 6 hours × \$30 per hour	\$	180
Overtime premium: 12 hours × \$15 per hour		180
Employee benefits: 52 hours × \$9 per hour		<u>468</u>
Total wages and employee benefits		<u>828</u>
Total wages and employee benefits		<u>\$2,208</u>

Problem 2-14 (continued)

4. Allocation of wages and employee benefits:

Direct labour:

Wage cost: 46 hours × \$30 per hour.....	\$1,380	
Employee benefits: 46 hours × \$9 per hour.....	<u>414</u>	\$1,794

Manufacturing overhead:

Idle time: 6 hours × \$30 per hour.....	180	
Overtime premium: 12 hours × \$15 per hour....	180	
Employee benefits: 6 hours × \$9 per hour.....	<u>54</u>	<u>414</u>
Total wages and employee benefits		<u>\$2,208</u>

Problem 2-15 (30 minutes)

Name of the Cost	Product Cost			Period			Opportunity Cost	Sunk Cost
	Variable Cost	Fixed Cost	Direct Materials	Direct Labour	Mfg. Overhead	(Selling and Admin.) Cost		
Rental revenue forgone, \$35,000 per year							X	
Direct materials cost, \$50 per unit ...	X		X					
Supervisor's salary, \$3,000 per month		X			X			
Direct labour cost, \$22 per unit.....	X			X				
Rental cost of warehouse, \$1,500 per month		X				X		
Rental cost of equipment, \$2,200 per month		X			X			
Depreciation of the building, \$7,000 per year		X			X			X
Advertising cost, \$28,000 per year		X				X		
Shipping cost, \$7 per unit.....	X					X		
Electrical costs, \$4 per unit.....	X				X			
Return earned on investments, \$5,000 per year							X	

Problem 2-16 (20 minutes)

Note to the Instructor: Some of the answers below are debatable.

<i>Cost Item</i>	<i>Variable or Fixed</i>	<i>Selling Cost</i>	<i>Adminis- trative Cost</i>	<i>Product Cost</i>	
				<i>Direct</i>	<i>Indirect</i>
1. Depreciation, executive jet.....	F		X		
2. Costs of shipping finished goods to customers	V	X			
3. Wood used in manufacturing furniture	V			X	
4. Sales manager's salary	F	X			
5. Electricity used in manufacturing furniture.....	V				X
6. Salary of secretary to the company president	F		X		
7. Aerosol attachment placed on a spray can produced by the company	V			X	
8. Billing costs	V	X*			
9. Packing supplies for shipping products overseas	V	X			
10. Sand used in manufacturing concrete	V			X	
11. Supervisor's salary, factory	F				X
12. Executive life insurance	F		X		
13. Sales commissions.....	V	X			
14. Employee benefits, assembly line workers	V			X**	
15. Advertising costs	F	X			
16. Property taxes on finished goods warehouses.....	F	X			
17. Lubricants for production equipment.....	V				X

*Could be an administrative cost.

**Could be an indirect cost.

Problem 2-17 (60 minutes)

1.

Medco, Inc.
Schedule of Cost of Goods Manufactured
For the year ended xxxx

Direct materials:		
Raw materials inventory, beginning.....	\$ 10,000	
Add: Purchases of raw materials.....	<u>90,000</u>	
Raw materials available for use.....	100,000	
Deduct: Raw materials inventory, ending	<u>17,000</u>	
Raw materials used in production		\$ 83,000
Direct labour		60,000
Manufacturing overhead:		
Depreciation, factory.....	42,000	
Insurance, factory.....	5,000	
Maintenance, factory.....	30,000	
Utilities, factory.....	27,000	
Supplies, factory	1,000	
Indirect labour.....	<u>65,000</u>	
Total overhead costs		<u>170,000</u>
Total manufacturing costs.....		313,000
Add: Work in process inventory, beginning		<u>7,000</u>
		320,000
Deduct: Work in process inventory, ending		<u>30,000</u>
Cost of goods manufactured		<u>\$290,000</u>

Problem 2-17 (continued)

2.

Medco, Inc.
Income Statement
For the year ended xxxx

Sales		\$450,000
Cost of goods sold:		
Finished goods inventory, beginning	\$ 10,000	
Add: Cost of goods manufactured	<u>290,000</u>	
Goods available for sale.....	300,000	
Deduct: Finished goods inventory, ending	<u>40,000</u>	<u>260,000</u>
Gross margin.....		190,000
Selling and administrative expenses:		
Selling expenses	80,000	
Administrative expenses.....	<u>70,000</u>	<u>150,000</u>
Operating income		<u>\$ 40,000</u>

3. Direct materials: $\$83,000 \div 10,000 \text{ units} = \8.30 per unit .
 Depreciation: $\$42,000 \div 10,000 \text{ units} = \4.20 per unit .

4. Direct materials:
 Unit cost: \$8.30 (unchanged)
 Total cost: 15,000 units \times \$8.30 per unit = \$124,500.
 Depreciation:
 Unit cost: $\$42,000 \div 15,000 \text{ units} = \2.80 per unit .
 Total cost: \$42,000 (unchanged)

5. Unit cost for depreciation dropped from \$4.20 to \$2.80, because of the increase in production between the two years. Since fixed costs do not change *in total* as the activity level changes, they will decrease on a unit basis as the activity level rises.

6. If the company produced 20,000 units then the following costs would appear in inventory:
- | | | |
|---|--|-----------------|
| Direct materials $(\$83,000/20,000)*4,000 \text{ units}$ | | = \$16,600 |
| Direct labour $(\$60,000/20,000)* 4,000 \text{ units}$ | | = 12,000 |
| Manufacturing overhead $(\$170,000/20,000) * 4,000 \text{ units}$ | | <u>= 34,000</u> |
| Total | | <u>\$62,600</u> |

Problem 2-18 (15 minutes)

1. The controller is correct that the salary cost should be classified as a selling (marketing) cost. The duties described in the problem have nothing to do with manufacturing the product, but rather deal with order-taking and shipping finished goods to customers. As stated in the text, selling costs include all costs necessary to secure customer orders and get the finished product into the hands of customers.
2. No, the president is not correct; how the salary cost is classified can affect the reported operating income for the year. If the salary cost is classified as a selling expense all of it will appear on the income statement as a period cost. However, if the salary cost is classified as a manufacturing (product) cost, then it will be added to Work in Process Inventory along with other manufacturing costs for the period. To the extent that goods are still in process at the end of the period, part of the salary cost will remain with these goods in the Work in Process Inventory account. Only that portion of the salary cost that has been assigned to finished units will leave the Work in Process Inventory account and be transferred into the Finished Goods Inventory account. In like manner, to the extent that goods are unsold at the end of the period, part of the salary cost will remain with these goods in the Finished Goods Inventory account. Only that portion of the salary that has been assigned to finished units *that are sold during the period* will appear on the income statement as an expense (part of Cost of Goods Sold) for the period.

Problem 2-19 (30 minutes)

1. <i>Name of the Cost</i>	Product Cost						Period	<i>Opportunity Cost</i>	<i>Sunk Cost</i>
	<i>Variable Cost</i>	<i>Fixed Cost</i>	<i>Product Cost</i>			<i>(Selling and Admin.) Cost</i>			
			<i>Direct Materials</i>	<i>Direct Labour</i>	<i>Mfg. Overhead</i>				
Todd's present salary of \$2,000 per month		X					X		
Rent on the production building, \$1,500 per month		X			X				
Rent of production equipment, \$550 per month		X			X				
Materials for producing brooms, at \$11.50 each	X		X						
Labour cost of producing brooms, at \$4.25 each	X			X					
Rent of room for a sales office, \$250 per month		X				X			
Voice mail, \$5 per month		X				X			
Interest lost on savings account, \$1,100 per year							X		
Advertising cost, \$450 per month		X				X			
Sales commission, at \$0.80 per broom	X					X			
Legal and filing fees, \$1,500.....		X				X		X	

Problem 2-19 (continued)

2. The \$1,500 legal and filing fees are not a differential cost. These legal and filing fees have already been paid and are a sunk cost. Sunk costs are never differential costs. Thus, the cost will not differ depending on whether Todd decides to produce brooms or to stay with the janitorial service. All other costs listed above are differential costs since they will be incurred only if Todd leaves the janitorial service and produces the brooms.

Problem 2-20 (45 minutes)

1.

<i>Cost Item</i>	<i>Cost Behaviour</i>		<i>Selling or Administrative Cost</i>	<i>Product Cost</i>	
	<i>Variable</i>	<i>Fixed</i>		<i>Direct</i>	<i>Indirect</i>
Direct materials used (wood, glass)	\$430,000			\$430,000	
General office salaries		\$110,000	\$110,000		
Factory supervision		70,000			\$ 70,000
Sales commissions	60,000		60,000		
Depreciation, factory building		105,000			105,000
Depreciation, office equipment		2,000	2,000		
Indirect materials, factory	18,000				18,000
Factory labour (cutting and assembly).	90,000			90,000	
Advertising		100,000	100,000		
Insurance, factory.....		6,000			6,000
General office supplies	4,000		4,000		
Property taxes, factory		20,000			20,000
Utilities, factory	<u>45,000</u>				<u>45,000</u>
Total costs	<u>\$647,000</u>	<u>\$413,000</u>	<u>\$276,000</u>	<u>\$520,000</u>	<u>\$264,000</u>

Problem 2-20 (continued)

2. Only the product costs will be included in the cost of a bookcase. The cost per bookcase will be:

Direct product costs	\$520,000
Indirect product costs	<u>264,000</u>
Total product costs	<u>\$784,000</u>

$$\$784,000 \div 4,000 \text{ bookcases} = \$196 \text{ per bookcase}$$

3. The cost per bookcase would increase. This is because the fixed costs would be spread over fewer units, causing the cost per unit to rise.
4. a. Yes, there probably would be a disagreement. The president is likely to want a price of at least \$196, which is the average cost per unit to manufacture 4,000 bookcases. He may expect an even higher price than this to cover a portion of the administrative costs as well. The neighbour will probably be thinking of cost as including only materials used, or perhaps materials and direct labour.
- b. The term is opportunity cost. Since the company is operating at full capacity, the president must give up the full, regular price of a set to sell a bookcase to the neighbour. Therefore, the president's cost is really the full, regular price of a set.

Problem 2-21 (15 minutes)

<i>Item</i>	<i>Description</i>	<i>Direct or Indirect Cost of the Immunization Centre</i>		<i>Direct or Indirect Cost of Particular Patients</i>		<i>Variable or Fixed with Respect to the Number of Immunizations Administered</i>	
		<i>Direct</i>	<i>Indirect</i>	<i>Direct</i>	<i>Indirect</i>	<i>Variable</i>	<i>Fixed</i>
a.	The salary of the head nurse in the Immunization Centre	X			X		X
b.	Costs of incidental supplies consumed in the Immunization Centre such as paper towels	X			X	X	
c.	The cost of lighting and heating the Immunization Centre	X			X		X
d.	The cost of disposable syringes used in the Immunization Centre	X		X		X	
e.	The salary of the Central Area Well-Baby Clinic's Information Systems manager		X		X		X
f.	The costs of mailing letters soliciting donations to the Central Area Well-Baby Clinic		X		X		X
g.	The wages of nurses who work in the Immunization Centre*	X			X		X
h.	The cost of medical malpractice insurance for the Central Area Well-Baby Clinic		X		X		X
i.	Depreciation on the fixtures and equipment in the Immunization Centre	X			X		X

* The wages of the nurses could be variable and a direct cost of serving particular patients.

Problem 2-22 (60 minutes)

1.

Veekay Company
Schedule of Cost of Goods Manufactured
For the Month Ended June 30

Direct materials:		
Raw materials inventory, June 1	\$ 19,000	
Add: Purchases of raw materials	<u>209,000</u>	
Raw materials available for use.....	228,000	
Deduct: Raw materials inventory, June 30	<u>46,000</u>	
Raw materials used in production		\$182,000
Direct labour		99,000
Manufacturing overhead:		
Rent on facilities (85% × \$40,000)	34,000	
Insurance (90% × \$10,000)	9,000	
Utilities (80% × \$55,000)	44,000	
Indirect labour.....	119,000	
Maintenance, factory.....	8,000	
Depreciation, factory equipment	<u>13,000</u>	
Total overhead costs		<u>227,000</u>
Total manufacturing costs.....		508,000
Add: Work in process inventory, June 1		<u>77,000</u>
		585,000
Deduct: Work in process inventory, June 30.....		<u>94,000</u>
Cost of goods manufactured		<u>\$491,000</u>

Problem 2-22 (continued)

2.

Veekay Company
Income Statement
For the Month Ended June 30

Sales		\$660,000
Cost of goods sold:		
Finished goods inventory, June 1	\$ 22,000	
Add: Cost of goods manufactured	<u>491,000</u>	
Goods available for sale.....	513,000	
Deduct: Finished goods inventory, June 30.....	<u>66,000</u>	<u>447,000</u>
Gross margin.....		213,000
Selling and administrative expenses:		
Selling and administrative salaries.....	39,000	
Rent on facilities (15% × \$40,000)	6,000	
Depreciation, sales equipment	11,000	
Insurance (10% × \$10,000).....	1,000	
Utilities (20% × \$55,000).....	11,000	
Advertising	<u>88,000</u>	<u>156,000</u>
Operating income		<u>\$ 57,000</u>

Note: the \$88,000 difference between the operating income shown above and the operating loss (\$31,000) shown on the June income statement can be reconciled as follows:

Operating loss.....		\$ (31,000)
Less opening inventories.....	(118,000)	(\$19,000 + \$77,000 + \$22,000)
Add closing inventories.....	<u>206,000</u>	(\$46,000 + \$94,000 + \$66,000)
Operating income.....		<u>\$ 57,000</u>

Problem 2-22 (continued)

3. In preparing the income statement shown in the text, the accountant failed to distinguish between product costs and period costs, and also failed to recognize the change in inventories between the beginning and end of the month. Once these errors have been corrected, the financial condition of the company looks much better and continuing operations appears more attractive.

Problem 2-23 (30 minutes)

1. Mr. Richart's first action was to direct that discretionary expenditures be delayed until the first of the new year. Providing that these "discretionary expenditures" can be delayed without hampering operations, this is a good business decision. By delaying expenditures, the company can keep its cash a bit longer and thereby earn a bit more interest. There is nothing unethical about such an action. The second action was to ask that the order for the parts be cancelled. Since the clerk's order was a mistake, there is nothing unethical about this action either.

The third action was to ask the accounting department to delay recognition of the delivery until the bill is paid in January. This action is dubious. Asking the accounting department to ignore transactions strikes at the heart of the integrity of the accounting system. If the accounting system cannot be trusted, it is very difficult to run a business or obtain funds from outsiders. However, in Mr. Richart's defense, the purchase of the raw materials really shouldn't be recorded as an expense. He has been placed in an extremely awkward position because the company's accounting policy is flawed.

2. The company's accounting policy with respect to raw materials is incorrect. Raw materials should be recorded as an asset when delivered rather than as an expense. If the correct accounting policy were followed, there would be no reason for Mr. Richart to ask the accounting department to delay recognition of the delivery of the raw materials. This flawed accounting policy creates incentives for managers to delay deliveries of raw materials until after the end of the fiscal year. This could lead to raw materials shortages and poor relations with suppliers who would like to record *their* sales before the end of the year.

The company's "manage-by-the-numbers" approach does not foster ethical behaviour—particularly when managers are told to "do anything so long as you hit the target profits for the year." Such "no excuses" pressure from the top too often leads to unethical behaviour when managers have difficulty meeting target profits.

Problem 2-24 (60 minutes)

1.

Carlton Manufacturing
Schedule of Cost of Goods Manufactured

Direct materials:

Raw materials inventory, beginning.....	\$ 25,000	
Add: Purchases of raw materials	<u>130,000</u>	
Raw materials available for use.....	155,000	
Deduct: Raw materials inventory, ending .	<u>20,000</u> *	
Raw materials used in production		\$135,000 (given)
Direct labour		32,500
Manufacturing overhead:		
Insurance, factory.....	4,000	
Rent, factory building	45,000 *	
Utilities, factory.....	26,000	
Indirect materials, factory	3,000	
Depreciation, factory equipment	55,000	
Maintenance, factory.....	<u>37,000</u>	
Total overhead costs		<u>170,000</u> (given)
Total manufacturing costs.....		337,500
Add: Work in process inventory, beginning .		<u>24,000</u>
		361,500
Deduct: Work in process inventory, end- ing...		<u>16,500</u> *
Cost of goods manufactured		<u>\$345,000</u> **

** computed in Cost of Goods Sold section next page

Problem 2-24 (continued)

The cost of goods sold section of the income statement follows:

Finished goods inventory, beginning	\$ 15,000	
Add: Cost of goods manufactured	<u>345,000</u>	*
Goods available for sale.....	360,000	(given)
Deduct: Finished goods inventory, ending	<u>42,500</u>	*
Cost of goods sold	<u>\$317,500</u>	

*These items must be computed by working backwards up through the statements. An effective way of doing this is to place the form and known balances on the paper, and then work toward the unknown figures.

2. Direct materials: $\$135,000 \div 15,000 \text{ units} = \9.00 per unit .
Rent, factory building: $\$45,000 \div 15,000 \text{ units} = \3.00 per unit .
3. Direct materials:
Per unit: \$9.00 (unchanged)
Total: 20,000 units \times \$9.00 per unit = \$180,000.
Rent, factory building:
Per unit: $\$45,000 \div 20,000 \text{ units} = \2.25 per unit .
Total: \$45,000 (unchanged).
4. The average cost per unit for rent dropped from \$3.00 to \$2.25, because of the increase in production between the two years. Since fixed costs do not change *in total* as the activity level changes, the *average* unit cost will decrease as the activity level rises.

Problem 2-25 (60 minutes)

	<u>Case 1</u>	<u>Case 2</u>	<u>Case 3</u>	<u>Case 4</u>
Direct materials	\$ 5,600	\$10,400	\$ 6,600	\$ 7,600
Direct labour	1,600	4,600	5,500*	2,900
Manufacturing overhead	8,000	13,800*	7,700	20,000
Total manufacturing costs	15,200*	28,800	19,800	30,500*
Beginning work in process inventory	2,400*	1,200	2,200	1,300*
Ending work in process inventory	(3,200)	(4,000)	(4,400)*	(1,900)
Cost of goods manufactured	\$14,400	\$26,000*	\$17,600	\$29,900
Sales	\$20,000	\$46,000	\$33,000	\$47,500
Beginning finished goods inventory	4,800	9,100*	7,700	8,600
Cost of goods manufactured	14,400	26,000*	17,600	29,900
Goods available for sale	19,200*	35,100*	25,300*	38,500*
Ending finished goods inventory	7,200	4,600	5,500*	6,700
Cost of goods sold	12,000*	30,500	19,800	31,800*
Gross margin	8,000*	15,500*	13,200*	15,700*
Selling and administrative expenses	4,800	9,200*	9,900*	9,500
Operating income	\$ 3,200*	\$ 6,300	\$ 3,300	\$ 6,200*

*Missing data in the problem.

Problem 2-26 (45 minutes)

1.

MITCHELL COMPANY
Schedule of Cost of Goods Manufactured
For the Year Ended December 31

Direct materials:		
Raw materials inventory, January 1	\$ 90,000	
Add: Purchases of raw materials.....	<u>750,000</u>	
Raw materials available for use	840,000	
Deduct: Raw materials inventory, December 31.....	<u>60,000</u>	
Raw materials used in production		\$ 780,000
Direct labour		150,000
Manufacturing overhead:		
Utilities, factory	36,000	
Depreciation, factory	162,000	
Insurance, factory	40,000	
Supplies, factory.....	15,000	
Indirect labour.....	300,000	
Maintenance, factory	<u>87,000</u>	
Total overhead costs.....		<u>640,000</u>
Total manufacturing costs.....		1,570,000
Add: Work in process inventory, January 1.		<u>180,000</u>
		1,750,000
Deduct: Work in process inventory, December 31.....		<u>100,000</u>
Cost of goods manufactured.....		<u><u>\$1,650,000</u></u>

Problem 2-26 (continued)

2. The cost of goods sold would be computed as follows:

Finished goods inventory, January 1	\$ 260,000
Add: Cost of goods manufactured.....	<u>1,650,000</u>
Goods available for sale	1,910,000
Deduct: Finished goods inventory, Decem- ber 31.....	<u>210,000</u>
Cost of goods sold	<u>\$1,700,000</u>

3.

MITCHELL COMPANY
Income Statement
For the Year Ended December 31

Sales	\$2,500,000
Less cost of goods sold (above).....	<u>1,700,000</u>
Gross margin.....	800,000
Less selling and administrative expenses: ..	
Selling expenses.....	\$140,000
Administrative expenses.....	<u>270,000</u>
Total expenses	<u>410,000</u>
Operating income	<u>\$ 390,000</u>

4. Ending finished good inventory:

Direct materials ($\$780,000/412,500 = \1.8909)	\$104,332
$\$1.8909 \times 55,176$	
Direct labour ($\$150,000/412,500 = \0.3636)	$\$0.3636 \times 20,062^*$
$55,176$	
Manufacturing overhead ($\$640,000/412,500 =$	<u>85,606</u>
$\$1.5515$) $\$1.5515 \times 55,176$	
Total cost.....	<u>\$210,000</u>

*Rounding down is undertaken to account for unit cost rounding.

Case 2-27 (30 minutes)

1. The error made by Ranton when calculating the 2016 expected operating income was to treat all expenses as if they were variable. This is incorrect since the case indicates that advertising and the salaries of the website administrator and the bookkeeper are fixed costs. By including these costs in the calculation of 2015 operating expenses on a per unit basis, Ranton is effectively treating them as if they will vary in direct proportion with unit activity. This will lead to an overstatement of the expected amount of these expenses because they will not increase proportionately with sales activity.
2. The expected results for 2016, along with the 2015 actual results for comparison, are shown below.

	Actual 2015	Expected 2016
Sales (units)	<u>8,000</u>	<u>10,000</u>
Sales	\$800,000	\$1,000,000
Cost of goods sold:	<u>640,000</u>	<u>800,000</u>
Gross margin	160,000	200,000
Operating expenses		
Advertising	8,000	8,000
Salaries	92,000	92,000
Commissions*	<u>8,000</u>	<u>10,000</u>
Total operating expenses.....	<u>108,000</u>	<u>110,000</u>
Operating income.....	<u>\$52,000</u>	<u>\$90,000</u>

The above shows that expected results for 2016 should have been \$90,000. This assumes, as per the case, that advertising and salaries remain fixed at respectively, \$8,000 and \$92,000 per year. The only variable operating expense is the commission paid to the website designer/administrator based on 1% of total sales. Compared to the recalculated expected 2016 results, the actual operating income of \$75,000 no longer looks as good since it is \$15,000 below the anticipated level.

Case 2-27 (continued)

3. Comparison of expected and actual operating expenses in 2016:

Expected expenses (per part 2 above)	\$110,000
Actual expenses	<u>\$135,000</u>
Difference	<u>\$ 25,000</u>

Assuming no mistakes were made by the bookkeeper in preparing the 2016 financial statements Ranton needs to focus on the only variable operating expense – sales commissions paid to the website designer. If salaries (\$92,000) and advertising (\$8,000) truly are both fixed costs and did not change in 2016, the \$25,000 difference between expected and actual operating expenses must be attributable to an increase in the amount of commissions actually paid. Perhaps a mistake was made in calculating the amount of the sales commissions but Ranton will want to get an answer.

Case 2-28 (30 minutes)

1. Differential revenues:
 - The rental revenue that will be received from sub-letting 15% of the new warehouse.
 - Sales proceeds (less real estate commissions, legal fees, etc.) received from selling old warehouse.
 - Revenues from existing parking lot.

Differential costs:

- Monthly lease payments for the new warehouse.
- Utility costs (expected to be lower at new warehouse).
- Property taxes (none paid at new building).
- Building insurance (none paid at new building).
- Maintenance and repair costs (likely lower at new building).
- Salary of current maintenance manager (won't be needed if PE moves to the new building).
- Cost of maintaining the existing parking lot.

Note: some students may want to also include the inventory insurance costs and the security personnel costs as differential costs. However, the facts of the case indicate that Reg does not believe these costs will change if the new warehouse is rented. As a result, these are not differential costs.

2. An opportunity cost is a potential benefit given up when one alternative is chosen over another. If PE sells the old warehouse they will incur an opportunity cost equal to the operating income currently being earned on the small parking lot set up on one corner of the property.
3. The depreciation expense represents a sunk cost because it represents the allocation to reporting periods of the original depreciable cost of the old warehouse. It should not be considered in deciding whether to lease the new warehouse. Because that original cost cannot be changed it is a sunk cost, and thus so too is the depreciation of that original cost.

