

- Sales are made for cash and on credit. The following collection pattern is used to estimate monthly cash collections:

Cash sales	41%
Credit sales—month of sale	35
Credit sales—month after sale	20
Uncollectible	<u>4</u>
Total	<u>100%</u>

- The company tries to maintain an inventory of 25% of the following month's sales. The company expects to have 1,125 suits on hand on June 30. Knab pays an average of \$146 per suit.
- The company pays for 70% of its purchases in the month of purchase and the remaining 30% in the month after purchase.
- The following monthly selling and administrative expenses are planned for the quarter, though advertising will have a one-time \$30,000 increase in August.

	<u>Fixed Overhead</u>	<u>Variable Cost/Unit</u>
Depreciation	\$ 9,000	
Rent	40,000	
Advertising	84,000	
Salaries	150,000	
Bad debts		\$9.00

- On September 30, the company plans to purchase \$45,000 of new office equipment. However, no additional depreciation will be recorded in the third quarter.
- Knab wants to maintain a minimum cash balance of \$20,000. An open line of credit at a local bank allows the company to borrow up to \$100,000 per quarter in \$1,000 increments.
- All borrowing is done at the beginning of the month, and all repayments are made at the end of a month in \$1,000 increments. Accrued interest is paid only when principal is repaid. The interest rate is 12% per year.
- Accrued expenses from the second quarter will be paid in July.
- Knab's tax rate is 30%.
- The June 30 balance sheet is budgeted as follows:

	<u>June 30</u>
Cash	\$ 21,000
Accounts receivable	180,000
Inventory	164,250
Plant & equipment	540,000
Accumulated depreciation	<u>(135,000)</u>
Total assets	<u>\$ 770,250</u>
Accounts payable	\$ 175,000
Accrued expenses	75,000
Common stock	300,000
Retained earnings	<u>220,250</u>
Total liabilities and equities	<u>\$ 770,250</u>

Required

- Prepare all components of Knab's master budget for the third quarter.
- Prepare a pro-forma income statement for the third quarter.
- Prepare a pro-forma balance sheet as of September 30.

5.42 (LO 1, 3, 4, 5) Ethics and budgeting Faced with three young children who were always complaining "I'm bored," Ann Newton looked for an interesting after-school activity. Finding nothing available in the community, she decided to solve her problem by renting an old bakery and turning it into Kiddie Kitchen. Three afternoons a week, Ann, her children, and several other children gathered to learn the art of cooking. In less than five years, Ann's business grew to over 30 franchised kitchens located throughout the state. In 2005, she retired from active management of the company and sold the majority of her stock to Bernice Mayfield, who now runs the firm.

Today, Kiddie Kitchen has 100 franchised locations and 50 corporate locations up and down the East Coast. The company is organized into five regional territories, each run by a director who reports to the vice president of operations. In addition to the vice president of operations, executive management includes the CFO, the vice president of marketing, and the vice president of human resources. All executive personnel work at the corporate headquarters, now located in Raleigh, North Carolina. Each director maintains a regional office, complete with an administrative staff.

Shortly after taking over the company, Mayfield revamped the budgeting process, replacing a bottom-up process that had been in place since the early 1990s with a top-down process. Since the new budget process influences the bonus compensation a director can earn, directors have a great deal of interest in developing the budget. At the beginning of the budget cycle, regional directors receive corporate directives concerning the coming year's budget. These directives include projected growth in locations and revenue, salary increases, and allocated corporate expenses. Directors prepare three budgets—one for franchised locations, one for corporate locations, and one for administrative costs associated with the regional offices. These budgets are passed up to the corporate office for consolidation into the corporate budget.

Max Green is director of the southeast region. His approach to preparing the budget for the coming year budget is a typical example of budget preparation. He passed the corporate budget directives to his accountant, Henri Duvall, who prepared the first draft of the budget. When Green reviewed the draft, he did not like what he saw. Budgeted net income was too high—so high that his region would never meet the target. He asked Duvall to make some adjustments.

The corporate directive had projected a general price level increase of 2–4%. The range was intended to allow higher cost-of-living areas, such as Boston and New York, to budget higher levels of cost increases than lower cost-of-living areas. But even though Green's office was located in the lowest cost-of-living area in the country, he told Duvall to budget an across-the-board increase of 4%. Green knew that as long as he was within the directive's guidelines, the corporate office wouldn't question the increase.

Green also told Duvall that the region would open ten new stores during the coming year and that the budget should reflect enough start-up expenses to cover the new locations. Green knew that no region had ever opened more than seven stores in a single year. In fact, he thought he would be lucky to open five new stores in the coming year.

Since Green had a reputation for retaliating against employees who chose to ignore his requests, Duvall made the changes without questioning them. The result was a \$250,000 reduction in budgeted net income.

Duvall, a certified management accountant, had a wife and three children, and could not afford to lose his job and his generous benefit package. Besides, his wife was in line to become owner of one of the new franchised stores in the coming year.

Required

- Why would Green care about the level of budgeted net income?
- What do you think Mayfield's reaction would be if she learned of Green's actions?
- What does Duvall have to gain from his actions? Does he have anything to lose?
- Refer to the IMA's Statement of Ethical Professional Practice in Exhibit 1.8 (pages 1-20 and 1-21). What responsibilities does Duvall have in this situation? Did he violate the Statement? If so, how?

Data Analytics Problems

5.43 (LO 3) Preparing a Sales Budget (Data set from "Café Data," Concetta A. DePaolo and David F. Robinson, *Journal of Statistics Education* Volume 19, Number 1 (2011) used by permission of the authors.)

The Peppy Paladin Café is an experiential learning lab at a state university in the Midwest. After the food service operator closed a dining location in the business building, students developed the concept to provide limited food and beverage options for students, faculty, and staff. Having just completed its first semester of operations, the café is operated by student volunteers who receive internship credit for running the café.

The café staff collected sales statistics from the most recent semester of operations (January–April), and it is now time to prepare the sales budget for next semester.

The Excel data files for answering this problem can be found in WileyPLUS.