

Elegant Decor Company's management is trying to decide whether to eliminate Department 200, which has produced losses or low profits for several years. The company's 2015 departmental income statements show the following.

Problem 25-6A
Analysis of possible
elimination of a
department

A1 

ELEGANT DECOR COMPANY			
Departmental Income Statements			
For Year Ended December 31, 2015			
	Dept. 100	Dept. 200	Combined
Sales	\$436,000	\$290,000	\$726,000
Cost of goods sold	262,000	207,000	469,000
Gross profit	174,000	83,000	257,000
Operating expenses			
Direct expenses			
Advertising	17,000	12,000	29,000
Store supplies used	4,000	3,800	7,800
Depreciation—Store equipment	5,000	3,300	8,300
Total direct expenses	26,000	19,100	45,100
Allocated expenses			
Sales salaries	65,000	39,000	104,000
Rent expense	9,440	4,720	14,160
Bad debts expense	9,900	8,100	18,000
Office salary	18,720	12,480	31,200
Insurance expense	2,000	1,100	3,100
Miscellaneous office expenses	2,400	1,600	4,000
Total allocated expenses	107,460	67,000	174,460
Total expenses	133,460	86,100	219,560
Net income (loss)	\$ 40,540	\$ (3,100)	\$ 37,440

In analyzing whether to eliminate Department 200, management considers the following:

- The company has one office worker who earns \$600 per week, or \$31,200 per year, and four salesclerks who each earn \$500 per week, or \$26,000 per year for each salesclerk.
- The full salaries of two salesclerks are charged to Department 100. The full salary of one salesclerk is charged to Department 200. The salary of the fourth clerk, who works half-time in both departments, is divided evenly between the two departments.
- Eliminating Department 200 would avoid the sales salaries and the office salary currently allocated to it. However, management prefers another plan. Two salesclerks have indicated that they will be quitting soon. Management believes that their work can be done by the other two clerks if the one office worker works in sales half-time. Eliminating Department 200 will allow this shift of duties. If this change is implemented, half the office worker's salary would be reported as sales salaries and half would be reported as office salary.
- The store building is rented under a long-term lease that cannot be changed. Therefore, Department 100 will use the space and equipment currently used by Department 200.
- Closing Department 200 will eliminate its expenses for advertising, bad debts, and store supplies; 70% of the insurance expense allocated to it to cover its merchandise inventory; and 25% of the miscellaneous office expenses presently allocated to it.

Required

- Prepare a three-column report that lists items and amounts for (a) the company's total expenses (including cost of goods sold)—in column 1, (b) the expenses that would be eliminated by closing Department 200—in column 2, and (c) the expenses that will continue—in column 3.
- Prepare a forecasted annual income statement for the company reflecting the elimination of Department 200 assuming that it will not affect Department 100's sales and gross profit. The statement should reflect the reassignment of the office worker to one-half time as a salesclerk.

Check Total expenses
(a) \$685,500, (b) \$45,100

Forecasted net
income without Department
200, \$31,510

Analysis Component

- Reconcile the company's combined net income with the forecasted net income assuming that Department 200 is eliminated (list both items and amounts). Analyze the reconciliation and explain why you think the department should or should not be eliminated.