Discontinued Operations

Accounting presentation created by
Rex A Schildhouse
2015-01-01
www.schildhouse.com

Discontinued Operations

- Making the decision to discontinue a division, department or product is actually rather complex and involves more than shown here.
- You may have customers because of your product mix and changing it may have indirect sales issues.

Discontinued Operations

- Here is our company's three divisions.
- Fixed operating expenses are those from the costs of operating headquarters and are allocated to each division.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	100,000.00	25,000.00	10,000.00	135,000.00
Operating income:	10,000.00	(15,000.00)	15,000.00	10,000.00

Discontinued Operations

- In the current situation, Okay Division is operating at a loss.
- However, reading for detail shows that this loss is generated by the allocation of headquarters costs.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	100,000.00	25,000.00	10,000.00	135,000.00
Operating income:	10,000.00	(15,000.00)	15,000.00	10,000.00

Discontinued Operations

- Directors and officers who do not read for detail and appreciate the presentation of values in the financials decide to close the Okay Division as this should increase Total Operating Income from $10,000 to $25,000.

Income Statement	**Best Division:**	**Okay Division:**	**Good Division**	**Total:**
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	100,000.00	25,000.00	10,000.00	135,000.00
Operating income:	10,000.00	(15,000.00)	15,000.00	10,000.00

Discontinued Operations

- With the Okay Division closed the cost of headquarters does not change.
- Now Best Division is burdened with $120,000 and Good Division is burdened with $15,000 of Fixed Operating Expenses from headquarter costs of $135,000.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00		$90,000.00	$890,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00		35,000.00	490,000.00
Variable operating expenses:	75,000.00		15,000.00	90,000.00
Contribution margin:	270,000.00		40,000.00	310,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00		15,000.00	175,000.00
Fixed operating expenses:	120,000.00		15,000.00	135,000.00
Operating income:	(10,000.00)		10,000.00	0.00

Discontinued Operations

- While the directors and officers expected Total Operating Income to increase from $10,000 to $25,000 by eliminating the $15,000 loss of Okay, the result was a loss of $10,000.
- With Okay gone Total Operating Income is $0.00!

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00		$90,000.00	$890,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00		35,000.00	490,000.00
Variable operating expenses:	75,000.00		15,000.00	90,000.00
Contribution margin:	270,000.00		40,000.00	310,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00		15,000.00	175,000.00
Fixed operating expenses:	120,000.00		15,000.00	135,000.00
Operating income:	(10,000.00)		10,000.00	0.00

Discontinued Operations

- Since the problem is now Best, directors and officers decide to close Best.
- With the closing of Best Total Operating Income ***MUST*** increase.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00		$90,000.00	$890,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00		35,000.00	490,000.00
Variable operating expenses:	75,000.00		15,000.00	90,000.00
Contribution margin:	270,000.00		40,000.00	310,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00		15,000.00	175,000.00
Fixed operating expenses:	120,000.00		15,000.00	135,000.00
Operating income:	(10,000.00)		10,000.00	0.00

Discontinued Operations

- So Best is closed and, this time the cost of operating headquarters is reduced from $135,000 to $45,000.
- And Total Operating Income is a loss of $20,000.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:			$90,000.00	$90,000.00
Less: Variable expenses:				
Variable manufacturing costs:			35,000.00	35,000.00
Variable operating expenses:			15,000.00	15,000.00
Contribution margin:			40,000.00	40,000.00
Less: Fixed expenses				
Fixed manufacturing costs:			15,000.00	15,000.00
Fixed operating expenses:			45,000.00	45,000.00
Operating income:			(20,000.00)	(20,000.00)

Discontinued Operations

- So the solution must be to close the company!
- Time out!
- The cost of headquarters appears to be excessive.
- However, the company was profitable, $10,000.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	100,000.00	25,000.00	10,000.00	135,000.00
Operating income:	10,000.00	(15,000.00)	15,000.00	10,000.00

Discontinued Operations

- In this allocation concept headquarters burden is allocated by percentage of sales revenues.
- While Okay is still “losing” it is contributing $10,000 to headquarters burden.

Fixed operating expenses allocated based on percentage of sales revenues.				
Income Statement	**Best Division:**	**Okay Division:**	**Good Division**	**Total:**
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	106,403.94	16,625.62	11,970.44	135,000.00
Operating income:	3,596.06	(6,625.62)	13,029.56	10,000.00

Discontinued Operations

- In this example the headquarters burden is allocated by percentage of contribution margin.
- Okay is still losing, but still contributing.

Fixed operating expenses allocated based on percentage of contribution margin.				
Income Statement	**Best Division:**	**Okay Division:**	**Good Division**	**Total:**
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	101,250.00	18,750.00	15,000.00	135,000.00
Operating income:	8,750.00	(8,750.00)	10,000.00	10,000.00

Discontinued Operations

- Assume that headquarters costs are reduced by 10% and allocated by the percentage of sales revenues.
- Okay is still contributing and "losing."
- Total operating income is up to $23,500.
- That is an improvement.

Income Statement	Best Division:	Okay Division:	Good Division	Total:
Sales revenues:	$800,000.00	$125,000.00	$90,000.00	$1,015,000.00
Less: Variable expenses:				
Variable manufacturing costs:	455,000.00	62,500.00	35,000.00	552,500.00
Variable operating expenses:	75,000.00	12,500.00	15,000.00	102,500.00
Contribution margin:	270,000.00	50,000.00	40,000.00	360,000.00
Less: Fixed expenses				
Fixed manufacturing costs:	160,000.00	40,000.00	15,000.00	215,000.00
Fixed operating expenses:	95,763.55	14,963.05	10,773.40	121,500.00
Operating income:	14,236.45	(4,963.05)	14,226.60	23,500.00

Discontinued Operations

- Discontinued operations, as shown in the first sequence, is called the death spiral.
- As divisions, departments, or products are dropped, headquarters or other burdens are not reduced appropriately.
- When would a headquarters group recommend ending their positions as the company winds down?

Discontinued Operations

- The saving grace from the start may have been to evaluate the costs incurred by headquarters and trim those costs first since all three divisions are contributors and headquarters is a taker.

Discontinued Operations

The end.