

# **COST ACCOUNTING**

**A MANAGERIAL EMPHASIS**



**HORNGREN DATAR RAJAN BEAUBIEN GRAHAM**

**SEVENTH CANADIAN EDITION**

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Stanford University

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To Our Families  
The Horngren Family (CH)  
Swati, Radhika, Gayatri, Sidharth (SD)  
Gayathri, Sanjana, Anupama (MVR)

This effort is dedicated to Ian, Megan, Evan, Lucy, Alec and Molly  
(and Charlie, too).

*-Louis Beaubien*

To Professor Howard Teal (a previous Canadian author of Horngren  
et al.) who, along with Professor Rick Robertson, first got me excited about  
accounting. And to my wife Joan and daughter Adrienne, who put up with/  
supported me during my “creative” process!

*-Chris Graham*

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# Brief Contents

Preface xiv

## **Part One Cost Accounting Fundamentals 1**

- 1 The Accountant's Vital Role in Decision Making 1
- 2 An Introduction to Cost Terms and Purposes 24
- 3 Cost–Volume–Profit Analysis 57
- 4 Job Costing 97
- 5 Activity-Based Costing and Management 134

Available online on MyAccountingLab: End-of-Part Case 1: Katherine's Truffle Creations—The Early Years

## **Part Two Tools For Planning And Control 172**

- 6 Master Budget and Responsibility Accounting 172
- 7 Flexible Budgets, Variances, and Management Control: I 226
- 8 Flexible Budgets, Variances, and Management Control: II 275
- 9 Income Effects of Denominator Level on Inventory Valuation 318

Available online on MyAccountingLab: End-of-Part Case 2: Katherine's Chocolate Creations—The Second Store

## **Part Three Cost Information For Decisions 359**

- 10 Analysis of Cost Behaviour 359
- 11 Decision Making and Relevant Information 409
- 12 Pricing Decisions: Profitability and Cost Management 453
- 13 Strategy, the Balanced Scorecard, and Profitability Analysis 489

Available online on MyAccountingLab: End-of-Part Case 3: Katherine's Chocolate Kompany Goes Public

## **Part Four Cost Allocation And Revenues 525**

- 14 Period Cost Application 525
- 15 Cost Allocation: Joint Products and Byproducts 561
- 16 Revenue and Customer Profitability Analysis 596
- 17 Process Costing 639
- 18 Spoilage, Rework, and Scrap 681

Available online on MyAccountingLab: End-of-Part Case 4: Non-Manufacturing Costs (and Benefits)

## **Part Five Control and Budgeting Strategies 712**

- 19 Inventory Cost Management Strategies 712
- 20 Capital Budgeting: Methods of Investment Analysis 752
- 21 Transfer Pricing and Multinational Management Control Systems 794
- 22 Multinational Performance Measurement and Compensation 827

Available online on MyAccountingLab: End-of-Part Case 5: Consolidating Manufacturing; End-of-Part Case 6: Winnipeg Beckons; End-of-Part Case 7: Batteries for Everyone: Assessing Performance

## **Appendix A Notes on Compound Interest and Interest Tables 871**

Glossary 877

Name Index 892

Subject Index 896

# Table of Contents

Preface xiv

## Part One Cost Accounting Fundamentals 1

### 1 The Accountant's Vital Role in Decision Making 1

#### **iTunes Variable Pricing: Downloads Are Down, but Profits Are Up**

Accounting Systems: Financial and Management Accounting 2

Strategic Decisions and Management Accounting 3

Value-Chain And Supply-Chain Analysis and Key Success Factors 4

Value-Chain Analysis 4

Supply-Chain Analysis 5

Key Success Factors (KSF) 5

#### **Concepts in Action: Management Accounting Beyond the Numbers**

Decision Making, Planning, and Control: The Five-Step Decision-Making Process 7

Key Management Accounting Guidelines and Organization Structure 9

Cost-Benefit Approach 9

Behaviourial and Technical Considerations 9

Different Costs for Different Purposes 10

Corporate Structure and Governance: Accountability, Ethics, and Social Responsibility 10

Corporate Governance 11

Professional Ethics 12

Institutional Support 12

Corporate Social Responsibility (CSR) 13

Sustainability Accounting 14

Alternative Reporting 15

*Pulling It All Together—Problem for Self-Study 16 | Summary Points 17 | Terms to Learn 17 | Assignment Material 18 | Short-Answer Questions 18 | Exercises 18 | Problems 20 | Collaborative Learning Case 23*

### 2 An Introduction to Cost Terms and Purposes 24

#### **High Fixed Costs Bankrupt Twinkie Maker**

Costs and Cost Terminology 25

Commonly Used Classifications of Manufacturing Costs 25

Direct Costs and Indirect Costs 26

Factors Affecting Direct/Indirect Cost Classifications 27

Prime Costs and Conversion Costs 27

Cost-Behaviour Patterns: Variable Costs and Fixed Costs 28

Variable Costs 28

Fixed Costs 28

Cost Drivers 30

#### **Concepts in Action: How AutoShare Reduces Business Transportation Costs**

Total Costs and Unit Costs 31

Unit Costs 31

Cost of Goods Sold and the Statement of Comprehensive Income 32

Inventory Valuation and the Statement of Financial Position 34

Types of Inventory 35

Inventoriable Costs 35

Period Costs 35

Illustrating the Flow of Inventoriable Costs: A Manufacturing-Sector Example 36

Inventoriable Costs and Period Costs for a Merchandising Company 38

Measuring and Classifying Costs Requires Judgment 38

Measuring Labour Costs 38

Decision Framework and Flexibility of Costing Methods 40

#### **Concepts in Action: Don't Overcharge the Government**

*Pulling It All Together—Problem for Self-Study 42 | Summary Points 43 | Terms to Learn 44 | Assignment Material 44 | Short-Answer Questions 44 | Exercises 45 | Problems 50 | Collaborative Learning Cases 55*

### 3 Cost-Volume-Profit Analysis 57

#### **How "The Biggest Rock Show Ever" Turned a Big Profit**

Essentials of CVP Analysis 58

CVP Analysis: An Example 58

Expressing CVP Relationships 60

Contribution Margin Percentage: Breakeven Point in Revenue 63

Using CVP to Calculate a Target Operating Income 63

Contribution Margin, Gross Margin, Operating Margin, and Net Income Margin 64

Target Net Income and Income Taxes 64

Using CVP Analysis to Make More Complex Decisions 65

CVP Analysis for Decision Making 65

Decision to Advertise 66

Decision to Reduce Selling Price 66

Margin of Safety and Risk 67

Alternative Fixed- and Variable-Cost Structures 68

Operating Leverage 69

#### **Concepts in Action: Sky-High Fixed Costs Trouble XM Satellite Radio**

Decision Models and Uncertainty 70

Role of a Decision Model 71

Expected Value 71

- Effects of Sales Mix on Income 72
  - Multiple Cost Drivers 74
  - CVP Analysis in Non-Profit and Public Sector Organizations 74

*Pulling It All Together—Problem for Self-Study 75 | Summary Points 78 | Terms to Learn 79 | Assignment Material 79 | Short-Answer Questions 79 | Exercises 79 | Problems 86 | Collaborative Learning Cases 96*

## 4 Job Costing 97

### What Does It Cost to Do the Job?

- Building Blocks of Costing Systems 98
  - Job-Costing and Process-Costing Systems 98
  - Job Costing: Evaluation and Implementation 99
- Actual, Budgeted, and Normal Costing 100
  - Normal Costing 100
  - Additional Points to Consider When Calculating Job-Cost Allocation Rates 104

### Concepts in Action: Job Costing on the Next-Generation Military Fighter Plane

- Actual Costing 105
- A Normal Job-Costing System and Cost Flow 106
  - General Ledger 107
  - Explanations of Transactions 108
  - Subsidiary Ledgers 109
  - Budgeted Indirect Costs and End-of-Accounting-Year Adjustments 112
  - Adjusted Allocation-Rate Approach 112
  - Proration Approach 113
  - Write-off to Cost of Goods Sold Approach 114
  - Choice Among Approaches 114

*Pulling it all Together—Problem for Self-Study 115 | Summary Points 117 | Terms to Learn 118 | Assignment Material 118 | Short-Answer Questions 118 | Exercises 118 | Problems 126 | Collaborative Learning Cases 131*

## 5 Activity-Based Costing and Management 134

### Accurate Assignment = Better Profit

- Product Costing: Overcosting and Undercosting 135
  - Undercosting and Overcosting 135
  - Product-Cost Cross-Subsidization 136
- Simple Costing System at Plastim Corporation 136
  - Design, Manufacturing, and Distribution Processes 136
  - Overview of Plastim's Simple Costing System 137
  - Applying the Five-Step Decision-Making Process at Plastim 139
- Guidelines for Refining a Costing System 140
  - Activity-Based Costing Systems 140
    - Plastim's ABC System 140
    - Cost Hierarchies 142
- Implementing Activity-Based Costing 144
- Comparing Alternative Costing Systems 146

- Considerations in Implementing Activity-Based-Costing Systems 147

### Concepts in Action: Hospitals Use Time-Driven Activity-Based Costing to Reduce Costs and Improve Care

- ABC: The Foundation of ABM 149
  - Pricing and Product-Mix Decisions 149
  - Cost Reduction and Process Improvement Decisions 149
  - Design Decisions 150

### Concepts in Action: If Only Everything Did Not Depend on Everything Else

- ABC in Service and Merchandising Companies 151

*Pulling It All Together—Problem for Self-Study 152 | Summary Points 154 | Terms to Learn 155 | Assignment Material 155 | Short-Answer Questions 155 | Exercises 156 | Problems 164 | Collaborative Learning Cases 171*

## Part Two Tools For Planning And Control 172

## 6 Master Budget and Responsibility Accounting 172

### Budgets Communicate Choices

- The Decision Framework and Budgets 173
  - Advantages of Budgets 174
  - Approaches to Budgeting 175
  - Operating and Strategic Performance Assessment 176
  - Coordination and Communication 176
- The Master Operating Budget 177
  - Time Coverage 177
  - Steps in Developing An Operating Budget 177
  - Basic Data and Requirements 179
  - Preparing a Master Operating Budget 181
- Preparing the Cash Budget 187

### Concepts in Action: Web-Enabled Budgeting and Hendrick Motorsports

- Preparation of the Cash Budget 190
- Responsibility Versus Controllability 194
  - Organizational Structure and Responsibility 194
  - Feedback 196
  - Definition of Controllability 196
  - Emphasis on Information and Behaviour 197
  - Human Aspects of Budgeting 197

### Concepts in Action: Management Accounting and the Corporate Governance Laws

- Budgeting: A Process In Transition 198

*Pulling It All Together—Problem for Self-Study 199*

### APPENDIX: Three Budget Strategies: Sensitivity Analysis, Kaizen Budgeting, and Activity-Based Budgets 204

*Summary Points 207 | Terms to Learn 207 | Assignment Material 208 | Short-Answer Questions 208 | Exercises 208 | Problems 213 | Collaborative Learning Cases 223*



## 7 Flexible Budgets, Variances, and Management Control: I 226

### Keeping It Real

The 5 DM Framework and Variance Analyses 227

Static and Flexible Budgets 227

The Costing System At Webb Company 228

Static-Budget Variances 229

Developing a Flexible Budget From the Cost MIS 231

Flexible-Budget Variances and Sales-Volume Variances 232

Direct Variable Rate and Efficiency Variances 235

An Illustration of Rate and Efficiency Variances for Inputs 236

Rate Variances 237

Efficiency Variances 238

Presentation of Rate and Efficiency Variances for Inputs 239

Flexible Budgeting and Activity-Based Costing 241

Relating Batch Costs to Product Output 242

Rate and Efficiency Variances 243

Focus On Hierarchy 243

Managerial Uses of Variance Analyses 244

Performance Evaluation 244

Financial and Nonfinancial Performance Measures 244

When to Investigate Variances 245

Continuous Improvement 245

### Concepts in Action: Starbucks Reduces Direct-Cost Variances to Brew a Turnaround

Impact of Inventories 247

*Pulling It All Together—Problem for Self-Study 247*

### APPENDIX 7A: Budgets, Benchmarks, and Standards 249

### APPENDIX 7B: Mix and Yield Level 4 Variances for Substitutable Inputs 254

*Summary Points 258 | Terms to Learn 259 | Assignment Material 259 | Short-Answer Questions 259 | Exercises 260 | Problems 265 | Collaborative Learning Cases 273*

## 8 Flexible Budgets, Variances, and Management Control: II 275

### Tracking Performance

Flexible-Budget MOH Cost Variances 276

The 5DM Framework and Overhead Costs 277

Assigning Fixed Manufacturing Overhead at Webb 278

Fixed Overhead Cost Variance Calculation and Analysis 278

Production-Volume Variance Calculation and Analysis 279

Journal Entries for Fixed Overhead Costs and Variances 282

### Concepts in Action: Cost Allocation Base Denominator Decision: There Is a Right Way

Flexible-Budget Variable Overhead Variances 284

Variable Overhead Cost Variance Calculations and Analyses 285

Level 2 Variable Manufacturing Overhead Variance Analysis 286

Level 3 Variable Manufacturing Overhead Rate and Efficiency Variances 287

Journal Entries for Variable Overhead Costs and Variances 290

Activity-Based Costing and Variance Analysis 291

ABC Variance Analyses 291

ABC Variance Analysis for Fixed Manufacturing Overhead Cost 293

Summary of All Overhead Cost Variances 294

### Concepts in Action: Interdependencies and Shared Benefits

Non-manufacturing Variance Analysis 297

Nonfinancial Performance Measures 297

*Pulling It All Together—Problem for Self-Study 300 | Summary Points 302 | Terms to Learn 303 | Assignment Material 303 | Short-Answer Questions 303 | Exercises 303 | Problems 308 | Collaborative Learning Cases 316*

## 9 Income Effects of Denominator Level on Inventory Valuation 318

### Capacity-Level Choices

Denominator Levels: A Complex Decision with Complex Effects 319

The Decision Framework and Denominator Choice 321

Effects on Reporting, Costing, Pricing, and Evaluation 323

Product Costing 325

Product Pricing: the Downward Demand Spiral 326

### Concepts in Action: Denominator-Level Choice Reflects Recoverable Costs in Strategic Pricing

Performance Evaluation 328

Capacity Decisions and Denominator-Level Issues 328

Inventory Valuation and Operating Income 329

Absorption and Variable Inventory Valuation Assumptions 329

Comparison of Standard Variable Costing and Absorption Costing 331

### Concepts in Action: Capacity at Nissan

Comparative Statements of Comprehensive Income 334

Explaining Differences in Operating Income 336

Effect of Sales and Production on

Operating Income 337

Performance Evaluation: Undesirable Buildup of Inventories 338

*Pulling It All Together—Problem for Self-Study 340 | Summary Points 341*

### APPENDIX 9A: Throughput: Super-Variable Costing 342

**APPENDIX 9B: Breakeven Under Two Costing**

Policies 344

*Terms to Learn 346 | Assignment Material 346 | Short-Answer Questions 346 | Exercises 347 | Problems 350 | Collaborative Learning Cases 357*

**Part Three Cost Information For Decisions 359****10 Analysis of Cost Behaviour 359****Cisco Understands Its Costs While Helping the Environment**

Basic Assumptions and Examples of Cost Functions 360

Basic Assumptions 360

Linear Cost Functions 360

Cost Classification: Choice of Cost Object 361

The Cause-and-Effect Criterion 362

Cost Drivers and the Decision-Making Process 363

Cost Estimation Methods 363

Industrial Engineering Method 363

Conference Method 364

Account Analysis Method 364

Quantitative Analysis Method 365

Steps in Estimating a Cost Function Using Quantitative

Analysis 365

The High-Low Method Compared to Regression

Analysis 367

Nonlinear Cost Functions 369

Time as a Cost Driver and as a Competitive Tool 370

Customer-Response Time and On-Time

Performance 370

Time as a Cost and Performance Driver 371

Relevant Costs of Time 372

Relevant Revenues of Time 373

Quality as an Element of Cost 374

Analyzing Quality 375

**Concepts in Action: What Does It Cost to Send a Text Message?**

Data Collection and Adjustment Issues 379

*Pulling it all Together—Problem for Self-Study 380***APPENDIX 10A: Regression Analysis 383****APPENDIX 10B: Learning Curves 391**

*Summary Points 394 | Terms to Learn 396 | Assignment Material 396 | Short-Answer Questions 396 | Exercises 397 | Problems 402 | Collaborative Learning Cases 405*

**11 Decision Making and Relevant Information 409****Relevant Costs, JetBlue, and Twitter**

Relevant Information and Decision-Making 410

The Concept of Relevance 410

Relevant Costs and Relevant Revenues 410

Quantitative and Qualitative Information 412

Output Level Changes: Short- and Long-Term Decisions 413

Outsourcing—Make or Buy—and Idle Facilities 415

Potential Problems in Relevant-Cost Analysis 417

**Concepts in Action: The LEGO Group**

Opportunity Costs and Outsourcing 418

The “Total-Alternatives” Approach 419

The Opportunity-Cost Approach 420

The Carrying Costs of Inventory 421

Product Mix Decisions 422

The Theory of Constraints 423

Irrelevance of Past Costs and Equipment Replacement Decisions 425

Decisions and Performance Evaluation 426

**APPENDIX 11A: Linear Programming 428****APPENDIX 11B: Using Excel Solver 430**

*Pulling it all Together—Problem for Self-Study 433 | Summary Points 435 | Terms to Learn 436 | Assignment Material 436 | Short-Answer Questions 436 | Exercises 436 | Problems 442 | Collaborative Learning Case 451*

**12 Pricing Decisions: Profitability and Cost Management 453****Fair and Square: Not What J. C. Penney Customers Wanted**

Major Influences on Pricing 454

Costing and Pricing for the Short Run 455

Relevant Costs for Short-Run Pricing Decisions 455

Strategic and Other Factors in Short-Run Pricing 455

Effect of Time Horizon on Short-Run Pricing

Decisions 456

Costing and Pricing for the Long Run 456

Calculating Product Costs for Long-Run Pricing

Decisions 456

Target Costing for Target Pricing 459

Understanding Customers’ Perceived Value 459

Doing Competitor Analysis 459

Implementing Target Pricing and Target Costing 459

Value-Analysis and Cross-Functional Teams 460

Cost-Plus Pricing 462

**Concepts in Action: Operating Income Analysis Reveals Strategic Challenges at Best Buy**

Alternative Cost-Plus Methods 464

Cost-Plus Pricing Contrasted Against Target

Pricing 465

Fixed and Variable Cost Coverage 466

Life-Cycle Pricing and Relevant Qualitative Factors in Pricing 466

Developing Life-Cycle Reports 467

Conducting Fair Business and Pricing Decisions 468

Environmental Sustainability 470

*Pulling it all Together—Problem for Self-Study 472 | Summary Points 474 | Terms to Learn 475 | Assignment Material 475 | Short-Answer Questions 475 | Exercises 476 | Problems 482 | Collaborative Learning Case 487*

### 13 Strategy, the Balanced Scorecard, and Profitability Analysis 489

#### The Balanced Scorecard at Volkswagen do Brasil

Five Forces Analysis to Define Strategic Alternatives 490

The Decision Framework Applied to Chipset's Strategy 492

Strategy Maps and the Balanced Scorecard 494

Balanced Scorecard: Measures of Performance 495

Four Perspectives of the Balanced Scorecard 495

#### Concepts in Action: Balanced Scorecard Helps Infosys Transform into a Leading Consultancy

Nonfinancial BSC Measures at Chipset 498

Implementing a Balanced Scorecard 498

Features of a Good Balanced Scorecard 499

Pitfalls When Implementing a Balanced Scorecard 500

Evaluation using the BSC 500

The Growth Component 502

The Price-Recovery Component 503

The Productivity Component 504

Further Analysis of Growth, Price-Recovery, and Productivity Components 505

Specific Productivity Improvement Measures 506

Calculating and Comparing Total Factor Productivity 507

Downsizing and the Management of Processing Capacity 508

Engineered and Discretionary Costs 509

Identifying Unused Capacity for Engineered and Discretionary Overhead Costs 509

Managing Unused Capacity 509

*Pulling it all Together—Problem for Self-Study 510 | Summary Points 513 | Terms to Learn 514 | Assignment Material 514 | Short-Answer Questions 514 | Exercises 515 | Problems 519 | Collaborative Learning Cases 523*

### Part Four Cost Allocation And Revenues 525

### 14 Period Cost Application 525

#### Good Period Overhead Cost-Application Methods Improve Management Decisions

Purposes of Cost Allocation 526

Four Possible Purposes 527

Criteria to Guide Cost-Allocation Decisions 528

Deciding Between Single- and Dual-Rate Cost Methods 529

Single-Rate and Dual-Rate Methods 530

Allocation Based on the Demand for (or Usage of) Computer Services 531

Allocation Based on the Supply of Capacity 532

Single-Rate Versus Dual-Rate Method 533

Budgeted Versus Actual Costs, and the Choice of Allocation Base 534

Budgeted Versus Actual Rates 534

Budgeted Versus Actual Usage 535

Manufacturing Overhead Cost Allocation Methods are Irrelevant 536

#### Concepts in Action: Allocation Decisions Critical to City of Atlanta

Deciding Among Direct, Step-Down, and Reciprocal Cost Allocation Methods 537

Relevance 538

Direct Method 539

Step-Down Method 539

Reciprocal Method—Linear Equation and Solver 542

Allocating Common Costs 546

Stand-Alone Cost Allocation Method 546

Incremental Cost Allocation Method 546

Justifying Reimbursement Costs 547

Contracting 548

Fairness of Pricing 548

*Pulling it all Together—Problem for Self-Study 548 | Summary Points 550 | Terms to Learn 551 | Assignment Material 551 | Short-Answer Questions 551 | Exercises 552 | Problems 556*

### 15 Cost Allocation: Joint Products and Byproducts 561

#### Challenges of Joint Cost Allocation

Joint-Cost Basics 562

Approaches to Allocating Joint Costs 564

Physical Measure Method 566

Sales Value at Splitoff Method 567

Two More Methods to Allocate Joint Cost 568

Estimated Net Realizable Value (NRV) Method 568

Constant Gross Margin Percentage of NRV Method 570

Comparison of the Four Methods 571

Irrelevance of Joint Costs for Decision Making 573

Sell or Process Further? 573

Challenges for Management Accountants 574

#### Concepts in Action: Overcoming the Challenges of Joint Cost Allocation

Accounting for Byproducts 575

Method A: Byproducts are Recognized When Production is Completed 576

Method B: Byproducts are Recognized at Time of Sale 578

*Pulling it all Together—Problem for Self-Study 578 | Summary Points 581 | Terms to Learn 581 | Assignment Material 582 | Short-Answer Questions 582 | Exercises 582 | Problems 590 | Collaborative Learning Cases 594*

### 16 Revenue and Customer Profitability Analysis 596

#### Revenue

Revenue Allocation and Bundled Products 597

#### Concepts in Action: Revenue Allocation by the Government and First Nations

Deciding on a Revenue-Allocation Method 598

- Stand-Alone Revenue-Allocation Methods 599
  - Incremental Revenue-Allocation Method 600
  - Other Revenue-Allocation Methods 603
  - ABC: The Cost Object is the Customer 603
    - Customer ABC Analysis 603
  - Contribution Margin Variance Analyses 607
    - Static-Budget Contribution Margin Variance 609
    - Flexible-Budget and Sales-Volume Contribution Margin Variances 609
    - Sales-Mix and Sales-Quantity Contribution Margin Variances 610
    - Market-Share Variance 613
    - Market-Size Contribution Margin Variance 613
  - Concepts in Action: Dropping Small, Local Business Customers Earns HSBC Complaints and Bad Publicity**
  - Customer Profitability Analysis 616
    - Assessing Customer Value 617
  - Customer Mix Analysis 618
    - Drop a Customer 619
    - Add a Customer 620
    - Drop or Add Branches 620
  - Pulling it all Together—Problem for Self-Study 622 | Summary Points 624 | Terms to Learn 624 | Assignment Material 624 | Short-Answer Questions 625 | Exercises 625 | Problems 628 | Collaborative Learning Case 638*
- 17 Process Costing 639**
- Allocation Affects Net Income—Reliable Estimates Are Important**
  - Process-Costing and Decision-Making 640
    - Process Costing: Alternative Methods 642
  - Concepts in Action: NI 52-109—Internal Control System Design**
  - Weighted-Average Method with no Beginning Wip Inventory 644
    - Global Defence—Ending WIP Inventory Valuation Using the Weighted-Average Method 646
    - Journal Entries 648
  - Weighted-Average Method with Beginning and Ending WIP Inventory 650
  - First-in, First-Out and Standard-Cost Methods 653
    - Comparing Weighted-Average and FIFO Methods 657
    - Computations Under Standard Costing 658
    - Accounting for Variances 660
    - Hybrid-Costing Systems 660
  - Transferred-in Costs in Process Costing 661
    - Transferred-in Costs and the Weighted-Average Method 663
    - Transferred-in Costs and the FIFO Method 665
    - Common Mistakes with Transferred-in Costs 667
  - Pulling it all Together—Problem for Self-Study 668 | Summary Points 669 | Terms to Learn 670 | Assignment Material 670 | Short-Answer Questions 670 | Exercises 671 | Problems 675 | Collaborative Learning Cases 679*
- 18 Spoilage, Rework, and Scrap 681**
- Spoilage and Rework—Building Planes That Can't be Delivered**
  - Defining and Accounting for Spoilage, Rework, and Scrap 682
    - Process Costing and Spoilage 683
  - Process Costing with Spoilage Under the Weighted-Average and FIFO Methods 685
    - Weighted-Average Method and Spoilage 686
    - FIFO Method and Spoilage 687
  - Process Costing Standard Costs 690
  - Concepts in Action: Managing Waste and Environmental Costs at Toyota**
  - Journal Entries 693
  - Allocating Costs of Normal Spoilage 693
    - Inspection and Spoilage at Intermediate Stages of Completion 694
  - Job Costing and Spoilage 695
  - Reworked Units and Scrap 696
    - Accounting for Scrap 698
    - Recognizing Scrap at the Time of Sale 698
    - Recognizing Scrap at the Time of Production 699
  - Pulling it all Together—Problem for Self-Study 700 | Summary Points 701 | Terms to Learn 701 | Assignment Material 702 | Short-Answer Questions 702 | Exercises 702 | Problems 706 | Collaborative Learning Case 711*
- Part Five Control and Budgeting Strategies 712**
- 19 Inventory Cost Management Strategies 712**
- Toyota Plans Changes after Millions of Defective Cars Are Recalled**
  - Inventory Management 713
    - Costs Associated with Goods for Sale 713
    - Economic Order Quantity Procurement Model 714
    - When to Order, Assuming Certainty 716
    - Safety Stock 717
    - Just-in-Time (JIT) Procurement and EOQ Model Parameters 718
  - Concepts in Action: Overcoming Wireless Data Bottlenecks**
  - Challenges in Supply-Chain Cost Management 720
    - Estimating Relevant Costs of a Supply Chain 721
    - Cost of a Prediction Error 721
    - Goal-Congruence Issues 722
  - Relevance and the JIT Strategy of Supply-Chain Management 722
    - Performance Measures and Control 725
  - Inventory Management: MRP and ERP 725
    - Enterprise Resource Planning (ERP) Systems 726
  - Backflush Costing 726
    - Simplified Normal or Standard Costing 727
    - Special Considerations in Backflush Costing 734

**Concepts in Action: Inventory Management as Strategy**

Lean Accounting 735

*Pulling it all Together—Problem for Self-Study 737 | Summary Points 739 | Terms to Learn 740 | Assignment Material 740 | Short-Answer Questions 740 | Exercises 741 | Problems 744 | Collaborative Learning Case 750*

**20 Capital Budgeting: Methods of Investment Analysis 752**

**Capital Budgeting for Sustainable Business**

Capital Budgeting and Decision-Making (SDM Approach) 753

A Note on Sources of Capital and Timing of Investments 755

Discounted Cash Flows and the Time Value of Money 755

Net Present Value Method 756

Internal Rate-of-Return Method 758

Comparison of Net Present Value and Internal Rate of Return Methods 759

Sensitivity Analysis 760

Income Tax and DCF in Capital Budgeting 761

Tax Shields and the Effect on Investment Cash Flows 761

Relevant Information and DCF 764

Non-DCF methods in Capital Budgeting 766

Payback Period 766

Accrual Accounting Rate of Return 768

Strategic Factors in Capital Budgeting Decisions 769

Customer Value and Capital Budgeting 769

**Concepts in Action: Capital Budgeting at Disney**

Investment in Research and Development 771

Capital Budgeting and Control: Evaluation and Application 771

Management Control: Performance Evaluation 771

Management Control: The Investment Activity 772

Management Control: The Post-Investment Audit 772

*Pulling it all Together—Problem for Self-Study 774 | Summary Points 776*

**APPENDIX 20A: Capital Budgeting and Inflation 777**

**APPENDIX 20B: The Weighted Average Cost of Capital 778**

*Terms to Learn 780 | Assignment Material 780 | Short-Answer Questions 780 | Exercises 781 | Problems 787 | Collaborative Learning Cases 791*

**21 Transfer Pricing and Multinational Management Control Systems 794**

**Software Multi-Nationals and Transfer Pricing**

Management Control Systems 795

Formal and Informal Systems 795

Effective Management Control 795

Organizational Structure and Decentralization 796

Benefits of Decentralization 796

Costs of Decentralization 797

Decentralization in Multinational Companies 797

Decisions About Responsibility Centres 797

**Concepts in Action: Transfer Pricing Dispute Temporarily Stops the Flow of Fiji Water**

Transfer Pricing 798

Alternative Transfer-Pricing Methods 799

**Concepts in Action: US\$3.4 Billion Is an Incentive**

Criteria for Evaluating Transfer Prices 800

Transfer Pricing in Practice 801

Interprovincial Transfers and Taxes 803

Market-Based Transfer Prices 804

Distress Prices 804

Cost-Based and Negotiated Transfer Prices 805

Full-Cost Bases 805

Variable Cost Bases 806

Prorating the Difference Between Minimum and Maximum Transfer Prices 806

Negotiated Transfer Prices and MNC Issues 807

Dual Pricing 807

A General Guideline for Transfer-Pricing Situations 808

Multi-National Corporation (MNC) Transfer Pricing and Tax Considerations 810

**Concepts in Action: India Calls Vodafone on Transfer Pricing Policy**

*Pulling it all Together—Problem for Self-Study 812 | Summary Points 814 | Terms to Learn 815 | Assignment Material 815 | Short-Answer Questions 815 | Exercises 816 | Problems 821 | Collaborative Learning Cases 825*

**22 Multinational Performance Measurement and Compensation 827**

**Qualitative and Nonfinancial Measures Are Relevant**

Financial and Nonfinancial Performance

Measures 828

Governance and Compensation Decisions 828

**Concepts in Action: Barrick Gold Shareholders Object to Chair's \$17 Million Pay as Shares Decline 50%**

Accounting Performance Measures 832

Return on Investment 833

Residual Income 835

Economic Value Added 836

Return on Sales 837

Comparing Performance Measures 838

Selecting the Time Horizon 839

Defining "Investment" 840

Evaluating Performance Measurement Alternatives 840

Current Cost 840

Long-Term Assets: Gross or Net Book Value? 841

Selecting Performance Goals 843

Selecting the Level of Relevance—The Timing of Feedback 843

Performance Measurement in Multinational Companies	844
Calculating the Foreign Division's ROI in the Foreign Currency	844
Calculating the Foreign Division's ROI in Canadian Dollars	845
Levels of Analysis Differ Between Managers and Subunits	845
Benchmarks and Relative Performance Evaluation	847
Executive Performance Measures and Compensation	847
Team-Based Compensation Arrangements	849
Executive Compensation Arrangements	849
Strategy and Levers of Control	850

### **Concepts in Action: Courage—Boundaries and Beliefs**

*Pulling it all Together—Problem for Self-Study 853 | Summary Points 854 | Terms to Learn 855 | Assignment Material 855 | Short-Answer Questions 855 | Exercises 855 | Problems 862 | Collaborative Learning Cases 868*

### **Appendix A Notes on Compound Interest and Interest Tables 871**

**Glossary 877**

**Name Index 892**

**Subject Index 896**

# Preface

Success in any business—big or small—requires the use of cost and management accounting concepts to inform decision making. Cost accounting provides key data to managers for planning and control, as well as providing techniques for costing products and services and for measuring performance. This book focuses on how cost accounting helps managers make better decisions by using financial and nonfinancial information better. In order to build these skills, we focus on the basic concepts and analytical techniques that make cost accounting an essential part of business strategy.

## Hallmark Features of *Cost Accounting*

- ◆ Exceptionally strong emphasis on managerial uses of cost information
- ◆ Clarity and understandability of the text
- ◆ Excellent balance in integrating modern topics with traditional coverage
- ◆ Emphasis on human behaviour aspects
- ◆ Extensive use of real-world examples
- ◆ Ability to teach chapters in different sequences
- ◆ Excellent quantity, quality, and range of assignment material

The first 13 chapters provide the essence of a one-term (quarter or semester) course. There is ample text and assignment material in the book's 22 chapters for a two-term course. This book can be used immediately after the student has had an introductory course in financial accounting. Alternatively, this book can build on an introductory course in managerial accounting.

Deciding on the sequence of chapters in a textbook is a challenge. Since every instructor has a unique way of organizing his or her course, we utilize a modular, flexible organization that permits a course to be custom tailored. *This organization facilitates diverse approaches to teaching and learning.*

As an example of the book's flexibility, consider our treatment of process costing. Process costing is described in Chapter 17. Instructors interested in filling out a student's perspective of costing systems can move directly from job costing described in Chapter 4 to Chapter 17 without interruption in the flow of material. Other instructors may want their students to delve into activity-based costing and budgeting and more decision-oriented topics early in the course. These instructors may prefer to postpone discussion of process costing.

## New to This Edition

### Deeper Consideration of Global Issues

Businesses today have no choice but to integrate into an increasingly global ecosystem. Virtually all aspects of business—including supply chains, product markets, and the market for managerial talent—have become increasingly international in their outlook. To do this, we have focused on examples in **Vignette Boxes** and **Concepts in Action** which focus on the global context of businesses in the production, merchandising, and service sectors. We have also developed examples and discussions in the chapter material that focus on the importance of transfer pricing as a technique to manage tax strategy (Chapter 21), the different nature of process flows in inventory management (Chapter 19), and capital budgeting (Chapter 20).

We have expanded the discussion through the text on the role of accounting systems in fostering and supporting innovation and developing organizational strategy. We have also added ideas based on current research in areas of the balanced scorecard, performance management, and enterprise resource planning systems and information technology.

## Streamlined Presentation and Chapter-by-Chapter Changes

We continue to simplify and streamline our presentation to make it as easy as possible for students to learn the concepts, frameworks, and tools. We have attempted to balance this against the desire to provide comprehensive explanations reflecting current research and modern organizational practice, as well as to offer a complete set of problems for students to practise these concepts. There have been some major changes in the Seventh Canadian Edition of *Cost Accounting*. To ease your transition from the Sixth Canadian Edition, we highlight the following changes, by chapter.

Chapter 1 has been rewritten to include expanded discussions of ethics and sustainability. The chapter also reflects the shifting landscape of professional accounting in Canada, as we discuss the changes that are emerging with the creation of Chartered Professional Accountants (CPA) of Canada from the legacy designations: the Chartered Accountants of Canada, the Society of Certified Management Accountants of Canada, and the Certified General Accountants of Canada.

Chapters 2 and 3 have been revised to make it easier for students to understand core concepts in accounting and to provide the grounding for the decision-making framework to be used throughout *Cost Accounting*. The content also reflects real decision-making processes in real companies from the Canadian and global contexts.

Chapters 4 and 5 have been updated to include a substantial amount of new material to enhance the coverage of manufacturing overhead allocation and manufacturing overhead control. The material also highlights the process of developing cost allocation pools from standard accounting classifications. These changes are intended to advance the understanding of how costing systems such as activity-based costing can effectively be implemented.

Chapter 6 frames the budgeting process as a decision-making activity. The financial figures in the budget schedules and cash flow budget are now internally consistent. A list of commonly used budget techniques has been added. The discussion on sensitivity, kaizen, and activity-based costing budgets now appears in the appendix to the chapter.

Chapter 7 presents the levels of variance analysis in a more consistent manner. The discussion on Level 4 variances (substitutable inputs) now appears in the appendix to the chapter. The section on not-for-profit benchmarks has been rewritten to include a list of characteristics for good NFP benchmarks.

Chapter 8 has new calculations showing the importance of fixed overheads and break-even issues for the firm. Some of the discussions have been shortened to improve readability.

Chapter 9 has been updated to reflect ASPE/IFRS with regard to capacity decisions for external reporting. The sections on throughput costing and the impact of capacity decisions on break-even analysis have been moved to an appendix.

Chapters 10 and 11 are a practical guide to various cost estimation techniques and the determination of the relevance of costs. Chapter 19 from the Sixth Canadian Edition of *Cost Accounting* has been eliminated and the content redistributed to several chapters in the Seventh Canadian Edition—most significantly to Chapters 10 and 11. So, along with familiar discussions of regression analysis and enhanced topics on correlation versus causation, the chapter has new content such as the costs of quality and the impact of time on the costing and decision-making process.

Chapter 12 focuses on pricing decisions in the long- and short-term contexts, and builds on material in Chapters 10 and 11 to expand the understanding of opportunity and relevant costs in how a pricing decision is made.

Chapter 13 reflects the diverse applicability of the balanced scorecard as an evaluative, communication, and strategy formulation tool in decision making. Emphasis is placed on understanding its application in financial, operational, and sustainability decision making.



Chapter 14 contains new exhibits for the support cost allocation methods that combine a graphic presentation with the calculations. A summary chart comparing the advantages and disadvantages of the three methods has been added. References to matrix algebra and the appendix have been removed from the narrative.

Chapter 15 has been updated to reflect ASPE/IFRS with regard to joint cost allocations. The section and exhibits showing the production and sales method for byproduct accounting have been changed to eliminate the issues with rounding.

Chapter 16 discusses revenue allocation methods and customer profitability. The exhibits for revenue allocation have been summarized to allow for easier comparison of the various methods. The discussion around revenue variance analysis is now focused on the contribution margin approach.

In Chapters 17 and 18, a discussion of when to use process costing has been added to the narrative. A number of the exhibits were changed slightly to make them more consistent across the two chapters and to ensure numerical consistency.

Chapter 19 (formerly Chapter 20) builds on the efforts to streamline content in Chapters 10, 11, 17, and 18 and provides revised content to examine traditional and just-in-time purchasing. The focus remains on developing an effective costing strategy for inventory management.

Chapter 20 (formerly Chapters 21 and 22) represents one of the most significant changes for *Cost Accounting*. Previously, the discussion on capital budgeting spanned two chapters. The material has now been streamlined and consolidated to focus on the decision-making process of capital acquisitions, including the impact of tax in the Canadian context.

Chapter 21 (formerly Chapter 23) has been revised to address the use of transfer payments as a tax minimization strategy. The updated content focuses on real-world examples and broader strategic concepts including decentralization.

Chapter 22 (formerly Chapter 24) has been revised to focus on the increasing responsibility of the executives and boards of directors for corporate governance. This chapter reviews the most recent legislation in Canada, the United States, and the European Union and how it impacts both executive compensation and corporate governance. A new summary chart compares the four common performance measurement tools (ROS, ROI, RI, and EVA).

## MyAccountingLab

MyAccountingLab delivers proven results in helping individual students succeed. It provides engaging experiences that personalize, stimulate, and measure learning for each student, including a personalized study plan, mini cases, and videos. MyAccountingLab is the portal to an array of learning tools for all learning styles—algorithmic practice questions with guided solutions are only the beginning!

The following features are **NEW** to MyAccountingLab for the Seventh Canadian Edition:

### For Students


- ◆ **Adaptive Assessment**—Integrated directly into the MyAccountingLab Study Plan, Pearson’s adaptive assessment is the latest technology for individualized learning and mastery. As students work through each question, they are provided with a custom learning path tailored specifically to the concepts they need to practise and master.
- ◆ **Enhanced Pearson eText**—End-of-chapter MyAccountingLab assessments are now linked directly to the eText, providing students with a seamless reading and practising experience.
- ◆ **Dynamic Study Modules**—Canadian study modules allow students to work through groups of questions and check their understanding of foundational accounting topics. As students work through questions, the Dynamic Study Modules assess their knowledge and only show questions that still require practice. Dynamic Study Modules can be completed online using a computer, tablet, or mobile device.

## For Instructors

- ◆ **Learning Catalytics**—This “bring your own device” student engagement, assessment, and classroom intelligence system allows instructors to engage students in class with a variety of question types designed to gauge student understanding.
- ◆ **Chartered Professional Accountant Competency Mapping and AACSB Learning Outcome Mapping**—Instructors can now view MyAccountingLab assessments by CPA Competencies and select questions based on the specific competencies that they’d like to test. Instructors can also sort questions by AACSB Learning Outcomes.

## Additional Resources

The following resources are available for Instructors at the Instructor’s Resource Centre on the catalogue, at [www.pearsoncanada.ca/highered](http://www.pearsoncanada.ca/highered).

- ◆ **Instructor’s Solutions Manual** provides instructors with a complete set of solutions to all the end-of-chapter material in this text. Available in both Word and PDF formats.
- ◆ **Pearson TestGen**, the test bank for *Cost Accounting*, offers a comprehensive suite of tools for testing and assessment. TestGen allows educators to easily create and distribute tests for their courses, either by printing and distributing through traditional methods or by online delivery. The more than 2,200 items are linked to the Learning Objectives, and ranked by difficulty.
- ◆ **Test Item File**. All the test questions from the TestGen testbank are also available in Microsoft Word format, available within MyStatLab or at [www.pearsoncanada.ca/highered](http://www.pearsoncanada.ca/highered).
- ◆  **Instructor’s Teaching Tips Digital eText Resource** Instructors can easily locate useful teaching tips and resources throughout the eText, annotated by apple icons throughout the chapters. This eText is located in MyAccountingLab.
- ◆ **PowerPoint Presentations** prepared for each chapter of the text. The interactive presentation offers helpful graphics that illustrate key figures and concepts from the text, chapter outlines, and additional examples. In addition, instructors can custom-create their own using a combination of these supplied slides and the Image Library of exhibits.
- ◆ **Image Library** includes the exhibits and illustrations from the text.

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## ACKNOWLEDGMENTS

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Our task is to serve the learning needs of students and teaching needs of instructors as they surmount the challenge of the impossible—creating, managing, and controlling the profitability of future outcomes. We welcome your comments and suggestions on how to serve you better.

Louis Beaubien  
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# The Accountant's Vital Role in Decision Making

# 1

## iTunes Variable Pricing: Downloads Are Down, but Profits Are Up<sup>1</sup>

Can selling less of something be more profitable than selling more of it? In 2009, Apple changed the pricing structure for songs sold through iTunes from a flat fee of \$0.99 to a three-tier price point system of \$0.69, \$0.99, and \$1.29. The top 200 songs in any given week make up more than one-sixth of digital music sales. Apple began charging the highest price (\$1.29) for these songs—songs by artists like Adele and Carly Rae Jepsen.

Six months after Apple implemented the new pricing model, the downloads of the top 200 tracks were down by about 6%. But although the number of downloads dropped, the higher prices generated more revenue than the old pricing structure. Because Apple's iTunes costs—wholesale song costs, network and transaction fees, and other operating costs—do not vary based on the price of each download, the profits from the 30% price increase more than made up for the losses from the 6% decrease in volume. Apple has also applied this new pricing structure to movies available through iTunes, which range from \$14.99 for new releases to \$9.99 for most other films.

To increase profits beyond those created by higher prices, Apple also began to manage the costs inherent in iTunes. Transaction costs (what Apple pays credit-card processors like Visa and MasterCard) have decreased, and Apple has also reduced the number of people working in the iTunes store.

By studying cost accounting, you will learn how successful managers and accountants run their businesses and prepare yourself for leadership roles in the firms you work for. Many large companies, including Nike and the Pittsburgh Steelers, have senior executives with accounting backgrounds.



Paul Sakuma/AP Images

### ► Learning Objectives

1. Explain how management accounting data are essential to the process of rational operating and strategic decision making.
2. Explain how business functions help management accountants organize accounting information.
3. Identify the five steps of decision making and the role of relevant accounting information.
4. Describe key guidelines management accountants follow and roles they assume to support management decisions.
5. Distinguish among corporate governance, professional codes of conduct, ethics, and corporate social responsibility.

<sup>1</sup> Sources: Apple, Inc. Frequently asked questions (FAQ) for purchased movies; Anthony Bruno and Glenn Peoples. 2009. Variable iTunes pricing a moneymaker for artists. Reuters, June 21; The long tale? 2009. *Billboard*, November 14. <http://www.reuters.com/article/idUSTRE55K0DJ20090621>; Nekesa Mumbi Moody. 2012. Adele, Carly Rae Jepsen top iTunes' year-end sales. *Billboard*, December 13; Eric Savitz. 2007. Apple turns out, iTunes makes money, Pacific Crest says; subscription service seems inevitable. *Barron's* "Tech Trader Daily" blog, April 23. <http://blogs.barrons.com/techtraderdaily/2007/04/23/apple-turns-out-itunes-makes-money-pacific-crest-says-subscription-service-seems-inevitable/>.

## Accounting Systems: Financial and Management Accounting

### ► LO 1

Explain how management accounting data are essential to the process of rational operating and strategic decision making.

Accounting systems are used to record economic events and transactions, such as sales and materials purchases, and process the data into information helpful to managers, sales representatives, production supervisors, and others. Processing any economic transaction means collecting, categorizing, summarizing, and analyzing. For example, costs are collected by category, such as materials, labour, and shipping. These costs are then summarized to determine a firm's total costs by month, quarter, or year. Accountants analyze the results and together with managers evaluate the organization (e.g., cost and revenue changes from one period to the next). Accounting systems also provide the information found in a firm's statement of comprehensive income, statement of financial position, statement of cash flows, and performance reports, such as the cost of serving customers or running an advertising campaign. Managers use this information to make decisions about the activities, businesses, or functional areas they oversee. For example, a report that shows an increase in sales of laptops and iPads at an Apple store may prompt Apple to hire more salespeople at that location. Understanding accounting information is essential for managers in doing their jobs.

Costs and other data are part of the **management information system (MIS)**. The MIS database stores information in a way that allows sales, distribution, and production managers to access the information they need. Many companies build their own comprehensive database, called an **enterprise resource planning (ERP) system**. The ERP software integrates data and provides managers with reports that highlight the interdependence of different business activities.

**Cost accounting** measures and reports financial and nonfinancial information related to the costs of acquiring and using resources. Cost accounting reports show how costs accumulate as corporations use resources to produce and sell their products and services. Costs are recovered when customers purchase products and services. **Cost management** includes the activities of identifying, reporting, and analyzing all costs of operations. Management decisions range from the quantity and quality of materials used to whether to shut down an entire company. As part of cost management, managers often deliberately incur additional costs in the short run—for example, in advertising and product modifications—to enhance revenues and profits in the long run.

**Financial accounting** focuses on reporting to external parties such as investors, government agencies, banks, and suppliers. The goal is to present fairly to external parties how the business activities during a specific time period affected the economic health of a company. This is called **economic substance**, which is the financial outcome of all the different types of business transactions that happened. Financial accountants report financial outcomes based on generally accepted accounting principles (GAAP) and standards.<sup>2</sup> Reports formatted in a way similar to statements of financial position, statements of comprehensive income, and statements of cash flows are common to both management accounting and financial accounting.

**Management accounting** measures, analyzes, and reports financial and nonfinancial information to internal managers. The goal is to use past performance to predict the future. The internal reports should plainly inform managers of the financial results of actual operations. The reports should also show how activities can be changed to affect and improve what will happen in the future. **Management accountants** reorganize and analyze financial and non-financial data using rigorous methods. The rigour of management accounting methods is intended to support managers in their efforts to decide on changes that will improve future financial success. The distinction between management accounting and cost accounting is not clear-cut, and we often use these terms interchangeably in the book.

Exhibit 1-1 summarizes the major differences between management accounting and financial accounting. Note, however, that reports such as statements of financial position,

<sup>2</sup> Generally Accepted Accounting Principles (i.e., GAAP) is a generic term referring to the practices and rules of accounting consistent with laws and regulations. In Canada, depending on the nature of the organization, GAAP refers to either International Financial Reporting Standards (IFRS) or Accounting Standards for Private Enterprises (ASPE).

**Exhibit 1-1** Major Differences Between Management Accounting and Financial Accounting

	Management Accounting	Financial Accounting
<b>Purpose of information</b>	To help managers make decisions to fulfill an organization's goals	To communicate the organization's financial position to investors, banks, regulators, and other outside parties
<b>Primary users</b>	Managers of the organization	External users such as investors, banks, regulators, and suppliers
<b>Focus and emphasis</b>	Future-oriented (budget for 2015 prepared in 2014)	Past-oriented (reports on 2014 performance prepared in 2015)
<b>Rules of measurement and reporting</b>	Internal measures and reports do not have to follow IFRS/ASPE but are based on cost-benefit analysis	Financial statements must be prepared in accordance with IFRS/ASPE and be attested to by independent auditors
<b>Time span and types of reports</b>	Varies from hourly information to 15 to 20 years, with financial and nonfinancial reports on products, departments, territories, and strategies	Annual and quarterly financial reports, primarily on the company as a whole, and presented as consolidated financial statements
<b>Behavioural implications</b>	Designed to influence the behaviour of managers and other employees	Primarily reports economic events but also influences behaviour because managers' compensation is often based on reported financial results

statements of comprehensive income, and statements of cash flows are common to both management accounting and financial accounting.

Business operations are complex sets of activities, and to maximize profit considerable information, analysis, and decision making is required in advance of actual action. Nevertheless, once a plan is implemented most operations run with little intervention from managers. Operating decisions are needed when exceptions arise, such as supplies of a raw material fail to be delivered, workers go on strike, or machines break down. Decisions are needed when there are real alternatives that managers can choose from to deal with operating problems. Without high-quality information, business could not be conducted.

## Strategic Decisions and Management Accounting

**Strategy** specifies how an organization matches its own capabilities with the opportunities in the marketplace. One of two strategies is available: either cost leadership or value leadership by means of product (service) differentiation.<sup>3</sup> Companies such as LG generate growth and profits by providing the right combination of generic product features—quality and low price (cost leadership). Companies such as Apple Inc. generate growth and profits by offering unique, innovative products or services (value leadership). Customers who believe the features are valuable will pay a higher price for this type of product. Both LG and Apple Inc. understand that their customers are willing to spend their scarce resources on products where there is a value-added component—whether that's low price or innovation (or both). Pursuing the most appropriate strategy sustains competitive advantage for each type of company.

Deciding between these strategies is a critical part of what managers do. Management accountants work closely with managers in formulating strategy by providing information and helping them answer questions such as:

- ◆ Who are our most important customers, and how do we deliver value to them?
- ◆ What substitute products exist in the marketplace, and how do we attract customers to purchase our product instead of others?
- ◆ What are we particularly competent at doing? Innovating? Applying technology? Production? Multiple factors such as price, quality, and timely delivery drive the customer's perception of value. How do we decide to create that value in an affordable way?

<sup>3</sup> Michael Porter (Harvard University) presented strategy as an interplay of internal and external factors. He distinguished the two generic strategies of differentiation and cost leadership.



- ◆ Will adequate cash be available to fund the strategy? If not, how can we acquire these additional funds?

The best-designed strategies and the best-developed capabilities are of no value unless they are executed well. In the next section, we describe a common framework within which managers take action to create value for their customers and how management accountants help them do it.

## Value-Chain and Supply-Chain Analysis and Key Success Factors

Customers demand more than a low price from companies. They expect a useful, quality product or service delivered in a timely way. These factors influence how customers experience their consumption of a product or service and assess its value-in-use. The more positive their experience, the higher is their perceived value added.

### ► LO 2

Explain how business functions help management accountants organize accounting information.

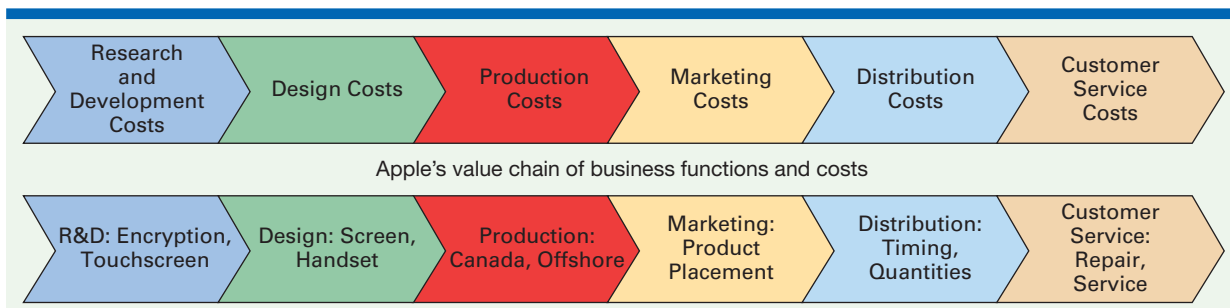
### Value-Chain Analysis

The **value chain** is the sequence of business functions in which customer usefulness is added to products or services. The flow of costs incurred in a corporation can be classified into the value-adding activities of research and development (R&D), design, production, marketing, distribution, and customer service. From innovation through to verifying customer satisfaction, these costs accumulate and cannot be recovered, plus some reasonable profit, unless customers are willing to pay.

Exhibit 1-2 illustrates these functions using Apple's iPhone division as an example. The business functions are coordinated to make sure that the money being spent on R&D, for example, will provide features of a product that will satisfy customers and for which they will pay. Cost, quality, and the speed with which new products are developed require teamwork among managers across the business functions. For example, it may be worthwhile to increase spending on product design if it saves more on costs related to customer service.

1. **Research and development (R&D)**—Generating and experimenting with ideas related to new products, services, or processes. At Apple, this function includes research on backup systems to ensure reliable access to its communications system.
2. **Design of products, services, or processes**—Detailed planning and engineering of products, services, or processes. Design at Apple, includes determining the number of component parts in a smartphone model and the effect of alternative product designs on quality and manufacturing costs.
3. **Production**—Acquiring, coordinating, and assembling resources to produce a product or deliver a service. Production of an iPhone includes the acquisition and assembly of the electronic parts, the handset, and the packaging used for shipping.
4. **Marketing**—Promoting and selling products or services to customers or prospective customers. Apple markets its iPhones through the internet, trade shows, and advertisements in newspapers and magazines.

**Exhibit 1-2** The Value Chain of Business Functions and Costs



5. **Distribution**—Delivering products or services to customers. Apple distribution systems to deliver iPhones include shipping globally to mobile telecommunications providers, governments, retail outlets, and direct sales via the internet.
6. **Customer service**—Providing after-sale support to customers. Apple provides customers both telephone and online help to set up and troubleshoot its smartphones.

## Supply-Chain Analysis

Supply-chain analysis is one way companies can implement strategy, cut costs, and create value. The term **supply chain** describes the flow of goods, services, and information from their initial sources to the delivery of products and services to consumers, regardless of whether those activities occur in one or more organizations. Consider Apple. Many companies play a role in bringing its iPhone products to consumers. Exhibit 1-3 presents an overview of Apple's supply chain with various global suppliers.

Cost management emphasizes integrating and coordinating activities across all companies in the supply chain, as well as across each business function in an individual company's value chain, to reduce costs. For example, Apple arranges for frequent delivery of small quantities of expensive materials like microchips directly to the production floor of its assembling companies around the world. This strategy reduces materials-handling costs from inventories held inside the factory.

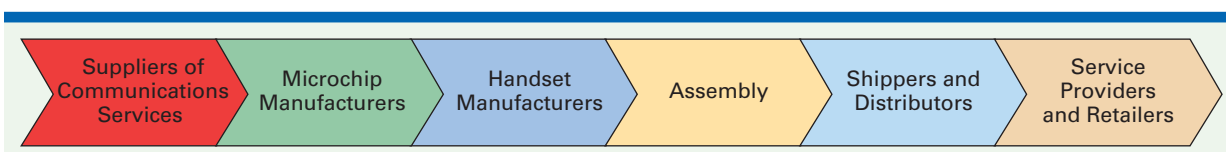
**Note** Customer relationship management (CRM) refers to a strategy that integrates people and technology across all business functions and enhances relationships with customers, suppliers, and other stakeholders.

## Key Success Factors (KSF)

Customers continue to demand that companies use the value chain and supply chain to deliver ever-improving levels of performance. **Key success factors** are those activities that are essential to successful corporate performance and include:

- ◆ **Cost and efficiency**—Companies such as IKEA set a target price and operating profit for a product first. Then, working together, managers and management accountants achieve the target cost by minimizing necessary activities and tasks in all value-chain business functions, from R&D through to customer service.
- ◆ **Quality**—Customers expect high levels of quality. Total quality management (TQM) directs attention toward simultaneously improving all operations throughout the value chain to deliver products and services that exceed customer expectations. TQM includes:
  - ◆ Designing products or services to meet the needs and wants of customers.
  - ◆ Producing products with zero (or minimal) defects and waste.
  - ◆ Maintaining low inventories.
- ◆ **Time**—Every value-chain activity takes time. The increasing pace of technological innovation has led to the need for companies to bring new products out faster because of shorter product life cycles. Customer response time continues to increase in importance. Companies compete to meet or exceed customers' expectations of responsiveness in production, delivery, and after-sales service.
- ◆ **Innovation**—Constant flows of innovative products in response to customer demand result in ongoing growth and success. Management accountants help managers evaluate alternative investment decisions and R&D decisions.

**Exhibit 1-3** Supply Chain for Apple



Management accountants help managers track and compare a company's performance on key success factors relative to their competitors. Tracking what is happening in other companies serves as a benchmark and alerts managers to the changes in the industry. The goal is for a company to continuously improve its critical operations—for example, on-time arrival for WestJet, customer access for online auctions at eBay, and cost reduction at Sumitomo Electric. Sometimes more fundamental changes in operations—such as redesigning a manufacturing process to reduce costs—may be necessary.

Strategy requires careful analyses of information and a decision about the most appropriate alternative to assure long-term success. However, successful strategy implementation requires more than value-chain and supply-chain analysis and execution of key success factors. Central to success is a rigorous decision-making process. Managers can use a well-known framework to assist them in improving the quality of their decisions. The framework encourages objective analyses of evidence in a logical and disciplined process.

## Concepts in Action

### Management Accounting Beyond the Numbers

To people outside the profession, it may seem like accountants are just “numbers people.” It is true that most accountants are adept financial managers, yet their skills do not stop there. The successful management accountant possesses several skills and characteristics that reach well beyond basic analytical abilities.

*Management accountants must work well in cross-functional teams and as business partners.* In addition to being technically competent, the best management accountants work well in teams, learn about business issues, understand the motivations of different individuals, respect the views of their colleagues, and show empathy and trust.

*Management accountants must promote fact-based analysis and make tough-minded, critical judgments without being adversarial.* Management accountants must raise tough questions for managers to consider, especially when preparing budgets. They must do so thoughtfully and with the intent of improving plans and decisions. Before the investment bank JP Morgan lost more than \$6 billion on “exotic” financial investments (credit-default swaps) in 2012, controllers should have raised questions about these risky investments and the fact that the firm was essentially betting that improving economic conditions abroad would earn it a large profit.

*They must lead and motivate people to change and be innovative.* Implementing new ideas, however good they may be, is difficult. When the United States Department of Defense (DoD) began consolidating more than 320 finance and accounting systems into a common platform, the accounting services director and his team of management accountants held meetings to make sure everyone in the agency understood the goal for such a change. Ultimately, the DoD aligned each individual's performance with the transformative change and introduced incentive pay to encourage personnel to adopt the platform and drive innovation within this new framework.

*They must communicate clearly, openly, and candidly.* Communicating information is a large part of a management accountant's job. When premium car companies such as Rolls Royce and Porsche design new models, management accountants work closely with engineers to ensure that each new car supports a carefully defined balance of commercial, engineering, and financial criteria. These efforts are successful because management accountants clearly communicate the information that multi-disciplinary teams need to deliver new innovations profitably.

*They must have a strong sense of integrity.* Management accountants must never succumb to pressure from managers to manipulate financial information. They must always remember that their primary commitment is to the organization and its shareholders. In 2012, Hewlett-Packard wrote down \$8.8 billion on the value of British software maker Autonomy, which it acquired in 2010, due to serious accounting problems. Hewlett-Packard has accused senior managers at Autonomy of “serious accounting improprieties” and “outright misrepresentations” by mischaracterizing some sales of low-margin hardware as software and recognizing some deals with partners as revenue, even when a customer never bought the product. These actions inflated Autonomy's revenue and profitability, which made the company a more attractive acquisition target.

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Sources: United States Senate Permanent Subcommittee on Investigations. *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*. Washington, DC: Government Printing Office, March 15, 2013; Wendy Garling, *Winning the Transformation Battle at the Defense Finance and Accounting Service*. Balanced Scorecard Report, May–June 2007; Bill Nixon, John Burns, and Mostafa Jazayeri. *The role of management accounting in new product design and development decisions*. Volume 9, Issue 1. London: Chartered Institute of Management Accountants, November 2011; and Ben Worthen, “H-P Says It Was Duped, Takes \$8.8 Billion Charge,” *The Wall Street Journal* (November 12, 2012).

## Decision Making, Planning, and Control: The Five-Step Decision-Making Process

We will apply and explain the five-step decision-making process using *Best News*, a fictional national newspaper, as an example. The five-step process is a robust and versatile framework within which to decide the best way to address a wide variety of operating and strategic challenges.

A key challenge for Nicole Simpson, the manager of *Best News*, was to increase revenues. To achieve this goal, Nicole worked through the five-step decision-making process.

### ► LO 3

Identify the five steps of decision making and the role of relevant accounting information.

**1. Identify the problem and uncertainties** Nicole's MIS reported a steady decline in revenue and Nicole and her team agreed that they must increase revenue without a disproportionate increase in costs.

**2. Obtain information** Decisions cannot be reasonably made without relevant and reliable information to help managers understand the uncertainties. Nicole asked her marketing manager to talk to some representative readers to gauge how they might react to an increase in the newspaper's selling price. She asked her advertising sales manager to talk to current and potential advertisers to get a better understanding of the advertising market. She also reviewed the effect that past price increases had on readership. Ramon Sandoval, the management accountant at *Best News*, provided information about past increases or decreases in advertising rates and the subsequent changes in advertising revenues. He also collected and analyzed information on advertising rates charged by competing media outlets, including other newspapers.

#### Note

What is happening in step 2 is called *benchmarking*.

**3. Make predictions about the future** On the basis of the information she obtained, Nicole can improve her predictions about the future. Her analysis of the marketing information indicates that readers would be quite upset if she increased prices. One result would be a significant drop in readership volume, which would make Nicole's problem worse, not better. But in contrast, after analyzing the information on advertising rates, it is clear Nicole would not lose any advertisers nor would the pages of advertising space sold decrease if she increased the rates. Ramon's information indicated a likely market-wide increase in all media advertising rates. None of Nicole's predictions are certain, but she is confident enough to decide to raise advertising rates and not subscription prices.

**4. Decide on one of the available alternatives** Nicole communicated her decision to the sales department to increase advertising rates to \$5,200 per page starting March 1, 2016—a 4% increase.

Steps 1 through 4 can be considered planning. **Planning** is a purposeful analysis of information to select and rank in importance the goals of an organization. Rigorous analyses are how managers make reasonable predictions about the best alternative set of actions to take to achieve goals. Management accountants are partners in these planning activities because they can explain and interpret financial and nonfinancial information to team members. Together, the team identifies activities that create value and the key success factors.

The most important planning tool is a budget. A **budget** is the quantitative expression of management's proposed plan of action; it is an aid to coordinating what must be done and when to implement a successful plan.

**5. Implement the decision, evaluate performance, and learn** Managers at *Best News* take actions to implement the March 2016 budget. Management accountants collect information to follow through on how actual performance compares to planned or budgeted performance (also referred to as scorekeeping). The comparison

**Exhibit 1-4** Performance Report of Advertising Revenues at *Best News* for March 2016

	Actual Result (1)	Budgeted Amount (2)	Difference: (Actual Result – Budgeted Amount) (3) = (1) – (2)	Difference as a Percentage of Budgeted Amount (4) = (3) ÷ (2)
Advertising pages sold	760 pages	800 pages	40 pages Unfavourable	5.0% Unfavourable
Average rate per page	\$5,080	\$5,200	\$120 Unfavourable	2.3% Unfavourable
Advertising revenues	\$3,860,800	\$4,160,000	\$299,200 Unfavourable	7.2% Unfavourable

of actual performance to budgeted performance is the control or post-decision role of information.

When exercising **control**, managers compare actual and targeted nonfinancial measures as well as financial measures and take corrective actions. Performance measures tell managers if subunits are performing as predicted. Rewards linked to achievement motivate managers, and rewards are both intrinsic (self-satisfaction for a job well done) and extrinsic (salary, bonuses, and promotions). A budget serves as both a control and a planning tool since it is a comparison benchmark against actual performance.

Consider performance evaluation at *Best News*. During March 2016, the newspaper sold advertising, issued invoices, and received payments that were all recorded in the accounting system. Exhibit 1-4 shows *Best News*'s performance report of advertising revenues for March 2016. This report indicates that 760 pages of advertising (40 pages fewer than the budgeted 800 pages) were sold. The average rate per page was \$5,080, compared with the budgeted \$5,200 rate, yielding actual advertising revenues of \$3,860,800. The actual advertising revenues were \$299,200 less than the budgeted \$4,160,000. The performance report in Exhibit 1-4 spurs investigation and learning.

The data in this performance report would prompt the management accountant to raise several questions about the implementation of the plan. This is not about laying blame, but rather is an opportunity to ask questions and learn.

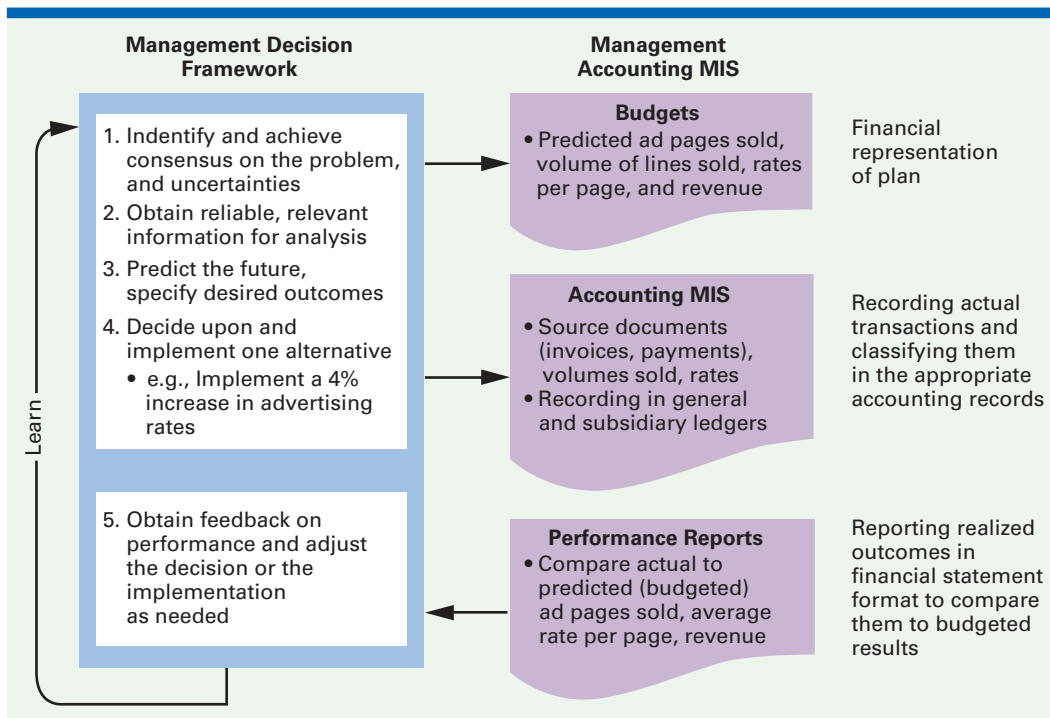
Management accountants might consider questions such as:

- ◆ Is the strategy of differentiating *Best News* from other newspapers attracting more readers?
- ◆ In implementing the new advertising rates, did the marketing and sales department make sufficient efforts to convince advertisers that, even with the higher rate of \$5,200 per page, advertising in *Best News* was a good buy?
- ◆ Why was the actual average rate per page \$5,080 instead of the budgeted rate of \$5,200?
- ◆ Did some sales representatives offer rate discounts?
- ◆ Did economic conditions cause the decline in advertising revenues?
- ◆ Did technological changes create alternative business processes or models, making previous ones less effective?
- ◆ Are revenues falling because editorial and production standards have declined?

Answers to these questions could prompt the newspaper's publisher to take subsequent actions, including, for example, adding more sales personnel or making changes in editorial policy. Good implementation requires the marketing, editorial, and production departments to work together and coordinate their actions and develop action plans.

The left side of Exhibit 1-5 provides an overview of the decision-making processes at *Best News*. The right side of the exhibit highlights how the management accounting system aids in decision making.

Action plans often include targets for market share, quality, new-product development, and employee satisfaction, but managers should understand that plans must be flexible because the future and outcomes are always uncertain. Unforeseeable outcomes often arise, and flexibility ensures that managers can seize unforeseen opportunities and remedy unforeseen threats to success. The plan is not a guarantee of any outcome.



**Exhibit 1-5** How Accounting Aids Decision Making, Planning, and Control at Best News

## Key Management Accounting Guidelines and Organization Structure

Three guidelines help management accountants provide the most value to their companies in strategic and operational decision making:

- ◆ Use a cost–benefit approach.
- ◆ Recognize both behavioural and technical considerations.
- ◆ Use different costs for different purposes.

### ► LO 4

Describe key guidelines management accountants follow and roles they assume to support management decisions.

## Cost–Benefit Approach

The **cost–benefit approach** (risk/return, downside risk/upside potential) is used to make resource allocations such that the expected benefits exceed the expected costs. The cost–benefit approach should be used to make resource-allocation decisions, such as whether to purchase a new software package or hire a new employee. This approach requires explicit comparisons of the financial costs and benefits of different alternatives. Often good ideas provide too little **upside potential** or benefit for the predicted costs that will be incurred. At other times the upside potential may be quite high, but the **downside risk** of failure is also quite high. When forecasting costs and benefits, managers should take uncertainty into consideration when they combine the two factors of risk and return in calculating the benefits.

## Behavioural and Technical Considerations

Consider the human (or behavioural) side of why budgeting is used. **Behavioural considerations** motivate managers and other employees to try to achieve the goals of the organization. Budgets improve decisions within an organization because of better collaboration, planning, and motivation. The **technical considerations** help managers make wise economic decisions. Technical data (e.g., costs in various value-chain categories) in