

SEVENTH EDITION

# MANAGERIAL ACCOUNTING

The Cornerstone of Business Decision Making



**MOWEN // HANSEN // HEITGER**

SEVENTH EDITION

# Managerial Accounting

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THE CORNERSTONE OF  
BUSINESS DECISION MAKING

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Australia • Brazil • Mexico • Singapore • United Kingdom • United States

**Managerial Accounting: The Cornerstone of Business  
Decision Making, Seventh Edition**

**Maryanne M. Mowen, Don R. Hansen, Dan L. Heitger**

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*This book is dedicated to our students—past, present, and future—  
who are at the heart of our passion for teaching.*

# Brief Contents

<b>CHAPTER 1</b>	<b>Introduction to Managerial Accounting</b>	<b>2</b>
<b>CHAPTER 2</b>	<b>Basic Managerial Accounting Concepts</b>	<b>30</b>
<b>CHAPTER 3</b>	<b>Cost Behavior and Forecasting</b>	<b>78</b>
<b>CHAPTER 4</b>	<b>Job-Order Costing and Overhead Application</b>	<b>148</b>
<b>CHAPTER 5</b>	<b>Activity-Based Costing and Management</b>	<b>214</b>
<b>CHAPTER 6</b>	<b>Process Costing</b>	<b>276</b>
<b>CHAPTER 7</b>	<b>Cost-Volume-Profit Analysis</b>	<b>332</b>
	<b>MAKING THE CONNECTION</b>	<b>390</b>
<b>CHAPTER 8</b>	<b>Tactical Decision Making and Relevant Analysis</b>	<b>392</b>
<b>CHAPTER 9</b>	<b>Profit Planning and Flexible Budgets</b>	<b>454</b>
<b>CHAPTER 10</b>	<b>Standard Costing and Variance Analysis</b>	<b>520</b>
	<b>MAKING THE CONNECTION</b>	<b>588</b>
<b>CHAPTER 11</b>	<b>Performance Evaluation and Decentralization</b>	<b>590</b>
<b>CHAPTER 12</b>	<b>Capital Investment Decisions</b>	<b>644</b>
	<b>MAKING THE CONNECTION</b>	<b>697</b>
<b>CHAPTER 13</b>	<b>Emerging Topics in Managerial Accounting</b>	<b>700</b>
<b>CHAPTER 14</b>	<b>Statement of Cash Flows</b>	<b>790</b>
<b>CHAPTER 15</b>	<b>Financial Statement Analysis</b>	<b>836</b>
	Glossary	891
	Check Figures	899
	Index	903

Dear Colleague,

We have been teaching managerial accounting for decades. We love it and believe strongly that managerial accounting is one of the most important courses in the business curriculum! Since it is one of the first business courses students take, we work to share our love and enthusiasm for the material and to show each student that managerial accounting is both FUN and RELATABLE to their current life, as well as to their future.

We wrote this book because there was no other book available that helped us reach the wide variety of students we see each term. Reaching students is a challenge because:

- There is so much material to teach that instructors don't have time for the "fun stuff;"
- Students don't connect the detail with the big picture;
- Many students juggle jobs, family, and so on, so they have little time—their time in the class must be optimized for understanding;
- Managerial accounting is not as straightforward as financial, and students must develop judgment skills in addition to absorbing material;
- There is a tremendous diversity of students (incoming skills, language, etc.); and
- There is no standard road map to teach the course (a.k.a., the balance sheet).

Our approach is to make the entire managerial accounting experience for instructors and students *timely, meaningful, fun, and relatable*. This edition contains numerous new features that achieve these goals in a way that positively sets our book apart from all other managerial accounting books. For instance, our new chapter, "Emerging Topics in Managerial Accounting," addresses timeliness by covering cutting-edge topics. Our unique "*Here's How It's Used*" pedagogy enables students to enjoy the process of developing a deeper understanding of managerial accounting and its implications for themselves, as well as businesses. Our watchwords are "Here's How:"

1. *Here's How It's Used Concept Clip Animations* for many major topics portray the most difficult concepts in a brief and fun animated cartoon. They present the information in a logical, entertaining, and relatable way that pertains not only to businesses, but also to students' everyday lives.
2. *Here's How It's Used Examples* (formerly Cornerstones) *throughout the text* walk students through the most important managerial accounting models and help them solve computations. Students say these examples really get them started on their homework and help them understand the material before class. As a result, the Examples allow the instructor to focus valuable class time on the "why," and allow students to understand the big picture—helping students see the relevance and importance of what they are learning.
3. *Here's Why It's Important* highlights for students the reason that key topics within each chapter are important. This new feature significantly helps students better understand the big picture of why managerial accounting is important.
4. *Experience Managerial Accounting Videos* focus on real companies, such as Coldstone Creamery, Second City Comedy Club, and Boyne USA ski resorts, and the integrated real-world examples of Kicker Speakers provide students with inside access into how management accounting is used to make real-world business decisions.

Using our text, you don't need to spend as much valuable class time teaching "how," you can focus on "why."

- Examples are built around how students work, summarizing key procedures to help students complete homework independently.
- Because students are able to complete homework independently, they do not bombard the instructor with "How do I do this?" type questions.

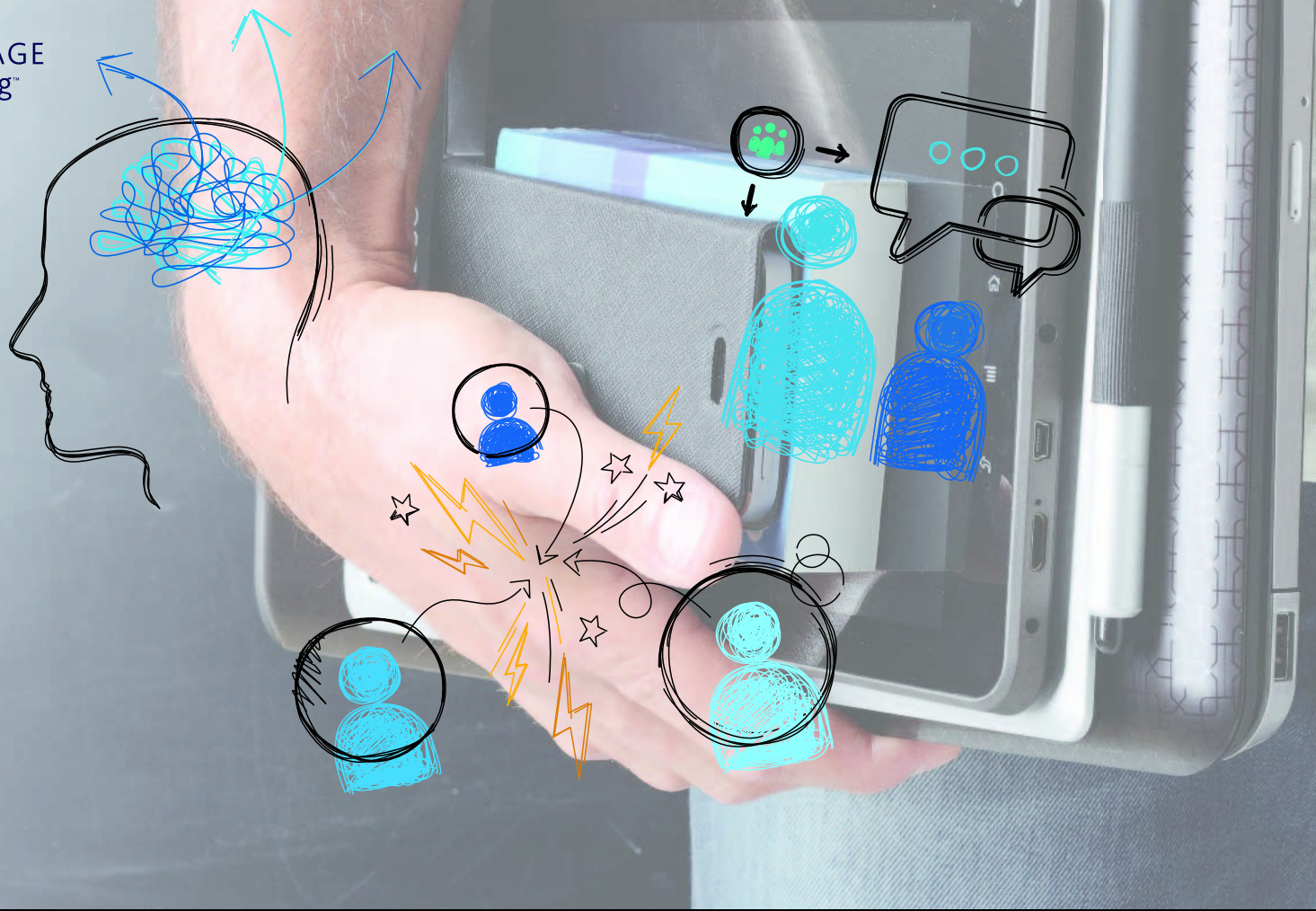
Students who want to go farther can use:

- ***Blueprint Problems.*** We wrote these expressly to accompany this book and help students expand their understanding.
- ***Blueprint Problems Using Excel.*** We wrote these to help develop students' spreadsheet skills. Students are required to develop their own Excel formulas to solve the problems.
- ***Analyzing Relationships.*** We developed these to help students use a graphical approach to see exactly how changing one or more underlying variables affects a model. These allow students to engage in sensitivity analysis and to consider the related analytical questions. These help to foster analytical skills and to develop judgment and understanding.

Our goal is to improve student understanding and preparedness while allowing you to focus on meaningful applications of managerial accounting to important real-world topics. We believe it will work in your classroom and look forward to teaming up with you to improve your students' success and make managerial accounting *meaningful, fun, and relatable*.

Sincerely,  
*Maryanne Mowen, Don Hansen, Dan Heitger*





# Close the Gap

Between Homework and Exam Performance

with **CengageNOWv2**

We've talked with hundreds of accounting instructors across the country and we are learning that online homework systems have created a new challenge in the accounting course.

We are hearing that students perform well on the homework but poorly on the exam, which leads instructors to believe that students are not truly learning the content, but rather memorizing their way through the system.



**CengageNOWv2 better prepares students for the exam by providing an online homework experience that is similar to what students will experience on the exam and in the real world.**

*Read on to see how CengageNOWv2 helps close this gap.*



# Closing the gap, one step at a time.



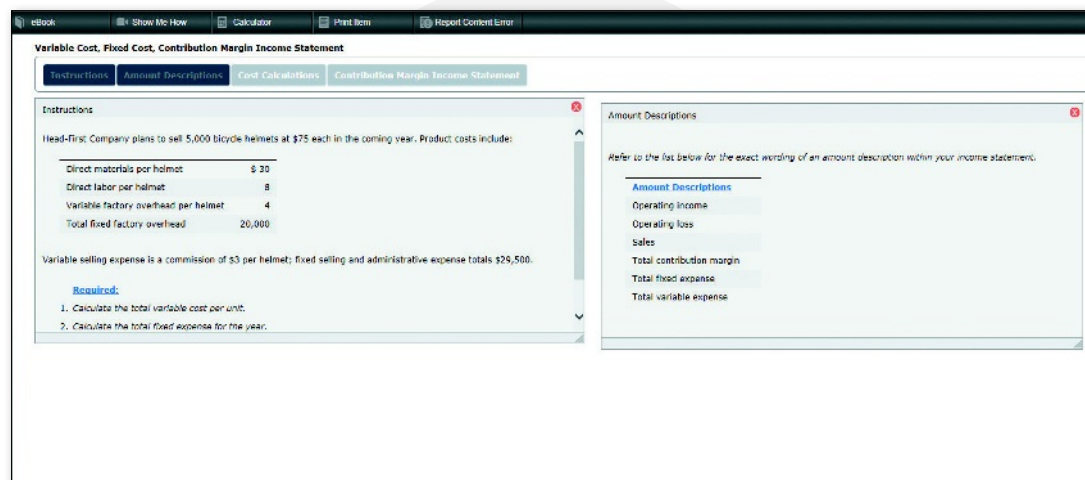
## Multi-Panel View

One of the biggest complaints students have about online homework is the scrolling, which prevents students from seeing the big picture and understanding the accounting system. This new Multi-Panel View in CengageNOWv2 enables students to see all the elements of a problem on one screen.

- Students make connections and see the tasks as connected components in the accounting process.
- Dramatically reduced scrolling eliminates student frustration.

## Blank Sheet of Paper Experience

Many students perform well on homework but struggle when it comes to exams. Now, with the new Blank Sheet of Paper Experience, students must problem-solve on their own, just as they would if taking a test on a blank sheet of paper. This discourages overreliance on the system.



# From Motivation to Mastery

## MOTIVATION:

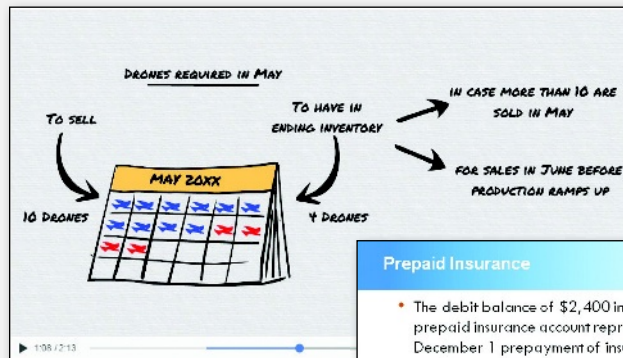
Engage students and better prepare them for class.

### Concept Clips

Written by the authors, these clips provide students with a deeper explanation into the why and the how of managerial accounting concepts.

### Video: Tell Me More

Tell Me More lecture activities explain the core concepts of the chapter through an engaging auditory and visual presentation that is ideal for all class formats—flipped mode, online, hybrid, face-to-face.



### Adaptive Study Plan

The Adaptive Study Plan is an assignable/gradable study center that adapts to each student's unique needs and provides a remediation pathway to keep students progressing.

#### Prepaid Insurance

- The debit balance of \$2,400 in NetSolutions' prepaid insurance account represents the December 1 prepayment of insurance for 12 months.

Dec. 31	Insurance Expense	25	200	200
	Prepaid Insurance	25		
	Insurance expired (\$2,400 ÷ 12).			

#### Accounting Equation Impact

Assets		=	Liabilities	+	Owner's Equity (Expense)
Prepaid Insurance	25				Insurance Expense
Adj Bal	2,375				25

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## APPLICATION:

Help students apply accounting concepts.

### Video: Show Me How

Linked to end-of-chapter problems in CengageNOWv2, Show Me How problem demonstration videos provide a step-by-step model of a similar problem.

#### Adjusting Entry for Prepaid Insurance

The balance in the prepaid insurance account, before adjustment at the end of the year, is \$21,700. Journalize the adjusting entry required under each of the following alternatives for determining the amount of the adjustment: (a) the amount of insurance expired during the year is \$16,450 (b) the amount of unexpired insurance applicable to future periods is \$5,250.

Date	Description	Post. Ref.	Debit	Credit
Dec. 31	Insurance Expense		16,450	
	Prepaid Insurance			16,450
	Insurance expired			

Assets		=	Liabilities	+	Owner's Equity (Expense)
Prepaid Insurance	21,700				Insurance Expense
Adj Bal	5,250				16,450

## MASTERY:

Teach students to go beyond memorization to true understanding.

### Mastery Problems for *Managerial Accounting, 7e*

These problems allow students to see the interrelationships among core concepts.

#### Transactions

January 1: Purchased merchandise on account from a supplier for \$22,100 with credit terms 2/10, n/30.

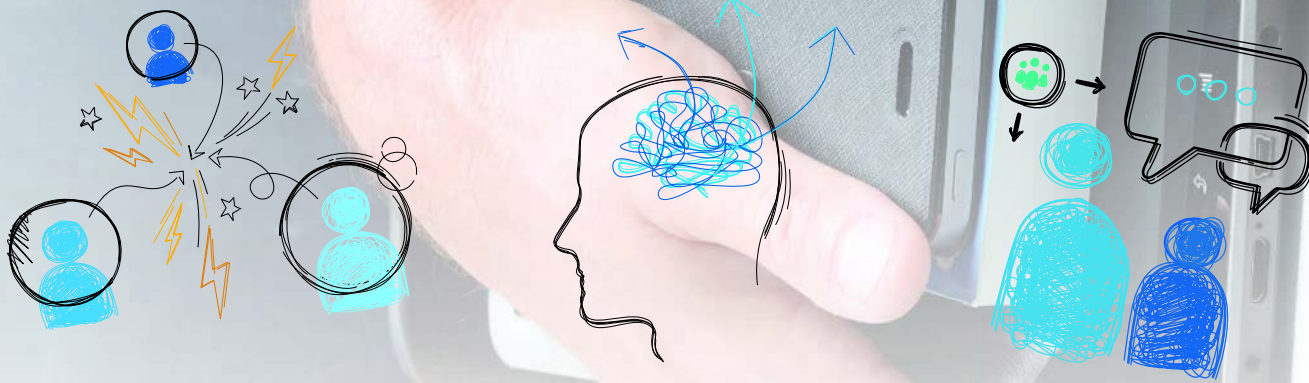
Click on **View the transactions.**

**View Analysis**

The journal entry for purchased merchandise on account from a supplier for \$22,100, with credit terms 2/10, n/30:

Date	Description	Post. Ref.	Debit	Credit
Jan. 01	Merchandise Inventory	115	22,100	
	Accounts Payable	230		22,100

Assets		=	Liabilities	+	Owner's Equity
Merchandise Inventory	22,100		Accounts Payable	22,100	
Adj Bal	22,100		Adj Bal	22,100	



## And that's not all...

You might also want to learn about the MindTap eReader, our LMS integration options, and more.

### MindTap eReader

The MindTap eReader is the most robust digital reading experience available.

- Fully optimized for the iPad.
- Note-taking, highlighting, and more.
- Off-line access on smartphones.

The MindTap eReader also features ReadSpeaker®, an online text-to-speech application that vocalizes, or “speechnables,” online educational content.

### LMS Integration

CengageNOWv2 can be seamlessly integrated with most learning management systems.

Adopters will enjoy:

- **A Seamless User Experience**—Access your Cengage resources seamlessly using only your LMS login credentials.
- **Simplified Registration Process**—Get students up and running faster!
- **Content Customization and Deep Linking**—Use our Content Selector to create a unique learning path for students that blends your content with Cengage Learning activities, eText, and more within your LMS course.
- **Automatic Grade Synchronization\***—Need to have your course grades recorded in your LMS gradebook? No problem. Simply select the activities you want synched and grades will automatically be recorded in your LMS gradebook.

\* Grade synchronization is currently available with Blackboard, Brightspace (powered by D2L), Angel 8, and Canvas.

### ADA Accessibility

Cengage Learning is committed to making its educational materials accessible to users of all abilities. We are steadily working to increase accessibility and create a full spectrum of usable tools, features, and choices that are accessible for users of all abilities. All new Cengage Learning products and services are designed with accessibility in mind.

- With the latest release of CengageNOWv2:
  - Images and graphics have been converted to HTML tables so that they can be read by screen readers.
  - The assignment experience now offers proper heading structure to support easy navigation with assistive technology.
- CengageNOWv2 solutions offer high contrast and well-structured HTML, which helps support screen reader interactivity.
- All videos are created with closed captioning and transcripts available for download.
- The MindTap eReader is HTML-based and compatible with most screen reading assistive software. The eReader supports browser settings for high-contrast narrative text, variable font sizes, and multiple foreground and background color options.

For more information on accessibility, please visit [www.cengage.com/accessibility](http://www.cengage.com/accessibility).

### IPAD Tablet Compatibility

CengageNOWv2 is fully compatible with the iPad and other tablet devices, with the exception of General Ledger (CLGL) and Excel Tutorials, which are flash based.

# New to this Edition



## I. New Additions to Each Chapter

A number of **meaningful features** were added to *each chapter* in this edition, including:

- \* **Here's How It's Used:** Several Here's How It's Used boxes in each chapter tell students how managerial concepts are used in a variety of businesses and in their own lives. This exciting new feature makes the material more relatable and meaningful. Here's How It's Used features include:
  - In Your Life
  - Data Analytics
  - Sustainability
  - At Kicker
  - At Real Companies
- \* **Here's Why It's Important:** Brief explanations of why the concepts are important are highlighted in the text to motivate students in their study.
- \* **New A and B sets of Brief Exercises:** These new sets of brief exercises give instructors more options for using illustrative exercises in class and then assigning very similar material to get students started with homework.
- \* **Animated Concept Clip:** All new brief animated video clips help students understand concepts and see them in a visual way.
- \* **Check Point questions at the conclusion of each learning objective section:** Check Point questions help students perform quick self-checks while reading chapter material.
- \* **Key Term Definitions:** To facilitate study and review, definitions for each key term are now found at the end of each chapter (in addition to the glossary at the end of the text).

## II. Creation of a New Chapter

The growing importance of managerial accounting in several critical areas led to the creation of a *completely new chapter*, **Emerging Topics in Managerial Accounting**, that provides students with exciting insights and cutting-edge perspectives on *Enterprise Risk*

*Management, Business Sustainability, Quality Cost Management, Lean Accounting, International Issues in Management Accounting, and the Role of Cost and Managerial Accounting in Fraud and Forensic Accounting.*

## III. Restructuring of Chapter Content and Organization

A restructuring of the text tightened and aligned topics in a natural sequence. In this edition:

- **Reduction in chapters.** *The total number of chapters was reduced from 16 to 15.* By streamlining, eliminating, and realigning topics, the number of chapters was reduced, but the number of topics available to cover was actually increased.
- **Chapter elimination.** *The chapter on variable and absorption costing and inventory management was eliminated and the basic material on absorption costing and variable costing was added to Chapter 3 on Cost Behavior and Forecasting.* Locating these topics in this chapter provides a good foundation for the costing chapters that follow. It also allows students the opportunity to see an immediate application of cost behavior. The inventory management topic was eliminated and its coverage deferred to a higher level course.
- **Chapter elimination.** *The chapter on flexible budgeting and overhead analysis was eliminated and its topics moved to other chapters.* The flexible budgeting material was added to Chapter 9 on Profit Planning to give students an overview of both static and flexible budgets in the same chapter. The overhead analysis material was added to the standard costing chapter (Chapter 10) to give students a complete picture of a standard costing system.
- **Chapters relocated.** *Cost-Volume-Profit Analysis has been moved to Chapter 7* to allow instructors to explain the basics of job-order, activity-based (moved to follow job order costing), and process costing. This relocation enables students to develop a richer understanding of costs used in CVP.
- **Chapter relocated.** *The Tactical Decision Making and Relevant Analysis chapter is positioned immediately after CVP and now includes material on segmented income statements to provide students with a more logical and impactful understanding of how to prepare and interpret Keep-or-Drop decisions.*

- **Topic depth increased and new chapter added.**

*The basic introduction to quality costing and environmental issues was removed from the chapter on activity based costing and management.* A much deeper treatment of these topics, as well as Enterprise Risk Management, Business Sustainability, Issues in International Managerial Accounting, and the Role of Cost and Managerial Accounting in Fraud and Forensic Accounting, is now found in the new chapter, Emerging Topics in Managerial Accounting (Chapter 13).

Our strong belief is that these additions and changes maintain all of the positive aspects of our previous editions that current users enjoy and appreciate, while significantly improving the managerial accounting experience for students and instructors alike. This new edition helps students to learn firsthand that managerial accounting is *timely, meaningful, fun, and relatable* to their everyday lives!



# Acknowledgments and Thanks

Thank you to the following instructors who contributed to the development of the 7th edition of *Managerial Accounting: The Cornerstone of Business Decision Making*. By reviewing, verifying, or participating in focus groups, you allowed us to create a text that will benefit all of our students and instructors that use this text.

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# Contents

## CHAPTER 1

### Introduction to Managerial Accounting 2

#### The Meaning of Managerial Accounting 4

- Information Needs of Managers and Other Users 5
- Planning 5
- Controlling 5
- Decision Making 6

#### Financial Accounting and Managerial Accounting 7

- Financial Accounting 7
- Managerial Accounting 7
- Comparison of Financial and Managerial Accounting 7
- Exhibit 1.1 Comparison of Financial and Managerial Accounting 8

#### Current Focus of Managerial Accounting 9

- New Methods of Costing Products and Services 9
- Customer Orientation 9
- Exhibit 1.2 The Value Chain 10
- Cross-Functional Perspective 11
- Total Quality Management 11
- Time as a Competitive Element 12
- Efficiency 13

#### The Role of the Managerial Accountant 13

- Exhibit 1.3 Kicker Inc. Organizational Chart 14

#### Managerial Accounting and Ethical Conduct 15

- Ethical Behavior 16
- Company Codes of Ethical Conduct 17
- Standards of Ethical Conduct for Managerial Accountants 18
- Exhibit 1.4 Statement of Ethical Professional Practice 19

#### Certification 20

- The Certified Management Accountant 20
- The Certified Public Accountant 21
- The Certified Internal Auditor 21

## CHAPTER 2

### Basic Managerial Accounting Concepts 30

#### The Meaning and Uses of Cost 32

- Cost 32
- Cost Objects 33
- Accumulating and Assigning Costs 33
- Assigning Costs to Cost Objects 33
- Exhibit 2.1 Object Costing 35

#### Product and Service Costs 37

- Providing Cost Information 38
- Determining Product Cost 38

- Exhibit 2.2 Product Costs Include Direct Materials, Direct Labor, and Overhead 39

#### Example 2.1 How to Calculate Product Cost in Total and Per Unit 40

#### Example 2.2 How to Calculate Prime Cost and Conversion Cost in Total and Per Unit 41

- Exhibit 2.3 The Impact of Product versus Period Costs on the Financial Statements 42

#### Preparing Income Statements 44

- Cost of Goods Manufactured 44

#### Example 2.3 How to Calculate the Direct Materials Used in Production 45

#### Example 2.4 How to Calculate Cost of Goods Manufactured and Cost of Goods Sold 46

#### Example 2.5 How to Calculate Cost of Goods Sold 46

- Exhibit 2.4 Relationship between the Flow of Costs, Inventories, and Cost of Goods Sold 47

- Income Statement: Manufacturing Firm 47

#### Example 2.6 How to Prepare an Income Statement for a Manufacturing Firm 48

#### Example 2.7 How to Calculate the Percentage of Sales Revenue for Each Line on the Income Statement 49

- Income Statement: Service Firm 50

#### Example 2.8 How to Prepare an Income Statement for a Service Organization 50

## CHAPTER 3

### Cost Behavior and Forecasting 78

#### Basics of Cost Behavior 80

- Measures of Output and the Relevant Range 81
- Fixed Costs 81
- Exhibit 3.1 Colley Computers Fixed Cost of Supervision 83
- Variable Costs 84
- Exhibit 3.2 Colley Computers Variable Cost of DVD-ROM Drives 86

#### More Advanced Cost Behavior: The Reasonableness of Straight-Line Cost Relationships 86

- Semi-Variable Costs 86

- Exhibit 3.3 Semi-Variable Cost: Decreasing Rate 86

- Exhibit 3.4 Semi-Variable Cost: Increasing Rate 87

#### Mixed Costs and Step Costs 88

- Mixed Costs 88

- Exhibit 3.5 Mixed Cost Behavior 89

- Step Cost Behavior 89

- Exhibit 3.6 Step Costs: Narrow Steps and Wide Steps 90

- Accounting Records and Need for Cost Separation 91

**Methods for Separating Mixed Costs into Fixed and Variable Components 91**

- Example 3.1** How to Create and Use a Cost Formula 92
  - The High-Low Method 93
- Example 3.2** How to Use the High-Low Method to Calculate Fixed Cost and the Variable Rate and to Construct a Cost Formula 94
- Example 3.3** How to Use the High-Low Method to Calculate Predicted Total Variable Cost and Total Cost for Budgeted Output 95
- Example 3.4** How to Use the High-Low Method to Calculate Predicted Total Variable Cost and Total Cost for a Time Period That Differs from the Data Period 96
  - Scattergraph Method 97
  - Exhibit 3.7 Anderson Company’s Materials Handling Cost 97
  - Exhibit 3.8 Scattergraphs with Nonlinear Cost 99
  - The Method of Least Squares 99
  - Exhibit 3.9 Line Deviations 99
  - Exhibit 3.10 A Portion of the Summary Output from Excel for Anderson Company 100
- Example 3.5** How to Use the Regression Method to Calculate Fixed Cost and the Variable Rate and to Construct a Cost Formula and to Determine Budgeted Cost 101
  - Comparison of Methods 101
  - Exhibit 3.11 Overview of Methods for Separating Mixed Costs into Fixed and Variable Components 102
  - Managerial Judgment 102

**Variable and Absorption Income Statements: Two Ways of Measuring Income 105**

- Absorption Costing 105
- Variable Costing 105
- Comparison of Variable and Absorption Costing Methods 105
- Exhibit 3.12 Classification of Costs under Absorption and Variable Costing as Product or Period Costs 105
- Inventory Valuation 106
- Example 3.6** How to Compute Inventory Cost under Absorption Costing 106
- Example 3.7** How to Compute Inventory Cost under Variable Costing 107
- Exhibit 3.13 Product Cost under Absorption and Variable Costing 108
- Income Statements Using Variable and Absorption Costing 108
- Example 3.8** How to Prepare an Absorption-Costing Income Statement 108
- Example 3.9** How to Prepare a Variable-Costing Income Statement 109
  - Production, Sales, and Income Relationships 109
  - Exhibit 3.14 Production, Sales, and Income Relationships 109

**Appendix 3A: Using the Regression Programs 110**

- Exhibit 3.15 Spreadsheet Data for Anderson Company 111
- Exhibit 3.16 Regression Output for Anderson Company 112
- Goodness of Fit 112

**CHAPTER 4**

**Job-Order Costing and Overhead Application 148**

**Characteristics of the Job-Order Environment 150**

- Job-Order Production and Costing 150
- Process Production and Costing 151
- Exhibit 4.1 Comparison of Job-Order and Process Costing 151
- Production Costs in Job-Order Costing 152

**Normal Costing and Overhead Application 152**

- Actual Costing versus Normal Costing 152
- Importance of Unit Costs to Manufacturing Firms 153
- Importance of Unit Costs to Service Firms 153
- Normal Costing and Estimating Overhead 154

**Example 4.1** How to Calculate the Predetermined Overhead Rate and Apply Overhead to Production 155

- Exhibit 4.2 Actual and Applied Overhead 156

**Example 4.2** How to Reconcile Actual Overhead with Applied Overhead 157

- Departmental Overhead Rates 157

**Example 4.3** How to Calculate Predetermined Departmental Overhead Rates and Apply Overhead to Production 158

**Example 4.4** How to Convert Departmental Data to Plantwide Data to Calculate the Overhead Rate and Apply Overhead to Production 159

- Unit Costs in the Job-Order System 159

**Keeping Track of Job Costs with Source Documents 161**

- Job-Order Cost Sheet 161
- Exhibit 4.3 Job-Order Cost Sheet 161
- Materials Requisitions 162
- Exhibit 4.4 Materials Requisition Form 162
- Time Tickets 162
- Exhibit 4.5 Time Ticket 163

**The Flow of Costs through the Accounts 164**

- Exhibit 4.6 Flow of Costs through the Accounts of a Job-Order Costing Firm 164
- Accounting for Materials 165
- Exhibit 4.7 Summary of Materials Cost Flows 165
- Accounting for Direct Labor Cost 165
- Exhibit 4.8 Summary of Direct Labor Cost Flows 166
- Accounting for Overhead 166
- Accounting for Actual Overhead Costs 167
- Exhibit 4.9 Summary of Overhead Cost Flows 167
- Accounting for Finished Goods 167

Exhibit 4.10 Summary of Cost Flows from Work in Process to Finished Goods 168

Accounting for Cost of Goods Sold 168

Exhibit 4.11 Schedule of Cost of Goods Manufactured 169

Exhibit 4.12 Statement of Cost of Goods Sold 169

**Example 4.5 How to Prepare Brief Job-Order Cost Sheets 170**

Accounting for Nonmanufacturing Costs 172

Exhibit 4.13 Income Statement 172

**Appendix 4A: Journal Entries Associated With Job-Order Costing 173**

Exhibit 4.14 Posting of Journal Entries to the Accounts 175

**Appendix 4B: Support Department Cost Allocation 176**

Types of Departments 176

Exhibit 4.15 Steps for Determining Product Costs by Using Predetermined Departmental Overhead Rates 177

Methods of Support Department Cost Allocation 177

Exhibit 4.16 Illustration of the Direct Method 178

**Example 4.6 How to Assign Support Department Costs by Using the Direct Method 178**

Exhibit 4.17 Illustration of the Sequential Method 180

**Example 4.7 How to Assign Support Department Costs by Using the Sequential Method 181**

**CHAPTER 5**

**Activity-Based Costing and Management 214**

**Limitations of Functional-Based Cost Accounting Systems 216**

Nonunit-Related Overhead Costs 216

Exhibit 5.1 ABC Hierarchy 217

Product Diversity 218

Illustrating the Failure of Unit-Based Overhead Rates 218

Exhibit 5.2 Product-Costing Data for Rio Novo's Porto Behlo Plant 219

**Example 5.1 How to Calculate Consumption Ratios 220**

**Example 5.2 How to Calculate Activity Rates 221**

**Example 5.3 How to Calculate Activity-Based Unit Costs 222**

Exhibit 5.3 Activity Rates and Activity-Based Unit Costs for Rio Novo's Porto Behlo Plant 222

Illustrating Relationships: Product Diversity and Product-Costing Accuracy 223

Exhibit 5.4 Diversity and Product-Costing Accuracy 225

**Activity-Based Product Costing 225**

Exhibit 5.5 Activity-Based Costing: Assigning Cost of Overhead 226

Identifying Activities and Their Attributes 226

Exhibit 5.6 Activity Dictionary for Hemingway Bank's Credit Card Department 228

Assigning Costs to Activities 228

Exhibit 5.7 Work Distribution Matrix for Hemingway Bank's Credit Card Department 228

**Example 5.4 How to Assign Resource Costs to Activities by Using Direct Tracing and Resource Drivers 229**

Exhibit 5.8 Activity Costs for Hemingway Bank's Credit Card Department 229

Assigning Costs to Products 229

Exhibit 5.9 Assigning Costs for Hemingway Bank's Credit Card Department 230

**Activity-Based Customer Costing and Activity-Based Supplier Costing 231**

Exhibit 5.10 Whale Curve of Cumulative Customer Profitability 232

Activity-Based Customer Costing 232

**Example 5.5 How to Calculate Activity-Based Customer Costs 233**

Activity-Based Supplier Costing 234

**Example 5.6 How to Calculate Activity-Based Supplier Costs 235**

**Process-Value Analysis 236**

Exhibit 5.11 Process-Value Analysis Model 237

Driver Analysis: The Search for Root Causes 237

Activity Analysis: Identifying and Assessing Value Content 237

**Example 5.7 How to Assess Nonvalue-Added Costs 241**

Activity Performance Measurement 241

**Example 5.8 How to Calculate Cycle Time and Velocity 242**

**CHAPTER 6**

**Process Costing 276**

**Characteristics of Process Manufacturing 278**

Types of Processes 278

Exhibit 6.1 Sequential Processing Illustrated 278

Exhibit 6.2 Parallel Processing Illustrated 279

How Costs Flow through the Accounts in Process Costing 280

Exhibit 6.3 Flow of Manufacturing Costs through the Accounts of a Process-Costing Firm 280

**Example 6.1 How to Account for Cost Flows Without Work-in-Process Inventories 280**

Accumulating Costs in the Production Report 281

Service and Manufacturing Firms 282

**The Impact of Work-In-Process Inventories on Process Costing 283**

Equivalent Units of Production 283

**Example 6.2 How to Calculate Equivalent Units of Production with No Beginning Work in Process 284**

**Example 6.3 How to Measure Output and Assign Costs: No Beginning Work in Process 285**



Two Methods of Treating Beginning Work-in-Process Inventory 286

**Weighted Average Costing 286**

Overview of the Weighted Average Method 287

**Example 6.4** How to Measure Output and Assign Costs: Weighted Average Method 287

Five Steps in Preparing a Production Report 288

**Example 6.5** How to Prepare a Physical Flow Schedule 289

Production Report 291

**Example 6.6** How to Prepare a Production Report: Weighted Average Method 292

Evaluation of the Weighted Average Method 292

**Multiple Inputs and Multiple Departments 293**

Nonuniform Application of Manufacturing Inputs 293

**Example 6.7** How to Calculate Equivalent Units, Unit Costs, and Valuing Inventories with Nonuniform Inputs 294

Multiple Departments 295

Exhibit 6.4 Production Report: Weighted Average Method 296

**Example 6.8** How to Calculate the Physical Flow Schedule, Equivalent Units, and Unit Costs with Transferred-In Goods 296

**Appendix 6A: Production Report—First-In, First-Out Costing 298**

Differences between the First-In, First-Out and Weighted Average Methods 298

Example of the First-In, First-Out Method 298

**Example 6.9** How to Calculate Output and Cost Assignments: First-In, First-Out Method 298

Exhibit 6.5 Physical Flow Schedule 300

**Example 6.10** How to Prepare a Production Report: First-In, First-Out Method 301

**CHAPTER 7**

**Cost-Volume-Profit Analysis 332**

**Break-Even Point in Units and in Sales Dollars 334**

Using Operating Income in Cost-Volume-Profit Analysis 334

Exhibit 7.1 The Contribution Margin Income Statement 335

**Example 7.1** How to Prepare a Contribution Margin Income Statement 336

Exhibit 7.2 Contribution Margin and Fixed Cost at Break-Even for Whittier Company 337

Break-Even Point in Units 337

**Example 7.2** How to Calculate the Break-Even Point in Units 338

Break-Even Point in Sales Dollars 338

**Example 7.3** How to Calculate the Variable Cost Ratio and the Contribution Margin Ratio 340

**Example 7.4** How to Calculate the Break-Even Point in Sales Dollars 341

**Units and Sales Dollars Needed to Achieve a Target Income 343**

Units to Be Sold to Achieve a Target Income 343

**Example 7.5** How to Calculate the Number of Units to Be Sold to Earn a Target Operating Income 344

Sales Revenue to Achieve a Target Income 345

**Example 7.6** How to Calculate Sales Needed to Earn a Target Operating Income 345

**Graphs of Cost-Volume-Profit Relationships 346**

The Cost-Volume-Profit Graph 347

Exhibit 7.3 Cost-Volume-Profit Graph 347

Assumptions of Cost-Volume-Profit Analysis 348

**Illustrating Relationships Among CVP Variables 348**

Exhibit 7.4 Cost-Volume-Profit Relationships 349

**Multiple-Product Analysis 351**

Break-Even Point in Units 352

**Example 7.7** How to Calculate the Break-Even Units for a Multiple-Product Firm 353

Break-Even Point in Sales Dollars 354

**Example 7.8** How to Calculate the Break-Even Sales Dollars for a Multiple-Product Firm 354

**Cost-Volume-Profit Analysis and Risk and Uncertainty 356**

Exhibit 7.5 Summary of the Effects of Alternative 1 357

Exhibit 7.6 Summary of the Effects of Alternative 2 358

Exhibit 7.7 Summary of the Effects of Alternative 3 358

Introducing Risk and Uncertainty 358

Exhibit 7.8 Margin of Safety 359

**Example 7.9** How to Calculate the Margin of Safety 360

**Example 7.10** How to Calculate the Degree of Operating Leverage 361

**Example 7.11** How to Calculate the Impact of Increased Sales on Operating Income Using the Degree of Operating Leverage 362

Exhibit 7.9 Differences between a Manual and an Automated System 363

Sensitivity Analysis and Cost-Volume-Profit 363

**MAKING THE CONNECTION: INTEGRATIVE EXERCISE (CHAPTERS 2, 3, AND 7) 390**

**CHAPTER 8**

**Tactical Decision Making and Relevant Analysis 392**

**Short-Run Decision Making 394**

The Decision-Making Model 394

Step 1: Recognize and Define the Problem 395

Step 2: Identify the Alternatives as Possible Solutions 395

Step 3: Identify the Costs and Benefits Associated with Each Feasible Alternative 396

Step 4: Estimate the Relevant Costs and Benefits for Each Feasible Alternative 396

Step 5: Assess Qualitative Factors 397



Step 6: Make the Decision	398
Relevant Costs Defined	399
Cost Behavior and Relevant Costs	401
<b>Some Common Relevant Cost Applications</b>	<b>402</b>
Make-or-Buy Decisions	403
Exhibit 8.1 Make-or-Buy Decisions	403
<b>Example 8.1 How to Structure a Make-or-Buy Problem</b>	<b>405</b>
Special-Order Decisions	406
Exhibit 8.2 Accept or Reject a Special Order	406
<b>Example 8.2 How to Structure a Special-Order Problem</b>	<b>407</b>
Keep-or-Drop Decisions	408
<b>Example 8.3 How to Prepare a Segmented Income Statement</b>	<b>410</b>
Exhibit 8.3 Comparison of Segmented Income Statement With and Without Allocated Common Fixed Expense	411
<b>Example 8.4 How to Structure a Keep-or-Drop Product-Line Problem</b>	<b>412</b>
<b>Example 8.5 How to Structure a Keep-or-Drop Product-Line Problem with Complementary Effects</b>	<b>414</b>
Further Processing of Joint Products	414
Exhibit 8.4 Further Processing of Joint Products	416
<b>Example 8.6 How to Structure the Sell-or-Process-Further Decision</b>	<b>416</b>
<b>Product Mix Decisions</b>	<b>417</b>
<b>Example 8.7 How to Determine the Optimal Product Mix with One Constrained Resource</b>	<b>418</b>
<b>Example 8.8 How to Determine the Optimal Product Mix with One Constrained Resource and a Sales Constraint</b>	<b>419</b>
Multiple Constrained Resources	420
<b>The Use of Costs in Pricing Decisions</b>	<b>420</b>
Cost-Based Pricing	420
<b>Example 8.9 How to Calculate Price by Applying a Markup Percentage to Cost</b>	<b>421</b>
Target Costing and Pricing	422
<b>Example 8.10 How to Calculate a Target Cost</b>	<b>423</b>

## CHAPTER 9

### Profit Planning and Flexible Budgets 454

#### Description of Budgeting 456

Budgeting and Planning and Control	456
Exhibit 9.1 Planning, Control, and Budgets	456
Advantages of Budgeting	457
The Master Budget	457
Exhibit 9.2 The Master Budget and Its Interrelationships	458

#### Preparing the Operating Budget 459

Sales Budget	459
<b>Example 9.1 How to Prepare a Sales Budget</b>	<b>460</b>
Production Budget	461
<b>Example 9.2 How to Prepare a Production Budget</b>	<b>461</b>
Direct Materials Purchases Budget	462

#### **Example 9.3 How to Prepare a Direct Materials Purchases Budget** 463

Direct Labor Budget	464
<b>Example 9.4 How to Prepare a Direct Labor Budget</b>	<b>464</b>
Overhead Budget	464

#### **Example 9.5 How to Prepare an Overhead Budget** 464

Ending Finished Goods Inventory Budget	465
<b>Example 9.6 How to Prepare an Ending Finished Goods Inventory Budget</b>	<b>465</b>

Cost of Goods Sold Budget	466
---------------------------	-----

#### **Example 9.7 How to Prepare a Cost of Goods Sold Budget** 466

Selling and Administrative Expenses Budget	466
--	-----

#### **Example 9.8 How to Prepare a Selling and Administrative Expenses Budget** 467

Budgeted Income Statement	467
---------------------------	-----

#### **Example 9.9 How to Prepare a Budgeted Income Statement** 467

### Preparing the Financial Budget 469

Cash Budget	469
-------------	-----

Exhibit 9.3 The Cash Budget	469
-----------------------------	-----

#### **Example 9.10 How to Prepare a Schedule for Cash Collections on Accounts Receivable** 470

#### **Example 9.11 How to Determine Cash Payments on Accounts Payable** 471

#### **Example 9.12 How to Prepare a Cash Budget** 472

Budgeted Balance Sheet	473
------------------------	-----

Exhibit 9.4 Budgeted Balance Sheet	474
------------------------------------	-----

### Using Flexible Budgets for Planning and Performance Reporting 475

#### **Example 9.13 How to Prepare a Before-the-Fact Flexible Budget** 476

Exhibit 9.5 Performance Report Comparing Actual Costs to the Static Budget	477
--	-----

#### **Example 9.14 How to Prepare a Performance Report Using a Flexible Budget** 478

### Using Budgets for Performance Evaluation 479

Frequent Feedback on Performance	480
Monetary and Nonmonetary Incentives	480
Participative Budgeting	480

Exhibit 9.6 The Art of Standard Setting	481
---	-----

Realistic Standards	481
---------------------	-----

Controllability of Costs	482
--------------------------	-----

Multiple Measures of Performance	482
----------------------------------	-----

## CHAPTER 10

### Standard Costing and Variance Analysis 520

#### Unit Standards and Basic Concepts of Standard Costing 522

How Standards Are Developed	523
Types of Standards	523

Exhibit 10.1 Types of Standards 523  
 Why Standard Cost Systems Are Adopted 524  
 Exhibit 10.2 Cost Assignment Approaches 525  
 Exhibit 10.3 Standard Cost Sheet for  
     Corn Chips 526  
**Example 10.1** How to Compute Standard Quantities  
     Allowed (*SQ* and *SH*) 527  
**Variance Analysis: General Description 528**  
     Price and Usage Variances 528  
 Exhibit 10.4 Variance Analysis:  
     General Description 529  
     The Decision to Investigate 529  
**Example 10.2** How to Use Control Limits to Trigger a  
     Variance Investigation 531  
**Variance Analysis: Materials And Labor 532**  
     Total Variance for Materials 532  
**Example 10.3** How to Calculate the Total Variance for  
     Materials 532  
     Direct Materials Variances 533  
**Example 10.4** How to Calculate Materials Variances:  
     Formula and Columnar Approaches 534  
     Using Materials Variance Information 535  
     Total Variance Analysis: Direct Labor 536  
**Example 10.5** How to Calculate the Total Variance for  
     Labor 537  
     Direct Labor Variances 538  
**Example 10.6** How to Calculate Labor Variances: Formula  
     and Columnar Approaches 539  
     Using Labor Variance Information 539  
     Additional Cost Management Practices 541  
**Overhead Analysis 543**  
     Total Variable Overhead Variance 543  
**Example 10.7** How to Calculate the Total Variable Overhead  
     Variance 543  
     Variable Overhead Variances 544  
**Example 10.8** How to Calculate Variable Overhead  
     Spending and Efficiency Variances: Columnar and Formula  
     Approaches 544  
     Comparison of the Variable Overhead Spending Variance with  
     the Price Variances of Materials and Labor 545  
     Responsibility for the Variable Overhead Spending  
     Variance 546  
     Responsibility for the Variable Overhead Efficiency  
     Variance 546  
     A Performance Report for the Variable Overhead Spending and  
     Efficiency Variances 546  
**Example 10.9** How to Prepare a Performance Report for the  
     Variable Overhead Variances 547  
     Fixed Overhead Analysis 547  
     Total Fixed Overhead Variance 548  
**Example 10.10** How to Calculate the Total Fixed Overhead  
     Variance 548  
     Fixed Overhead Variances 549

**Example 10.11** How to Calculate Fixed Overhead Variances:  
     Columnar and Formula Approaches 549  
     Responsibility for the Fixed Overhead Spending Variance 550  
     Analysis of the Fixed Overhead Spending Variance 550  
     Responsibility for the Fixed Overhead Volume Variance 551  
     Analysis of the Volume Variance 552  
     Exhibit 10.5 Graphical Analysis of the Volume Variance 552  
**Appendix 10A: Accounting for Variances 552**  
     Entries for Direct Materials Variances 553  
     Entries for Direct Labor Variances 553  
     Disposition of Materials and Labor Variances 554  
**MAKING THE CONNECTION: INTEGRATIVE  
 EXERCISE (CHAPTERS 5, 9, AND 10) 588**

**CHAPTER 11**

**Performance Evaluation and Decentralization 590**  
**Decentralization and Responsibility Centers 592**  
     Exhibit 11.1 Centralization and Decentralization 592  
     Reasons for Decentralization 592  
     Divisions in the Decentralized Firm 593  
     Types of Goods or Services 593  
     Exhibit 11.2 Decentralized Divisions 594  
     Geographic Lines 594  
     Responsibility Centers 594  
     Exhibit 11.3 Types of Responsibility Centers and Accounting  
     Information Used to Measure Performance 595  
**Measuring the Performance of Investment Centers by Using  
 Return on Investment 596**  
     Return on Investment 596  
     Margin and Turnover 597  
**Example 11.1** How to Calculate Average Operating Assets,  
     Margin, Turnover, and Return on Investment 597  
     Exhibit 11.4 Comparison of Divisional Performance 598  
     Advantages of Return on Investment 599  
     Disadvantages of the Return on Investment Measure 600  
**Measuring the Performance of Investment Centers by Using  
 Residual Income and Economic Value Added 602**  
     Residual Income 603  
**Example 11.2** How to Calculate Residual Income 603  
     Economic Value Added (EVA) 604  
**Example 11.3** How to Calculate Economic Value Added 605  
**Transfer Pricing 607**  
     Impact of Transfer Pricing on Divisions and the Firm as a  
     Whole 607  
     Exhibit 11.5 Impact of Transfer Price on Transferring Divisions  
     and the Company, ABC Inc., as a Whole 607  
     Transfer Pricing Policies 608  
**Example 11.4** How to Calculate Transfer Price 609  
**Appendix 11A: The Balanced Scorecard—Basic  
 Concepts 611**  
     Exhibit 11.6 Balanced Scorecard for Ashley Hotel\* 612  
     Strategy Translation 612

- Exhibit 11.7 Testable Strategy Illustrated 614
- The Four Perspectives and Performance Measures 615
- Exhibit 11.8 Summary of Objectives and Measures: Financial Perspective 616
- Exhibit 11.9 Summary of Objectives and Measures: Customer Perspective 617
- Example 11.5** How to Compute Cycle Time and Velocity 618
- Example 11.6** How to Calculate Manufacturing Cycle Efficiency 620
- Exhibit 11.10 Summary of Objectives and Measures: Internal Perspective 621
- Exhibit 11.11 Summary of Objectives and Measures: Learning and Growth Perspective 622

## CHAPTER 12

### Capital Investment Decisions 644

#### Types of Capital Investment Decisions 646

- Independent and Mutually Exclusive Projects 646
- Making Capital Investment Decisions 646

#### Nondiscounting Models: Payback Period and Accounting Rate of Return 647

- Payback Period 648
- Example 12.1** How to Calculate Payback 648
- Accounting Rate of Return 650
- Example 12.2** How to Calculate the Accounting Rate of Return 651

#### Discounting Models: The Net Present Value Method 652

- Net Present Value Defined 652
- Net Present Value Illustrated 653
- Example 12.3** How to Assess Cash Flows and Calculate Net Present Value 653
- Illustrating Relationships: NPV, Discount Rates, and Cash Flows 654
- Exhibit 12.1 NPV, Discount Rates, and Cash Flow 655

#### Internal Rate of Return 656

- Internal Rate of Return Defined 656
- Internal Rate of Return Illustrated: Multiple-Period Setting with Uniform Cash Flows 656
- Example 12.4** How to Calculate Internal Rate of Return with Uniform Cash Flows 657
- Internal Rate of Return Illustrated: Multiple-Period Setting with Uneven Cash Flows 657

#### Postaudit of Capital Projects 659

- Postaudit Illustrated 659
- Postaudit Benefits 660
- Postaudit Limitations 661

#### Mutually Exclusive Projects 661

- Net Present Value Compared with Internal Rate of Return 661
- Exhibit 12.2 Net Present Value Compared with Internal Rate of Return 662
- NPV Analysis for Mutually Exclusive Projects Illustrated 662

#### **Example 12.5** How to Calculate Net Present Value and Internal Rate of Return for Mutually Exclusive Projects 663

- Special Considerations for Advanced Manufacturing Environment 664
- Exhibit 12.3 Investment Data; Direct, Intangible, and Indirect Benefits 665

#### Appendix 12A: Present Value Concepts 667

- Future Value 667
- Present Value 667
- Present Value of an Uneven Series of Cash Flows 668
- Exhibit 12A.1 Present Value of an Uneven Series of Cash Flows 668
- Present Value of a Uniform Series of Cash Flows 669
- Exhibit 12A.2 Present Value of an Annuity 669

#### Appendix 12B: Present Value Tables 669

- Exhibit 12B.1 Present Value of a Single Amount 670
- Exhibit 12B.2 Present Value of an Annuity 671

### MAKING THE CONNECTION: INTEGRATIVE EXERCISE (CHAPTERS 3, 5, 8, AND 12) 697

## CHAPTER 13

### Emerging Topics in Managerial Accounting 700

#### Enterprise Risk Management 702

- Exhibit 13.1 Key Steps within the ERM Process 702
- Determining Risk Appetite 703
- Exhibit 13.2 Key Elements of a Portfolio Risk Management Perspective 703
- Identifying Top Risks 703
- Assessing Inherent Risks 703
- Responding to Risks Using a Portfolio Perspective 705
- Example 13.1** How to Use Net Benefit to Evaluate Risk Response Alternatives 707
- Monitoring the ERM Process 708

#### Business Sustainability 709

- Exhibit 13.3 The Role of Management Accounting in the Business Sustainability Cycle 710
- Exhibit 13.4 Business Sustainability Issues throughout the Value Chain 711
- Exhibit 13.5 The Relationship Between Stakeholders and Strategy 712
- Exhibit 13.6 Stakeholder Engagement Activities at Eli Lilly 713
- Exhibit 13.7 The Relationship between Stakeholder Concerns and Business Success at UPS 714
- Exhibit 13.8 Rapid Growth in Corporate Sustainability Reporting Since Its Inception 716
- Exhibit 13.9 Widespread Adoption of Corporate Sustainability Reporting across Industries 716
- Exhibit 13.10 The Global Phenomenon of Corporate Sustainability Reporting 717
- Exhibit 13.11 Growth in Independent Assurance of Corporate Sustainability Information 718

**Quality Cost Management 719**

- Costs of Quality 720
- Exhibit 13.12 Examples of Quality Costs by Category 721
- Reporting Quality Costs 721
- Example 13.2 How to Prepare a Quality Cost Report 721**
- Exhibit 13.13 Quality Cost Categories: Relative Contribution by Category 723
- Controlling Quality Costs 724
- Example 13.3 How to Prepare an Interim Quality Performance Report 724**
- Example 13.4 How to Prepare Multiple-Period Quality Trend Reports 726**
- Exhibit 13.14 Multiple-Period Trend Graph: Total Quality Costs 726
- Exhibit 13.15 Multiple-Period Trend Graph: Individual Quality Cost Categories 727

**Lean Manufacturing and Lean Accounting 727**

- Lean Manufacturing 727
- Exhibit 13.16 Order Fulfillment Value Stream 728
- Exhibit 13.17 Traditional Batch Production Process 729
- Exhibit 13.18 Proposed Manufacturing Cell 730
- Example 13.5 How to Calculate Production Time for Traditional and Cellular Manufacturing 730**
- Lean Accounting 731
- Exhibit 13.19 Value-Stream Cost Assignments 732
- Exhibit 13.20 Value-Stream Costs and Production Hours: Models X12 and Y35 735
- Example 13.6 How to Calculate Value-Stream Product Costs 735**
- Value-Stream Operational Control 736
- Exhibit 13.21 Holland Company Value-Stream Box Scorecard 736

**International Issues in Management Accounting 738**

- Types of Involvement in the International Economy 738
- Foreign Currency Exchange 740
- Example 13.7 How to Calculate the Value of an Exchange in Another Currency 741**
- Transfer Pricing and the Multinational Firm 743
- Exhibit 13.22 Use of Transfer Pricing to Affect Taxes Paid 743

**The Role of Cost and Managerial Accounting in Fraud And Forensic Accounting 745**

- Fraud and Management Accounting 745
- Forensic Accounting in Management Accounting 747
- Exhibit 13.23 Applying Different Types of Accounting Knowledge to Forensic Accounting 748

**CHAPTER 14**

**Statement of Cash Flows 790**

**Overview of the Statement of Cash Flows 792**

- Cash Defined 792
- Sources and Uses of Cash 792
- Exhibit 14.1 Sources and Uses of Cash 792

- Methods for Calculating Operating Cash Flows 793
- Example 14.1 How to Classify Activities and Identify Them as Sources or Uses of Cash 793**
- Noncash Exchanges 794

**Preparation of the Statement: Indirect Method 795**

- Exhibit 14.2 Balance Sheets: Lemmons Company 795
- Step 1: Compute the Change in Cash 796
- Example 14.2 How to Compute the Change in Cash 796**
- Step 2: Compute Operating Cash Flows 796
- Example 14.3 How to Calculate Operating Cash Flows Using the Indirect Method 796**
- Step 3: Compute Investing Cash Flows 798
- Example 14.4 How to Compute Investing Cash Flows 798**
- Step 4: Compute Financing Cash Flows 799
- Example 14.5 How to Compute Financing Cash Flows 799**
- Step 5: Prepare the Statement of Cash Flows 800
- Example 14.6 How to Prepare the Statement of Cash Flows 800**

**The Direct Method: An Alternative Approach 801**

- Example 14.7 How to Calculate Operating Cash Flows Using the Direct Method 802**

**Worksheet Approach to the Statement of Cash Flows 803**

- Exhibit 14.3 Balance Sheets: Portermart Company 804
- Example 14.8 How to Prepare a Statement of Cash Flows Using a Worksheet Approach 804**
- Analysis of Transactions 806
- The Final Step 807
- Exhibit 14.4 Worksheet-Derived Statement of Cash Flows for Portermart Company 808

**CHAPTER 15**

**Financial Statement Analysis 836**

**Common-Size Analysis 838**

- Exhibit 15.1 Common-Size Analysis 839
- Horizontal Analysis 839
- Example 15.1 How to Prepare Common-Size Income Statements Using Base Period Horizontal Analysis 839**
- Vertical Analysis 840
- Example 15.2 How to Prepare Income Statements Using Net Sales as the Base: Vertical Analysis 840**
- Percentages and Size Effects 841

**Ratio Analysis 842**

- Standards for Comparison 842
- Exhibit 15.2 Ratio Analysis 843
- Classification of Ratios 844
- Exhibit 15.3 Income Statement and Statement of Retained Earnings for Payne Company for Year 2 844
- Exhibit 15.4 Comparative Balance Sheets for Payne Company for Years 1 and 2 845

**Liquidity Ratios 846**

- Current Ratio 846
- Quick or Acid-Test Ratio 848



<b>Example 15.3</b> How to Calculate the Current Ratio and the Quick (or Acid-Test) Ratio 848	<b>Example 15.9</b> How to Calculate the Average Total Assets and the Return on Assets 857
Accounts Receivable Turnover Ratio 848	Return on Common Stockholders' Equity 857
<b>Example 15.4</b> How to Calculate the Average Accounts Receivable, the Accounts Receivable Turnover Ratio, and the Accounts Receivable Turnover in Days 849	<b>Example 15.10</b> How to Calculate the Average Common Stockholders' Equity and the Return on Stockholders' Equity 858
Inventory Turnover Ratio 850	Earnings per Share 859
<b>Example 15.5</b> How to Calculate the Average Inventory, the Inventory Turnover Ratio, and the Inventory Turnover in Days 851	<b>Example 15.11</b> How to Compute Earnings per Share 859
Impact of the Just-in-Time Manufacturing Environment 852	Price-Earnings Ratio 859
<b>Leverage Ratios 853</b>	<b>Example 15.12</b> How to Compute the Price-Earnings Ratio 860
Times-Interest-Earned Ratio 853	Dividend Yield and Payout Ratios 860
<b>Example 15.6</b> How to Calculate the Times-Interest-Earned Ratio 853	<b>Example 15.13</b> How to Compute the Dividend Yield and the Dividend Payout Ratio 861
Debt Ratio 854	The Importance of Profitability Ratios to External Users of the Financial Statements 861
<b>Example 15.7</b> How to Calculate the Debt Ratio and the Debt-to-Equity Ratio 855	
<b>Profitability Ratios 856</b>	Glossary 891
Return on Sales 856	Check Figures 899
<b>Example 15.8</b> How to Calculate the Return on Sales 856	Index 903
Return on Total Assets 856	

SEVENTH EDITION

# Managerial Accounting

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THE CORNERSTONE OF  
BUSINESS DECISION MAKING



# 1

## Introduction to Managerial Accounting

After studying Chapter 1, you should be able to:

- 1 Explain the meaning of managerial accounting.
- 2 Explain the differences between managerial accounting and financial accounting.
- 3 Identify and explain the current focus of managerial accounting.
- 4 Describe the role of managerial accountants in an organization.
- 5 Explain the importance of ethical behavior for managers and managerial accountants.
- 6 Identify three forms of certification available to managerial accountants.

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## EXPERIENCE MANAGERIAL DECISIONS

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*with BuyCostumes.com*

The greatest benefit of managerial accounting is also its biggest challenge—to provide managers with information that improves decisions and creates organizational value. This information helps inform managers about the impact of various strategic and operational decisions on key nonfinancial performance measures and their eventual impact on the organization's financial performance. The information is challenging to prepare and analyze because it requires an understanding of all value chain components that affect the organization, including research and development, production, marketing, distribution, and customer service.

Since its inception in 1999, **BuyCostumes.com** has blended the right managerial accounting information and an innovative business model to provide over 10 billion costume combinations to millions of customers all over the world. Using the Internet and marketing creativity, BuyCostumes.com serves a growing market of consumers. For example, U.S. consumers spend over \$2.5 billion each year on Halloween costumes for adults, children and even pets (who account for \$350 million of this amount)!

According to BuyCostumes.com's CEO, the company measures key performance indicators to guide its decision making. For example, managerial accountants analyze measures of customer satisfaction, average time between order placement and costume arrival for each shipping method, and the profitability of individual customer types. As customer trends change, competitors emerge, and technological advances occur, BuyCostumes.com's managerial accounting information adapts to provide crucial insight into the company's performance and how its strategy should evolve to remain one of the world's largest Internet costume retailers.

“Using the Internet and marketing creativity, BuyCostumes.com serves a market of 150 million U.S. consumers who spend \$2.5 billion on Halloween costumes each year.”

**OBJECTIVE 1**

Explain the meaning of managerial accounting.

*Here's* **Why It's important****THE MEANING OF MANAGERIAL ACCOUNTING**

What do we mean by managerial accounting? Quite simply, **managerial accounting** is the provision of accounting information for a company's internal users. More specifically, managerial accounting represents the firm's internal accounting system designed to provide the necessary financial and nonfinancial information that helps company managers make the best possible decisions. Unlike financial accounting, managerial accounting is not bound by any formal criteria such as generally accepted accounting principles (GAAP). Managerial accounting has three broad objectives:



- To provide information for planning the organization's actions.
- To provide information for controlling the organization's actions.
- To provide information for making effective decisions.

Using recent examples from many companies in both the for-profit and not-for-profit sectors, this textbook explains how all manufacturing (e.g., aircraft producer—**Boeing Corporation**), merchandising (e.g., clothing retailer—**American Eagle Outfitters**), and service (e.g., healthcare provider—**Cleveland Clinic**, or online retailer **Amazon.com**) organizations use managerial accounting information and concepts. People in all types of positions—from corporate presidents to graphic designers to hospital administrators—can improve their managerial skills by being well-grounded in the basic concepts and use of managerial accounting information for planning, controlling, and decision making.

The exciting reality is that the importance and scope of managerial accounting information is growing rapidly around the globe. As a result, the demand for businesspeople who possess the ability to create, understand, use, and communicate managerial accounting information continues to grow. Chapter 13 explores special and emerging managerial accounting areas, such as enterprise risk management, lean and quality accounting, corporate sustainability reporting, and fraud and forensic accounting.

*Here's How It's Used:* **SUSTAINABILITY**

One of the fastest growing needs in business is the area of corporate sustainability measurement and reporting. Managerial accounting plays an important role in this exciting aspect of business. Thousands of companies increasingly release to the public (i.e., suppliers, regulators, employees, human rights organizations, environmental groups, customers, etc.) very large quantities of managerial accounting information that traditionally either did not exist or was released only internally. This information is released through optional reports known as corporate sustainability reports (e.g., **Coca-Cola**, **McDonald's**), social responsibility reports (e.g., **Starbucks**, **Target**), or citizenship reports (e.g., **ExxonMobil**, **General Electric**). The release of these reports often occurs because firms want

to manage their reputation by preparing and releasing such information themselves, rather than having Internet bloggers, newspapers, and cable news networks publish their own estimates of such information. Some leading companies (e.g., **Clorox**, **Eli Lilly**, **Novo Nordisk**) have even moved so far as to combine their sustainability report with their annual report, thereby resulting in a single, integrated report containing both traditional financial accounting information as well as managerial accounting information.<sup>1</sup> Measuring the nonfinancial aspects of corporate business sustainability, including economic, social, environmental, legal, and political issues, and then linking their impact on the company's financial performance requires the unique insights and expertise of managerial accountants!

<sup>1</sup> For a more in-depth discussion of the future of sustainability accounting, see "Currents of Change: The KPMG Survey of Corporate Responsibility Reporting 2015," taken from KPMG's website, [www.kpmg.com/crreporting](http://www.kpmg.com/crreporting); or Brian Ballou, Dan Heitger, and Chuck Landes, "Accounting for the Sustainability Cycle," 2013, taken from the American Institute of Certified Public Accountants' website, [www.aicpa.org/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/sustainability/whitepaper\\_accounting\\_for\\_the\\_sustainability\\_cycle.pdf](http://www.aicpa.org/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/sustainability/whitepaper_accounting_for_the_sustainability_cycle.pdf).



## Information Needs of Managers and Other Users

Managerial accounting information is needed by a number of individuals. In particular, managers and empowered workers need comprehensive, up-to-date information for the following activities:

- planning
- controlling
- decision making

## Planning

The detailed formulation of action to achieve a particular end is the management activity called **planning**. Planning requires setting objectives and identifying methods to achieve those objectives. For example, a firm may set the objective of increasing its short- and long-term profitability by improving the overall quality of its products. **DaimlerChrysler** drastically improved the quality and profitability of its **Chrysler** automobile division in the early 21st century to the point where its quality surpassed that of **Mercedes-Benz** (also owned by DaimlerChrysler). By improving product quality, firms like DaimlerChrysler (now Daimler AG) should be able to reduce scrap and rework, decrease the number of customer complaints and warranty work, reduce the resources currently assigned to inspection, and so on, thus increasing profitability. To realize these benefits, management must develop some specific methods that, when implemented, will lead to the achievement of the desired objective. A plant manager, for example, may start a supplier evaluation program to identify and select suppliers who are willing and able to supply defect-free parts. Empowered workers may be able to identify production causes of defects and to create new methods for producing a product that will reduce scrap and rework and the need for inspection. The new methods should be clearly specified and detailed.

## Controlling

Planning is only half the battle. Once a plan is created, it must be implemented and its implementation monitored by managers and workers to ensure that the plan is being carried out as intended. The managerial activity of monitoring a plan's implementation and taking corrective action as needed is referred to as **controlling**. Control is usually achieved by comparing actual performance with expected performance. This information can be used to evaluate or to correct the steps being taken to implement a plan. Based on the feedback, a manager (or worker) may decide to let the plan continue as is, take corrective action of some type to put the actions back in harmony with the original plan, or do some midstream replanning.

The managerial accounting information used for planning and control purposes can be either financial or nonfinancial in nature. For example, **Duffy Tool and Stamping** saved \$14,300 per year by redesigning a press operation. In one department, completed parts (made by a press) came down a chute and fell into a parts tub. When the tub became full, press operators had to stop operation while the stock operator removed the full tub and replaced it with an empty one. Workers redesigned the operation so that each press had a chute with two branches—each leading to a different tub. Now when one tub is full, completed parts are routed into the other tub. The \$14,300 savings are a financial measure of the success of the redesign. The redesign also eliminated machine downtime and increased the number of units produced per hour (operational feedback), both of which are examples of nonfinancial performance. Both types of measures convey important information. Often, financial and nonfinancial feedback is given to managers in the form of performance reports that compare the actual data with planned data or other benchmarks.

## Decision Making

The process of choosing among competing alternatives is called **decision making**. This managerial function is intertwined with planning and control in that a manager cannot successfully plan or control the organization's actions without making decisions regarding competing alternatives. For instance, if **BMW** contemplates the possibility of offering a car that runs on gasoline and hydrogen, its ultimate decision would be improved if information about the alternatives (e.g., pertaining to gasoline versus hydrogen versus hybrid combinations of these two automobile fuel options) is gathered and made available to managers. One of the major roles of the managerial accounting information system is to supply information that facilitates decision making. For example, based on managerial accounting information concerning current market size and potential growth opportunities in the costume market, **BuyCostumes.com** decided to sell many different types of costumes internationally in order to best meet customer demand. As a result, the company offers a selection of exclusive and licensed costumes and accessories that equate to over 10 billion costume combinations! This important strategic decision allows BuyCostumes.com to serve as a premier destination for the 10 million global partiers that visit its website each Halloween. Interestingly, since its creation, BuyCostumes.com management has correctly predicted the outcome of each presidential election based on the sales data from its presidential candidate mask collection.

### Here's How It's Used: AT COSTCO

#### What Constitutes Managerial Accounting Information?

You are the **Costco** executive who has been chosen to decide whether or not the company should continue its policy of sourcing its finest coffee from Rwanda.

**What types of information should you consider as you decide how best to structure and analyze this important long-term strategic decision? What challenges do you expect to face in making this decision?**

What constitutes managerial accounting information is growing considerably as organizations must make decisions that include the global consequences of their actions, as well as the impact on an increasingly large number of vocal, well-informed, and powerful stakeholders. Stakeholders include the company's customers, suppliers, employees, regulators, politicians, lawmakers, and local community members. Generally speaking, managerial accounting information can be *financial* in nature, such as sales revenue or cost of sales, or *nonfinancial* in nature, such as the number of quality defects or the percentage of manufacturing plants that are inspected for compliance with human rights policies. One of the most exciting—and yet daunting—aspects of managerial accounting is that one can choose to measure *anything*, assuming the resources, information technology, and creativity exist to capture the desired performance measure.

As a Costco executive, one of the first nonfinancial factors you likely would consider measuring is the quality of the Rwandan coffee to ensure that it fulfills Costco's strategic goal of creating a competitive advantage by providing premium coffee to customers. Quality could be defined by the beans' taste, shelf life

longevity, or other factors valued by customers. Other important nonfinancial performance measures might include the time required to ship the harvested beans from Rwanda to Costco stores around North America and the presence of a local farming workforce in Rwanda critical to successfully sustaining a long-term supply chain between Rwandan fields and Costco customers.

One of the most important financial items to measure would be the importance to Costco's customers of purchasing premium quality coffee, which could be measured by the additional price they are willing to pay for Rwandan coffee over and above more average quality coffee. Other financial measures might include the cost of harvesting, inspecting, and shipping beans, as well as investments in Rwandan farming communities (e.g., physical infrastructure and schools) that ensure the relationship is sustainable for future generations.

Finally, you should consider how the decision to continue sourcing premium coffee from Rwanda will be perceived by Costco's important stakeholders, including its customers who buy the coffee, suppliers who provide the coffee beans, and government officials in the United States and Rwanda who set trading policies between the two countries. Accurately measuring issues like stakeholder perceptions of such decisions can be difficult because the managerial accountant oftentimes must invent new measures, figure out where the data to create such measures might come from, and estimate how accurate these measures will be once collected.

**The managerial accountant's ability to inform executive decision makers by providing innovative, accurate, and timely performance measures can create an important competitive advantage for the organization by improving its key decisions.**



## Check Point

### 1. Which activity generally occurs first: decision making, planning, or control?

#### Answer:

Planning usually occurs first to set objectives, followed by controlling to monitor implementation of the planned objectives, and, finally, decision making to choose the best alternative(s).

### 2. The desire to attract and retain the most talented workers in a given industry is an example of which activity: decision making, planning, or control?

#### Answer:

Planning. Setting an objective to improve workforce quality is an example of an important planning activity.

## FINANCIAL ACCOUNTING AND MANAGERIAL ACCOUNTING

There are two basic kinds of accounting information systems: financial accounting and managerial accounting. The company's accounting system should be designed to provide both financial and managerial accounting information. The key point is flexibility—the system should be able to supply different *information* for different *purposes*.

### Financial Accounting

**Financial accounting** is primarily concerned with producing information (financial statements) for *external* users, including investors, creditors, customers, suppliers, government agencies (Food and Drug Administration, Federal Communications Commission, etc.), and labor unions. This information has a historical orientation and is used for such things as investment decisions, stewardship evaluation, monitoring activity, and regulatory measures. Financial statements must conform to certain rules and conventions that are defined by various agencies, such as the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the International Accounting Standards Board (IASB). These rules pertain to issues such as the recognition of revenues; timing of expenses; and recording of assets, liabilities, and stockholders' equity.

### Managerial Accounting

The managerial accounting system produces information for *internal* users, such as managers, executives, and workers. Thus, managerial accounting could be properly called *internal accounting*, and financial accounting could be called *external accounting*. Specifically, managerial accounting identifies, collects, measures, classifies, and reports financial and nonfinancial information that is useful to internal users in planning, controlling, and decision making.

### Comparison of Financial and Managerial Accounting

When comparing financial accounting to managerial accounting, several differences can be identified. Some of the more important differences follow and are summarized in Exhibit 1.1.

## OBJECTIVE 2

Explain the differences between managerial accounting and financial accounting.

Here's **Why It's important**

- *Targeted users.* Managerial accounting focuses on providing information for internal users, while financial accounting focuses on providing information for external users.
- *Restrictions on inputs and processes.* Managerial accounting is not subject to the requirements of generally accepted accounting principles set by the SEC and the FASB that must be followed for financial reporting. The inputs and processes of financial accounting are well defined. Only certain kinds of economic events qualify as inputs, and processes must follow generally accepted methods. Unlike financial accounting, managerial accounting has no official body that prescribes the format, content, and rules for selecting inputs and processes and preparing reports.
- *Type of information.* The restrictions imposed by financial accounting tend to produce objective and verifiable financial information. For managerial accounting, information may be financial and nonfinancial and may be much more subjective in nature.
- *Time orientation.* Financial accounting has a historical orientation (i.e., looking through the rearview mirror). It records and reports events that have already happened. Although managerial accounting also records and reports events that have already occurred, it strongly emphasizes providing information about future events (i.e., looking through the front windshield). Management, for example, may want to know what it will cost to produce a product next year. This future orientation is necessary for planning and decision making.
- *Degree of aggregation.* Managerial accounting provides measures and internal reports used to evaluate the performance of entities, product lines, departments, and managers. Essentially, detailed information is needed and provided. Financial accounting, on the other hand, focuses on overall firm performance, providing a more aggregated viewpoint.
- *Breadth.* Managerial accounting is much broader than financial accounting. It includes aspects of managerial economics, industrial engineering, and management science as well as numerous other areas.

### Exhibit 1.1

#### Comparison of Financial and Managerial Accounting

Financial Accounting	Managerial Accounting
<ul style="list-style-type: none"> <li>• Externally focused</li> <li>• Must follow externally imposed rules</li> <li>• Objective financial information</li> </ul>	<ul style="list-style-type: none"> <li>• Internally focused</li> <li>• No mandatory rules</li> <li>• Financial and nonfinancial information; subjective information possible</li> </ul>
<ul style="list-style-type: none"> <li>• Historical orientation</li> <li>• Information about the firm as a whole</li> </ul>	<ul style="list-style-type: none"> <li>• Emphasis on the future</li> <li>• Internal evaluation and decisions based on very detailed information</li> </ul>
<ul style="list-style-type: none"> <li>• More self-contained</li> </ul>	<ul style="list-style-type: none"> <li>• Broad, multidisciplinary</li> </ul>

### Check Point

**1. Is the preparation of financial statements for the annual report a task more suited to managerial accounting or financial accounting?**

**Answer:**

Financial accounting. While managerial accounting provides important inputs (such as work-in-process inventory or cost of goods sold) to external financial statements, financial accounting focuses most heavily on producing financial statements for use by external parties.

**2. Is performance measurement information concerning internal product failure rates an example of financial accounting information or managerial accounting information?**

**Answer:**

Managerial accounting. Product failure rates are an example of important internal managerial accounting information that would be helpful in forecasting future financial accounting performance measures such as sales revenue.

## CURRENT FOCUS OF MANAGERIAL ACCOUNTING

The business environment in which companies operate has changed dramatically over the past several decades. For instance, advances in technology, the Internet, the opening of markets around the world, increased competitive pressures, and increased complexity of strategy (e.g., alliances between **McDonald's** and **The Walt Disney Company** for promotional tie-ins) and operations all have combined to produce a global business environment. Effective managerial accounting systems also have changed in order to provide information that helps improve companies' planning, control, and decision-making activities. Several important uses of managerial accounting resulting from these advances include new methods of estimating product and service cost and profitability, understanding customer orientation, evaluating the business from a cross-functional perspective, and providing information useful in improving total quality.

### OBJECTIVE 3

Identify and explain the current focus of managerial accounting.

Here's **Why It's important**

### New Methods of Costing Products and Services

Today's companies need focused, accurate information on the cost of the products and services they produce. In the past, a company might have produced a few products that were roughly similar to one another. Only the cost of materials and labor might have differed from one product to another, and figuring out the cost of each unit was relatively easy. Now, with the increase in technology and automation, it is more difficult to generate the costing information needed by management. As Peter Drucker, internationally respected management guru, points out:

*Traditional cost accounting in manufacturing does not record the cost of nonproducing such as the cost of faulty quality, or of a machine being out of order, or of needed parts not being on hand. Yet these unrecorded and uncontrolled costs in some plants run as high as the costs that traditional accounting does record. By contrast, a new method of cost accounting developed in the last 10 years—called “activity-based” accounting—records all costs. And it relates them, as traditional accounting cannot, to value-added.<sup>2</sup>*

Activity-based costing (ABC) is a more detailed approach to determining the cost of goods and services. ABC improves costing accuracy by emphasizing the cost of the many activities or tasks that must be done to produce a product or offer a service. **United Parcel Service Inc. (UPS)** used ABC to discover and manage the cost of the activities involved with shipping packages by truck, rather than by plane, in order to beat **FedEx** at its overnight delivery business in quick mid-distance (up to 500 miles) overnight deliveries.<sup>3</sup> Process-value analysis focuses on the way in which companies create value for customers. The objective is to find ways to perform necessary activities more efficiently and to eliminate those that do not create customer value.

### Customer Orientation

Customer value is a key focus because firms can establish a competitive advantage by creating better customer value for the same or lower cost than competitors or creating equivalent value for lower cost than that of competitors. Customer value is the difference between what a customer receives and what the customer gives up when buying a product or service. When we talk about customer value, we consider the complete range of tangible and intangible benefits that a customer receives from a purchased product. Customers receive basic and special product features, service, quality, instructions for use, reputation, brand name, and other important factors. On the other hand, customers give up the cost of purchasing the product, the time and

<sup>2</sup> Peter F. Drucker, “We Need to Measure, Not Count,” *The Wall Street Journal* (April 13, 1993): A14.

<sup>3</sup> Charles Haddad and Jack Ewing, “Ground Wars: UPS's Rapid Ascent Leaves FedEx Scrambling,” *BusinessWeek* (May 21, 2001): 64–68.