Contents

1 Introduction  1
   A. Managerial Accounting: Decision Making and Control  2
   B. Design and Use of Cost Systems  4
   C. Marmots and Grizzly Bears  8
   D. Management Accountant's Role in the Organization  11
   E. Evolution of Management Accounting: A Framework for Change  14
   F. Vortec Medical Probe Example  16
   G. Outline of the Text  19
   H. Summary  20

2 The Nature of Costs  24
   A. Opportunity Costs  25
      1. Characteristics of Opportunity Costs  26
      2. Examples of Decisions Based on Opportunity Costs  26
   B. Cost Variation  31
      1. Fixed, Marginal, and Average Costs  31
      2. Linear Approximations  34
      3. Other Cost Behavior Patterns  35
      4. Activity Measures  36
   C. Cost–Volume–Profit Analysis  38
      1. Copier Example  38
      2. Calculating Break-Even and Target Profits  39
      3. Limitations of Cost–Volume–Profit Analysis  43
      4. Multiple Products  44
      5. Operating Leverage  45
   D. Opportunity Costs versus Accounting Costs  48
      1. Period versus Product Costs  49
      2. Direct Costs, Overheads, and Opportunity Costs  50
   E. Cost Estimation  53
      1. Account Classification  53
      2. Motion and Time Studies  53
   F. Summary  54
   Appendix: Costs and the Pricing Decision  55

3 Opportunity Cost of Capital and Capital Budgeting  92
   A. Opportunity Cost of Capital  93
   B. Interest Rate Fundamentals  96
      1. Future Values  96
      2. Present Values  97
4. Perpetuities 99
5. Annuities 100
6. Multiple Cash Flows per Year 101

C. Capital Budgeting: The Basics 103
1. Decision to Acquire an MBA 103
2. Decision to Open a Video Rental Store 104
3. Essential Points about Capital Budgeting 105

D. Capital Budgeting: Some Complexities 107
1. Risk 107
2. Inflation 108
3. Taxes and Depreciation Tax Shields 110

E. Alternative Investment Criteria 112
1. Payback 112
2. Accounting Rate of Return 112
3. Internal Rate of Return (IRR) 114
4. Methods Used in Practice 117

F. Summary 118

4 Organizational Architecture 138

A. Basic Building Blocks 139
1. Self-Interested Behavior, Team Production, and Agency Costs 139
2. Decision Rights and Rights Systems 145
3. Role of Knowledge and Decision Making 146
4. Markets versus Firms 147
5. Influence Costs 149

B. Organizational Architecture 150
1. Three-Legged Stool 150
2. Decision Management versus Decision Control 155

C. Accounting’s Role in the Organization’s Architecture 157

D. Example of Accounting’s Role: Executive Compensation Contracts 160

E. Summary 162

5 Responsibility Accounting and Transfer Pricing 175

A. Responsibility Accounting 176
1. Cost Centers 178
2. Profit Centers 180
3. Investment Centers 181
4. Economic Value Added (EVA®) 186
5. Controllability Principle 189

B. Transfer Pricing 191
1. International Taxation 191
2. Economics of Transfer Pricing 193
3. Common Transfer Pricing Methods 198
4. Reorganization: The Solution If All Else Fails 204
5. Recap 204

C. Summary 207
6 Budgeting 237

A. Generic Budgeting Systems 240
   1. Country Club 240
   2. Private University 244
   3. Large Corporation 247

B. Trade-Off between Decision Management and Decision Control 250
   1. Communicating Specialized Knowledge versus Performance Evaluation 250
   2. Budget Ratcheting 251
   3. Participative Budgeting 254
   4. New Approaches to Budgeting 254
   5. Managing the Trade-Off 257

C. Resolving Organizational Problems 258
   1. Short-Run versus Long-Run Budgets 259
   2. Line-Item Budgets 261
   3. Budget Lapsing 262
   4. Static versus Flexible Budgets 263
   5. Incremental versus Zero-Based Budgets 266

D. Summary 267

Appendix: Comprehensive Master Budget Illustration 268

7 Cost Allocation: Theory 312

A. Pervasiveness of Cost Allocations 314
   1. Manufacturing Organizations 316
   2. Hospitals 316
   3. Universities 317

B. Reasons to Allocate Costs 319
   1. External Reporting/Taxes 319
   2. Cost-Based Reimbursement 321
   3. Decision Making and Control 322

C. Incentive/Organizational Reasons for Cost Allocations 322
   1. Cost Allocations Are a Tax System 322
   2. Factor Price Understates Total Cost 324
   3. Insulating versus Noninsulating Cost Allocations 330

D. Summary 334

8 Cost Allocation: Practices 359

A. Death Spiral 360

B. Allocating Capacity Costs: Depreciation 365

C. Allocating Service Department Costs 365
   1. Direct Allocation Method 367
   2. Step-Down Allocation Method 369
   3. Service Department Costs and Transfer Pricing of Direct and Step-Down Methods 370
   4. Reciprocal Allocation Method 374
   5. Recap 376
D. Joint Costs 376
  1. Chickens 378
  2. Net Realizable Value 379
  3. Decision Making and Control 383
E. Segment Reporting and Joint Benefits 384
F. Summary 385
Appendix: Reciprocal Method for Allocating Service Department Costs 386

9 Absorption Cost Systems 420
A. Job Order Costing 422
B. Cost Flows through the T-Accounts 424
C. Allocating Overhead to Jobs 426
  1. Overhead Rates 427
  2. Over/Underabsorbed Overhead 429
  3. Flexible Budgets to Estimate Overhead 431
  4. Expected versus Normal Volume 434
D. Permanent versus Temporary Volume Changes 438
E. Plantwide versus Multiple Overhead Rates 439
F. Process Costing: The Extent of Averaging 443
G. Summary 444
Appendix A: Process Costing 444
Appendix B: Demand Shifts, Fixed Costs, and Pricing 450

10 Criticisms of Absorption Cost Systems: Incentive to Overproduce 484
A. Incentive to Overproduce 486
  1. Example 486
  2. Reducing the Overproduction Incentive 490
B. Variable (Direct) Costing 491
  1. Background 491
  2. Illustration of Variable Costing 491
  3. Overproduction Incentive under Variable Costing 493
C. Problems with Variable Costing 495
  1. Classifying Fixed Costs as Variable Costs 495
  2. Ignores Opportunity Cost of Capacity 496
D. Beware of Unit Costs 497
E. Summary 499

11 Criticisms of Absorption Cost Systems: Inaccurate Product Costs 519
A. Inaccurate Product Costs 520
B. Activity-Based Costing 524
  1. Choosing Cost Drivers 525
  2. Absorption versus Activity-Based Costing: An Example 531
C. Analyzing Activity-Based Costing 535
  1. Reasons for Implementing Activity-Based Costing 535
  2. Benefits and Costs of Activity-Based Costing 537
  3. ABC Measures Costs, Not Benefits 538
D. Acceptance of Activity-Based Costing 540
E. Summary 544
12 Standard Costs: Direct Labor and Materials  576
   A. Standard Costs  577
      1. Reasons for Standard Costing  578
      2. Setting and Revising Standards  579
      3. Target Costing  584
   B. Direct Labor and Materials Variances  586
      1. Direct Labor Variances  586
      2. Direct Materials Variances  590
      3. Risk Reduction and Standard Costs  593
   C. Incentive Effects of Direct Labor and Materials Variances  594
      1. Build Inventories  594
      2. Externalities  595
      3. Discouraging Cooperation  595
      4. Mutual Monitoring  596
      5. Satisficing  596
   D. Disposition of Standard Cost Variances  597
   E. The Costs of Standard Costs  598
   F. Summary  602

13 Overhead and Marketing Variances  617
   A. Budgeted, Standard, and Actual Volume  618
   B. Overhead Variances  621
      1. Flexible Overhead Budget  621
      2. Overhead Rate  622
      3. Overhead Absorbed  623
      4. Overhead Efficiency, Volume, and Spending Variances  624
      5. Graphical Analysis  627
      6. Inaccurate Flexible Overhead Budget  629
   C. Marketing Variances  630
      1. Price and Quantity Variances  630
      2. Mix and Sales Variances  631
   D. Summary  633

14 Management Accounting in a Changing Environment  655
   A. Integrative Framework  657
      1. Organizational Architecture  658
      2. Business Strategy  659
      3. Environmental and Competitive Forces Affecting Organizations  661
      4. Implications  661
   B. Organizational Innovations and Management Accounting  662
      1. Total Quality Management (TQM)  663
      2. Just-in-Time (JIT) Production  667
      3. Six Sigma and Lean Production  670
      4. Balanced Scorecard  672
   C. When Should the Internal Accounting System Be Changed?  679
   D. Summary  679

Solutions to Concept Questions  707
Glossary  717
Index  727