Contents

1 Cost Accounting: Information for Decision Making 2
   In Action: The Importance of Understanding Costs 3

Value Creation in Organizations 3
   Why Start with Value Creation? 3
   Value Chain 4
   Supply Chain and Distribution Chain 5
   In Action: Focus on the Supply Chain 5
   Using Cost Information to Increase Value 5
   Accounting and the Value Chain 6

Accounting Systems 6
   Financial Accounting 6
   Cost Accounting 6
   Cost Accounting, GAAP, and IFRS 7
   Customers of Cost Accounting 7

Our Framework for Assessing Cost Accounting Systems 8
   The Manager's Job Is to Make Decisions 8
   Decision Making Requires Information 8
   Finding and Eliminating Activities That Don't Add Value 9
   Identifying Strategic Opportunities Using Cost Analysis 9
   Owners Use Cost Information to Evaluate Managers 9

Cost Data for Managerial Decisions 10
   Costs for Decision Making 10
   In Action: Fast-Food Chain Menu Items and Costs 11
   Costs for Control and Evaluation 11
   Different Data for Different Decisions 13
   Trends in Cost Accounting throughout the Value Chain 14
      Cost Accounting in Research and Development (R&D) 14
      Cost Accounting in Design 14
      Cost Accounting in Purchasing 15
      Cost Accounting in Production 15
      Cost Accounting in Marketing 15
      Cost Accounting in Distribution 16
      Cost Accounting in Customer Service 16
      Enterprise Resource Planning 16
      Creating Value in the Organization 16

Key Financial Players in the Organization 17
   Choices: Ethical Issues for Accountants 18
      What Makes Ethics So Important? 18
      Ethics 19
      Sarbanes-Oxley Act of 2002 and Ethics 19
      In Action: Options Backdating at Apple 20

Cost Accounting and Other Business Disciplines 21
   The Debrief 21
   Summary 22
   Key Terms 22
   Appendix: Institute of Management Accountants Code of Ethics 22
   Review Questions 24
   Critical Analysis and Discussion Questions 25
   Exercises 25
   Problems 27
   Integrative Cases 33
   Solutions to Self-Study Questions 34

2 Cost Concepts and Behavior 36
   In Action: Higher Transportation Costs Lead Company to Move Manufacturing Back to the United States 37
Short-Run versus Long-Run Pricing Decisions 113
Short-Run Pricing Decisions: Special Orders 114
Long-Run Pricing Decisions 116
Long-Run versus Short-Run Pricing: Is There a Difference? 116
Cost Analysis for Pricing 116
In Action: Take-Back Laws in Europe 117

Legal Issues Relating to Costs and Sales Prices 118
Predatory Pricing 118
Dumping 118
Price Discrimination 119
Peak-Load Pricing 119
Price Fixing 120

Use of Differential Analysis for Production Decisions 120
Make-It or Buy-It Decisions 120
Make-or-Buy Decisions Involving Differential Fixed Costs 120
Opportunity Costs of Making 124
Decision to Add or Drop a Product Line or Close a Business Unit 125
Product Choice Decisions 127

The Theory of Constraints 130
The Debrief 132

What Methods Are Used to Estimate Cost Behavior? 156
Engineering Method 156
Account Analysis Method 157
Statistical Cost Estimation 159
In Action: Using Statistical Analysis to Improve Profitability 165
Multiple Regression 165
Practical Implementation Problems 166

Learning Phenomenon 168
In Action: Learning Curves 168
Applications 169

How Is an Estimation Method Chosen? 171
Data Problems 171
Effect of Different Methods on Cost Estimates 172
The Debrief 173

Cost Estimation 154

Why Estimate Costs? 155
Basic Cost Behavior Patterns 155
In Action: The Variable Cost of a Text Message 156

Cost Management Systems 199
Reasons to Calculate Product or Service Costs 199
In Action: Importance of Distinguishing between Production Costs and Overhead Costs 200
Cost Allocation and Product Costing 200
Cost Flow Diagram 201

Fundamental Themes Underlying the Design of Cost Systems for Managerial Purposes 201

Costing in a Single Product, Continuous Process Industry 202
Basic Cost Flow Model 202
Assigning Costs Using First-In, First-Out (FIFO) Process Costing 277
   Step 1: Measure the Physical Flow of Resources 278
   Step 2: Compute the Equivalent Units of Production 278
   Step 3: Identify the Product Costs for Which to Account 280
   Step 4: Compute the Costs per Equivalent Unit: FIFO 280
   Step 5: Assign Product Cost: FIFO 281
   How This Looks in T-Accounts 281

Determining Which Is Better: FIFO or Weighted Average? 282

Computing Product Costs: Summary of the Steps 282

Using Costs Transferred in from Prior Departments 282
   Who Is Responsible for Costs Transferred in from Prior Departments? 284

Choosing between Job and Process Costing 286

Operation Costing 286
   Product Costing in Operations 287
   Operation Costing Illustration 287

Comparing Job, Process, and Operation Costing 290
   The Debrief 290

Summary 291
Key Terms 291
Review Questions 292
Critical Analysis and Discussion Questions 292
Exercises 293
Problems 298
Integrative Cases 305
Solutions to Self-Study Questions 307

9 Activity-Based Costing 310

Reported Product Costs and Decision Making 311
   Dropping a Product 311
   The Death Spiral 313

Two-Stage Cost Allocation 314
   Two-Stage Cost Allocation and the Choice of Cost Drivers 315
   Plantwide versus Department-Specific Rates 317
   Choice of Cost Allocation Methods: A Cost-Benefit Decision 318

Activity-Based Costing 319
   In Action: Activity-Based Costing in a Not-for-Profit 320
   Developing Activity-Based Costs 320

Cost Hierarchies 322
   In Action: The ABC Cost Hierarchy—Maintenance Costs for an Airline 323

Activity-Based Costing Illustrated 323
   Step 1: Identify the Activities 323
   Step 2: Identify the Cost Drivers 324
   Step 3: Compute the Cost Driver Rates 324
   Step 4: Assign Costs Using Activity-Based Costing 324
   Unit Costs Compared 325

Cost Flows through Accounts 326

Choice of Activity Bases in Modern Production Settings 328
   In Action: Evidence on the Benefits of Activity-Based Costing 329

Activity-Based Costing in Administration 329

Who Uses ABC? 330
   The Debrief 331

Summary 331
Key Terms 332
Review Questions 332
Critical Analysis and Discussion Questions 332
Exercises 333
Problems 340
Integrative Cases 347
Solutions to Self-Study Questions 352
10  
**Fundamentals of Cost Management**  354

Using Activity-Based Cost Management to Add Value  355
   Using Activity-Based Cost Information to Improve Processes  357
   Using Cost Hierarchies  358

Managing the Cost of Customers and Suppliers  358
   In Action: **Customer Profitability—Revenue and Cost Effects**  359
   Using Activity-Based Costing to Determine the Cost of Customers and Suppliers  360
   Determining Why the Cost of Customers Matters  362
   Using Cost of Customer Information to Manage Costs  362
   In Action: **Analyzing Customer Profitability at Best Buy**  363

Determining the Cost of Suppliers  363
   Capturing the Cost Savings  364

Managing the Cost of Capacity  365
   Using and Supplying Resources  365
   Computing the Cost of Unused Capacity  367
   Assigning the Cost of Unused Capacity  368
   Seasonal Demand and the Cost of Unused Capacity  369

Managing the Cost of Quality  371
   How Can We Limit Conflict between Traditional Managerial Accounting Systems and Total Quality Management?  371
   What Is Quality?  372
   What Is the Cost of Quality?  372
   Trade-Offs, Quality Control, and Failure Costs  374
   In Action: **Cost Elements Included in Reported Quality Costs**  375
   The Debrief  376

Summary  376
Key Terms  377
Review Questions  377
Critical Analysis and Discussion Questions  377
Exercises  378
Problems  384

11  
**Service Department and Joint Cost Allocation**  392

Service Department Cost Allocation  393
   In Action: **Outsourcing Information Services—Managed Service Providers**  394

Methods of Allocating Service Department Costs  395
   Allocation Bases  395
   Direct Method  396
   Step Method  399
   In Action: **Step Method at Stanford University**  402
   Reciprocal Method  402
   Comparison of Direct, Step, and Reciprocal Methods  404
   The Reciprocal Method and Decision Making  406

Allocation of Joint Costs  408
   Joint Costing Defined  408
   Reasons for Allocating Joint Costs  408

Joint Cost Allocation Methods  409
   Net Realizable Value Method  409
   Physical Quantities Method  412
   Evaluation of Joint Cost Methods  412

Deciding Whether to Sell Goods Now or Process Them Further  413
   In Action: **Different Demands for Different Parts**  414

Deciding What to Do with By-Products  414
   The Debrief  415

Summary  416
Key Terms  417
Appendix: Calculation of the Reciprocal Method Using Computer Spreadsheets  417
Review Questions  419
Critical Analysis and Discussion Questions  419
Exercises  420
Problems  425
Integrative Case  433
Solutions to Self-Study Questions  435
12
Fundamentals of Management Control Systems 438

Why a Management Control System? 439
Alignment of Managerial and Organizational Interests 440
Evolution of the Control Problem: An Example 440

Decentralized Organizations 440
Why Decentralize the Organization? 441
Advantages of Decentralization 441
Disadvantages of Decentralization 442

Framework for Evaluating Management Control Systems 442
Organizational Environment and Strategy 443
Results of the Management Control System 443
Elements of a Management Control System 443
Balancing the Elements 444

Delegated Decision Authority: Responsibility Accounting 444
Cost Centers 445
Discretionary Cost Centers 445
Revenue Centers 446
Profit Centers 446
Investment Centers 446
Responsibility Centers and Organization Structure 446

Measuring Performance 446
Two Basic Questions 447
In Action: Teacher Pay and Student Performance 447
Cost Centers 448
Revenue Centers 448
Profit Centers 448
Investment Centers 449

Evaluating Performance 449
Relative Performance versus Absolute Performance Standards 449
Evaluating Managers’ Performance versus Economic Performance of the Responsibility Center 449

13
Planning and Budgeting 472

How Strategic Planning Increases Competitiveness 473
In Action: Using the Budget to Help Manage Cash Flow 474

Overall Plan 474
Organization Goals 474
Strategic Long-Range Profit Plan 475
Master Budget (Tactical Short-Range Profit Plan): Tying the Strategic Plan to the Operating Plan 475

Human Element in Budgeting 476
Value of Employee Participation 476

Developing the Master Budget 477
## Contents

**Where to Start?** 477  
- Sales Forecasting 477

**Comprehensive Illustration** 479  
- Forecasting Production 479  
- Forecasting Production Costs 480  
- Direct Labor 482  
- Overhead 482  
- Completing the Budgeted Cost of Goods Sold 482  
- Revising the Initial Budget 484

**Marketing and Administrative Budget** 484

**Pulling It Together into the Income Statement** 486

**Key Relationships: The Sales Cycle** 487

**Using Cash Flow Budgets to Estimate Cash Needs** 487  
- Multiperiod Cash Flows 488  
- In Action: The “Curse” of Growth 490

**Planning for the Assets and Liabilities on the Budgeted Balance Sheets** 490

**Big Picture: How It All Fits Together** 490

**Budgeting in Retail and Wholesale Organizations** 492

**Budgeting in Service Organizations** 493  
- In Action: Budget Is the Law in Government 493

**Ethical Problems in Budgeting** 494

**Budgeting under Uncertainty** 494  
- The Debrief 495

**Summary** 496  
**Key Terms** 496  
**Review Questions** 497  
**Critical Analysis and Discussion Questions** 497  
**Exercises** 497  
**Problems** 503  
**Integrative Case** 509  
**Solutions to Self-Study Questions** 510

### 14

**Business Unit Performance Measurement** 514

**Divisional Performance Measurement** 515  

**Accounting Income** 516  
- Computing Divisional Income 516  
- Advantages and Disadvantages of Divisional Income 517  
- Some Simple Financial Ratios 517

**Return on Investment** 518  
- Performance Measures for Control: A Short Detour 519  
- Limitations of ROI 519

**Residual Income Measures** 522  
- Limitations of Residual Income 523

**Economic Value Added (EVA)** 524  
- In Action: EVA at Best Buy 525  
- Limitations of EVA 526  
- In Action: Does Using Residual Income as a Performance Measure Affect Managers’ Decisions? 526

**Divisional Performance Measurement: A Summary** 527

**Measuring the Investment Base** 527  
- Gross Book Value versus Net Book Value 527  
- Historical Cost versus Current Cost 527  
- Beginning, Ending, or Average Balance 528

**Other Issues in Divisional Performance Measurement** 530  
- The Debrief 530

**Summary** 531  
**Key Terms** 531  
**Review Questions** 531  
**Critical Analysis and Discussion Questions** 531  
**Exercises** 532  
**Problems** 535  
**Integrative Cases** 540  
**Solutions to Self-Study Questions** 545
### Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Summary of Overhead Variances</td>
<td>602</td>
</tr>
<tr>
<td>Key Points</td>
<td>603</td>
</tr>
<tr>
<td>In Action: Does Standard Costing Lead to Waste?</td>
<td>603</td>
</tr>
<tr>
<td>The Debrief</td>
<td>603</td>
</tr>
<tr>
<td>Summary</td>
<td>604</td>
</tr>
<tr>
<td>Key Terms</td>
<td>605</td>
</tr>
<tr>
<td>Appendix: Recording Costs in a Standard Cost System</td>
<td>605</td>
</tr>
<tr>
<td>Review Questions</td>
<td>608</td>
</tr>
<tr>
<td>Critical Analysis and Discussion Questions</td>
<td>608</td>
</tr>
<tr>
<td>Exercises</td>
<td>609</td>
</tr>
<tr>
<td>Problems</td>
<td>615</td>
</tr>
<tr>
<td>Integrative Case</td>
<td>621</td>
</tr>
<tr>
<td>Solutions to Self-Study Questions</td>
<td>624</td>
</tr>
<tr>
<td>17 Additional Topics in Variance Analysis</td>
<td>626</td>
</tr>
<tr>
<td>Profit Variance Analysis When Units Produced Do Not Equal Units Sold</td>
<td>627</td>
</tr>
<tr>
<td>In Action: Financial Analysis and Variance Analysis</td>
<td>629</td>
</tr>
<tr>
<td>Reconciling Variable Costing Budgets and Full Absorption Income Statements</td>
<td>629</td>
</tr>
<tr>
<td>Materials Purchases Do Not Equal Materials Used</td>
<td>630</td>
</tr>
<tr>
<td>Market Share Variance and Industry Volume Variance</td>
<td>632</td>
</tr>
<tr>
<td>Sales Activity Variances with Multiple Products</td>
<td>634</td>
</tr>
<tr>
<td>Evaluating Product Mix</td>
<td>634</td>
</tr>
<tr>
<td>Evaluating Sales Mix and Sales Quantity</td>
<td>634</td>
</tr>
<tr>
<td>In Action: Sales Mix and Financial Reporting</td>
<td>636</td>
</tr>
<tr>
<td>Production Mix and Yield Variances</td>
<td>636</td>
</tr>
<tr>
<td>Mix and Yield Variances in Manufacturing</td>
<td>636</td>
</tr>
<tr>
<td>Variance Analysis in Nonmanufacturing Settings</td>
<td>639</td>
</tr>
<tr>
<td>Using the Profit Variance Analysis in Service and Merchandise Organizations</td>
<td>639</td>
</tr>
<tr>
<td>Efficiency Measures</td>
<td>639</td>
</tr>
<tr>
<td>Mix and Yield Variances in Service Organizations</td>
<td>640</td>
</tr>
<tr>
<td>Keeping an Eye on Variances and Standards</td>
<td>641</td>
</tr>
<tr>
<td>How Many Variances to Calculate</td>
<td>641</td>
</tr>
<tr>
<td>When to Investigate Variances</td>
<td>641</td>
</tr>
<tr>
<td>Updating Standards</td>
<td>642</td>
</tr>
<tr>
<td>The Debrief</td>
<td>642</td>
</tr>
<tr>
<td>Summary</td>
<td>643</td>
</tr>
<tr>
<td>Key Terms</td>
<td>643</td>
</tr>
<tr>
<td>Review Questions</td>
<td>643</td>
</tr>
<tr>
<td>Critical Analysis and Discussion Questions</td>
<td>644</td>
</tr>
<tr>
<td>Exercises</td>
<td>644</td>
</tr>
<tr>
<td>Problems</td>
<td>648</td>
</tr>
<tr>
<td>Integrative Case</td>
<td>653</td>
</tr>
<tr>
<td>Solutions to Self-Study Questions</td>
<td>655</td>
</tr>
<tr>
<td>18 Nonfinancial and Multiple Measures of Performance</td>
<td>658</td>
</tr>
<tr>
<td>Beyond the Accounting Numbers</td>
<td>659</td>
</tr>
<tr>
<td>Organizational Environment and Business Strategy</td>
<td>660</td>
</tr>
<tr>
<td>Responsibilities According to Level of Organization</td>
<td>660</td>
</tr>
<tr>
<td>Business Model</td>
<td>661</td>
</tr>
<tr>
<td>Multiple Measures or a Single Measure of Performance?</td>
<td>662</td>
</tr>
<tr>
<td>Balanced Scorecard</td>
<td>663</td>
</tr>
<tr>
<td>Continuous Improvement and Benchmarking</td>
<td>666</td>
</tr>
<tr>
<td>In Action: Supplier Scorecards at Sun Microsystems</td>
<td>669</td>
</tr>
<tr>
<td>In Action: Sources and Uses of Benchmarking Data</td>
<td>670</td>
</tr>
<tr>
<td>Performance Measurement for Control</td>
<td>671</td>
</tr>
<tr>
<td>Some Common Nonfinancial Performance Measures</td>
<td>671</td>
</tr>
<tr>
<td>Customer Satisfaction Performance Measures</td>
<td>671</td>
</tr>
<tr>
<td>In Action: Loyal Customers Might Not Be Profitable</td>
<td>672</td>
</tr>
<tr>
<td>Functional Performance Measures</td>
<td>672</td>
</tr>
<tr>
<td>Productivity</td>
<td>673</td>
</tr>
<tr>
<td>Nonfinancial Performance and Activity-Based Management</td>
<td>677</td>
</tr>
<tr>
<td>Objective and Subjective Performance Measures</td>
<td>677</td>
</tr>
</tbody>
</table>