Chapters 1-19

Introduction to Management Accounting



Horngren

Sundem Stratton

Introduction to Management Accounting

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INTRODUCTION TO MANAGEMENT ACCOUNTING

Twelfth Edition

CHARLES T. HORNGREN

Stanford University

GARY L. SUNDEM

University of Washington—Seattle

WILLIAM O. STRATTON

Pepperdine University



PRENTICE HALL, Upper Saddle River, New Jersey 07458

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To Joan, Chelsea, Erik, Marissa, Liz, Garth, Jens, Norma, Gina, Adam, Nisha, and Tiana

Charles T. Horngren (center) is the Edmund W. Littlefield Professor of Accounting, Emeritus, at Stanford University. A graduate of Marquette University, he received his MBA from Harvard University and his Ph.D. from the University of Chicago. He is also the recipient of honorary doctorates from Marquette University and DePaul University.

A Certified Public Accountant, Horngren served on the Accounting Principles Board for six years, the Financial Accounting Standards Board Advisory Council for five years, and the Council of the American Institute of Certified Public Accountants for three years. For six years, he served as a trustee of the Financial Accounting Foundation, which oversees the Financial Accounting Standards Board and the Government Accounting Standards Board.

Horngren is a member of the Accounting Hall of Fame.

A member of the American Accounting Association, Horngren has been its President and its Director of Research. He received its first annual Outstanding Accounting Educator Award.

The California Certified Public Accountants Foundation gave Horngren its Faculty Excellence Award and its Distinguished Professor Award. He is the first person to have received both awards.

The American Institute of Certified Public Accountants presented its first Outstanding Educator Award to Horngren.

Horngren was named Accountant of the Year, Education, by the national professional accounting fraternity, Beta Alpha Psi.

Professor Horngren is also a member of the Institute of Management Accountants, where he has received its Distinguished Service Award. He was a member of the Institute's Board of Regents, which administers the Certified Management Accountant examinations.

Horngren is the author of other accounting books published by Prentice-Hall: *Cost Accounting: A Managerial Emphasis*, Tenth Edition, 2000 (with George Foster and Srikant Datar); *Introduction to Financial Accounting*, Eighth Edition, 2002 (with Gary L. Sundem and John A. Elliott); *Accounting*, Fifth Edition, 2002 (with Walter T. Harrison, Jr., and Linda Bamber); and *Financial Accounting*, Fourth Edition, 2001 (with Walter T. Harrison, Jr.).

Horngren is the Consulting Editor for the Charles T. Horngren Series in Accounting.

Gary L. Sundem (left) is the Julius A. Roller Professor of Accounting and Associate Dean at the University of Washington, Seattle. He received his B.A. degree from Carleton College and his MBA and Ph.D. degrees from Stanford University.

Professor Sundem was the 1992–93 President of the American Accounting Association. He was Executive Director of the Accounting Education Change Commission, 1989–91, and served as Editor of *The Accounting Review*, 1982–86.

A member of the Institute of Management Accountants, Sundem is past president of the Seattle chapter. He has served on IMA's national Board of Directors, and chaired its Academic Relations and Professional Development Committees.

Professor Sundem has numerous publications in accounting and finance journals including *Issues in Accounting Education, The Accounting Review, Journal of Accounting Research*, and *The Journal of Finance*. He was selected as the Outstanding Accounting Educator by the American Accounting Association in 1998 and by the Washington Society of CPAs in 1987. He has made more than 200 presentations at universities in the United States and abroad.

William O. Stratton (right) is Professor of Accounting at Pepperdine University. He received B.S. degrees from Florida State University and Pennsylvania State University, his MBA from Boston University, and his Ph.D. from the Claremont Graduate University.

A Certified Management Accountant, Stratton has lectured extensively at management accounting conferences in North America, South America, and Europe. He has developed and delivered professional workshops on activity-based management and performance achievement to manufacturing and service organizations throughout the United States and South America. In 1993, Professor Stratton was awarded the Boeing Competition prize for classroom innovation.

Stratton has numerous publications in accounting and international business journals including *Management Accounting, Decision Sciences, IIE Transactions*, and *Synergie*.



PREFACE

"Managers have to understand how their decisions affect costs if they want to make good decisions."

Introduction to Management Accounting, 12/E, takes the view that managers make important economic decisions. We want students to view management accounting as an essential tool that enhances managers' abilities to make good economic decisions. IMA, 12/E, describes the concepts and techniques that managers and accountants use to produce information for decision making. Because understanding concepts is more important than memorizing techniques, this book introduces the concepts together with the techniques. From the first chapter, students are encouraged to think about why techniques are used, not to blindly apply the techniques. We hope that students will thus be able to learn both the theory and practice of management accounting. Understanding today's accounting practice, though, goes beyond mere concepts and techniques. To illustrate real-world practice and to highlight how management accounting helps managers understand the potential impacts of their decisions, the concepts and techniques in this book are presented in the context of real decisions. Two of the authors were members of the Accounting Education Change Commission (AECC) and recommendations of the AECC have been implemented throughout the text.

This book attempts a balanced, flexible approach. It deals as much with nonprofit, retail, wholesale, selling, and administrative situations as it does with manufacturing. It focuses broadly on planning and control decisions, not on product costing for inventory valuation and income determination.

OUR PHILOSOPHY

Introduce the simple concepts and principles early, revisit them at more complex levels as students gain understanding, and provide appropriate real-company examples at every stage.

Just as management accounting builds on financial accounting, the concepts within management accounting build on one another as they are used to facilitate managerial decision making. Once students have fully grasped the more basic concepts, they can then build on what they have learned and progress on to more complex topics. Students begin their understanding of managerial decision making by asking, "How will my decisions affect the costs and revenues of the organization?" and then progress to more complex questions: What is the most appropriate cost management system for the company? What products should we produce? What do our budget variances mean? As students absorb the simpler concepts and techniques of management accounting and move on to the more complex, they will become more comfortable with, and more adept at, using those concepts and techniques to make business decisions.

Our goals have been to choose relevant subject matter and to present it clearly and accessibly, using many examples drawn from actual companies. *IMA*, 12/E, stresses the understanding of concepts, yet makes them concrete with numerous illustrations.

WHO SHOULD USE THIS BOOK?

Introduction to Management Accounting, 12/E, is primarily for students who have had one or two terms of basic accounting. It is also appropriate for continuing educational programs of varying lengths in which the students have had no formal training in accounting. The four financial accounting chapters (Chapters 16–19) make the book especially appropriate for short courses introducing managers to accounting because both financial and management accounting can be presented from a user's perspective without requiring two textbooks.

This text is oriented to managers who use management accounting reports, not accountants. Managers should understand the basics of management accounting, and this book shows how management accounting will be useful to them. However, *IMA*, 12/E, also pays ample attention to the needs of potential accountants and provides them with an understanding of how the reports they produce will be used by decision makers. In focusing on accounting within the context of the overall managerial function, this text covers important topics that all business students should study and demonstrates how accounting bolsters and fits into the broader scheme of today's business environment.

NEW AND RETAINED FEATURES

- NEW and revised Chapter Opening Vignettes with "On Location!" Videos. Chapter openers help students understand accounting's role in current business practice. "On Location!" video segments, specially produced for this text, reinforce and expand upon chapter openers. New segments include Three Dog Bakery, Nantucket Nectars, Oracle, and Teva Sandals.
- NEW "Take 5's". Study Breaks appear throughout each chapter and encourage students to stop and think about material just read. Answers immediately follow.
- **NEW Cognitive Exercises.** Based on focus group feedback, short cognitive exercises serve as critical-thinking "warm-ups" to more complex case material.
- NEW and revised Business First Boxes. Provide insights into operations at well-known domestic and international companies, including technology and e-Commerce companies.
- Introduction to Financial Accounting 8/e and its companion text, Introduction to Management Accounting 12/e, provide a seamless presentation for any first year accounting course. Please ask your Prentice Hall representative about cost-saving discounts when you adopt and package both books together.

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- NEW Instructor Resource CD-ROM contains all print and technology supplements so that instructors can provide seamless classroom presentations.
- NEW Mastering Accounting CD-ROM

 Allows students to watch professionally written, acted, and filmed videos about a fictional Internet start-up company to see how accounting concepts are related to workplace events and challenges.

UPDATED MATERIAL INCLUDES:

- Expanded discussion of ABC and ABM in chapter 4, including both two-stage and multi-stage ABC. New structure introduced to describe traditional and ABC systems.
- Complete revision of "Opportunity, Outlay, and Differential Costs" in chapter 6.
- Expanded discussion of Balanced Scorecard in chapter 9 with emphasis on the importance of intellectual capital and learning as a driver of competitiveness. Includes new illustration using General Electric.
- Expanded discussion of economic value added (EVA) in chapter 10, with real world company illustrations, and end-of-chapter exercises and problems.
- Chapter 12 uses new illustrations to present general guidelines for allocation, stepdown allocation methods for service departments, joint-cost allocation, two-stage ABC allocation, and multi-stage ABC allocation.
- New structure in chapter 14 compares job-order and process costing and applies material to Planters Specialty Peanut Company.

SUPPLEMENTS FOR INSTRUCTORS

NEW Instructor Resource CD-ROM (see description under "Online and Technology Solutions")

Instructor's Resource Manual by Scott Yetmar (Drake University) Contains chapter overviews, chapter outlines organized by objectives, teaching tips, chapter quiz, transparency masters derived from textbook exhibits, and suggested readings each chapter of the text.

SOLUTIONS MANUAL AND SOLUTIONS TRANSPARENCIES BY TEXT AUTHORS Special thanks to Robert Bauman, Allan Hancock College, and to Rosalie C. Hallbauer, Florida International University, for their technical reviews.

TEST ITEM FILE BY ANNE WESSLEY The Test Item File includes multiple choice, true/false, exercises, comprehensive problems, short answer problems, critical thinking essay questions, etc. Each test item is tied to the corresponding learning objective, has an assigned difficulty level, and provides a page reference.

PRENTICE HALL WINDOWS CUSTOM TEST MANAGER, BY ENGINEERING SOFT-WARE ASSOCIATES (ESA), INC. This easy-to-use computerized testing program can create exams, evaluate, and track student results. The PH Test Manager also provides online testing capabilities. You may *call 1-800-550-1701*, *our Test Paper Preparation Center*, to have a hardcopy of your custom test created to suit your classroom needs.

ON LOCATION! CUSTOM VIDEO LIBRARY BY BEVERLY AMER (NORTHERN ARIZONA UNIVERSITY) Highlighted companies include Three Dog Bakery, Nantucket Nectars, Oracle, Teva Sport Sandals, Dell, etc. A Video Guide in the Instructor's Resource Manual helps integrate the videos into your classroom lectures.

SUPPLEMENTS FOR STUDENTS

STUDY GUIDE BY FRANK SELTO (UNIVERSITY OF COLORADO AT BOULDER) For each chapter of the text, the study guide contains a chapter overview, a detailed chapter review including study tips, self-test questions and demonstration problems with worked-out solutions. Special thanks to Mary Sheets, University of Central Oklahoma, for technical assistance.

STUDENT RESOURCE CD-ROM All student software programs, from Power-Points to ReEnforcer, tutorial available on one CD-ROM.

ADDITIONAL RESOURCES

New WALL STREET JOURNAL offer: 10 weeks for \$10.00 net with new student texts.

ACTIVITIES IN MANAGEMENT ACCOUNTING BY MARTHA DORAN

Free eBiz FOR ACCOUNTING booklet may be packaged with new student texts.

Appendix

A

RECOMMENDED READINGS

The following readings will aid readers who want to pursue some topics in more depth than is possible in this book. There is a hazard in compiling a group of recommended readings. Inevitably, some worthwhile books or periodicals are omitted. Moreover, such a list cannot include books published subsequent to the compilation date. The list is not comprehensive, but it suggests many excellent readings.

PERIODICALS

PROFESSIONAL JOURNALS

The following professional journals are typically available in university libraries and include articles on the application of management accounting:

- Accounting Horizons. Published by the American Accounting Association; stresses current practice-oriented articles in all areas of accounting.
- CMA Management. Published by CMA Canada; includes much practice-oriented research in management accounting.
- Financial Executive. Published by the Financial Executives Institute; emphasizes general policy issues for accounting and finance executives.
- GAO Journal. Covers managerial accounting issues of interest to the General Accounting Office of the U.S. government.
- Harvard Business Review. Published by Harvard Business School; directed to general managers, but contains excellent articles on applications of management accounting.
- *Journal of Accountancy*. Published by the American Institute of CPAs; emphasizes financial accounting and is directed at the practicing CPA.
- Journal of Strategic Performance Measurement. Covers issues related to performance measurement.
- Management Accounting Quarterly. Published by the Institute of Management Accountants; practical articles with an academic bent.
- Strategic Finance. Published by the Institute of Management Accountants; many articles on actual applications by individual organizations.
- Business Week, Forbes, Fortune, The Economist, The Wall Street Journal. Popular publications that cover a variety of business and economics topics; often their articles relate to management accounting.

ACADEMIC JOURNALS

The academic journal that focuses most directly on current management and cost accounting research is the Journal of Management Accounting Research, published by the Management Accounting section of the American Accounting Association. The Accounting Review, the general research publication of the American Accounting Association, and Journal of Accounting Research, published at the University of Chicago, and Contemporary Accounting Research, published by the Canadian Academic Association, cover all accounting topics at a more theoretical level. Accounting, Organizations and Society, a British journal, publishes much research on behavioral aspects of management accounting. The Journal of Accounting and Economics covers economics-based accounting research.

Most of the topics in this text are covered in more detail in the many books entitled *Cost Accounting including Cost Accounting: A Managerial Emphasis* by C. T. Horngren, G. Foster, and Srikant Datar (Prentice Hall, 2000). You can find more advanced coverage in *Advanced Management Accounting*, 3rd ed. by R. S. Kaplan and Anthony A. Atkinson (Prentice Hall, 1998).

The Financial Executives Institute, 10 Madison Avenue, P.O. Box 1938, Morristown, NJ 07960, and the Institute of Management Accounting, 10 Paragon Drive, P.O. Box 433, Montvale, NJ 07645-0433, have long lists of accounting research publications.

HANDBOOKS, GENERAL TEXTS, AND CASE BOOKS

The books in this list have wide application to management accounting issues. The hand-books are basic references. The textbooks are designed for classroom use but may be useful for self-study. The case books present applications from real companies.

- Belkaoui, A., Handbook of Cost Accounting. Quorum Books, 1991.
- Bierman, H., Jr., C. Bonini, and W. Hausman, Quantitative Analysis for Management, 9th ed. Homewood, IL: Richard D. Irwin, 1997.
- Bierman, H., Jr., and S. Smidt, *The Capital Budgeting Decision*, 8th ed. New York: Macmillan, 1992. Expands the capital budgeting discussion in Chapter 11.
- Brinker, B. ed. Guide to Cost Management. New York: John Wiley & Sons, 2000.
- Lukka, K., and T. Groot (eds.), Cases in Management Accounting: Practices in European Companies. London: Financial Times Management, 2000.
- Manning, G., Financial Investigation and Forensic Accounting. Boca Raton, FL: CRC Press, 1999.
- Pryor, T., et al., Activity Dictionary: A Comprehensive Reference Tool for ABM and ABC, ICMS, Inc., 1992.
- Rotch, W., B. Allen, and R. Brownlee, *Cases in Management Accounting and Control Systems* 3rd ed., Upper Saddle River, NJ: Prentice Hall, 1995.
- Shank, J., Cases in Cost Management: A Strategic Emphasis, 2nd Ed. Cincinnati, South-Western, 2000.

STRATEGIC NATURE OF MANAGEMENT ACCOUNTING

Management accountants realize that cost and performance information is most useful to organizations when it helps define strategic alternatives and helps in the management of resources to achieve strategic objectives. The books in this list, though not necessarily accounting books, provide valuable foundation to the interaction of strategy and accounting information.

- Ansari, S., and J. Bell, *Target Costing: The Next Frontier in Strategic Cost Management*, Chicago: Irwin, 1997.
- Ehrbar, A., EVA: The Real Key to Creating Wealth, New York: Wiley, 1998.
- Hronec, S., Vital Signs. New York: Amacom, 1993.
- Porter, M., The Michael Porter Trilogy. New York: Free Press, 1998.
- Rappaport, A., Creating Shareholder Value: A Guide for Manager's and Investors. New York: Free Press, 1997.

- Small, P., The Ultimate Game of Strategy: Establishing a Personal Niche in the World of e-Business, Upper Saddle River, N.J.: Prentice Hall, 2001.
- Stewart, G., The Quest for Value, Harper Business, 1999.

MODERN MANUFACTURING

The following books provide background on the nature of modern manufacturing.

- Chase, R., and N. Aquilano, Production and Operation Management. Homewood, IL: Irwin, 1997.
- Heizer, J. and B. Render, Principles of Operations Management and Interactive CD, Fourth Edition, Upper Saddle River, N.J.: Prentice Hall, 2001.
- Schonberger, R., World Class Manufacturing: The Next Decade. New York, Free Press, 1996.
- Teece, D., Competitive Challenge. Harper Business, 1987.
- Zuboff, S., In the Age of the Smart Machine. New York: Basic Books, 1989.

MANAGEMENT ACCOUNTING IN MODERN MANUFACTURING SETTINGS

These books present responses of management accountants and others to changes in manufacturing methods and practices.

- Atkinson, A., R. Banker, R. Kaplan, and S. Young, *Management Accounting*, 2nd ed., Upper Saddle River, NJ: Prentice Hall, 1997.
- Bennett, R., J. Hendricks, D. Keys, and E. Rudnicki, Cost Accounting for Factory Automation. Montvale, NJ: National Association of Accountants, 1987.
- Cooper, R. and R. Kaplan, Design of Cost Management Systems, Second Edition, Upper Saddle River, N.J.: Prentice Hall, 1999.
- Goldratt, E., and J. Cox, *The Goal*. Croton-On-Hudson, NY: North River Press, Inc., 1992. A novel illustrating the new manufacturing environment.
- Goldratt, E., Critical Chain. Croton-On-Hudson, NY: North River Press, Inc., 1997.
- Kaplan R. and R. Cooper, Cost & Effect, Boston: Harvard Business School Press, 1998.
- Kaplan, R., ed., *Measures for Manufacturing Excellence*, Boston, MA: Harvard Business School Press, 1990.
- Player, S. and R. Lacerda, Arthur Andersen's Global Lessons in Activity-Based Management, New York, Wiley, 1999.

MANAGEMENT CONTROL SYSTEMS

The topics of Chapters 7 to 10 can be explored further in several books, including:

- Anthony, R. N., and V. Govindarajan, *Management Control Systems*, 10th Irwin/McGraw-Hill, 2001.
- Arrow, K. J., The Limits of Organization. New York: Norton, 1974. A readable classic by the Nobel laureate.
- Brimson, J. and J. Antos, Driving Value Using Activity-Based Budgeting, Wiley, 1999.

- Emmanuel, C., K. Merchant, and D. Otley, *Accounting for Management Control*. Chapman & Hall, 1990.
- Kaplan, R., and D. Norton, *The Balanced Scorecard*. Boston: Harvard Business School Press, 1996.
- Maciariello, J. A. and C. Kirby, Management Control Systems: Using Adaptive Systems to Attain Control, Upper Saddle River, NJ: Prentice Hall, 1994.
- Merchant, K., Modern Management Control Systems: Text and Cases, Upper Saddle River, N.J.: Prentice Hall, 1998.
- Simons, R., Performance Measurement and Control Systems for Implementing Strategy, Upper Saddle River, N.J.: Prentice Hall, 2000.
- Solomons, D., *Divisional Performance: Measurement and Control.* New York: Markus Wiener, 1983. A reprint of a 1965 classic that is still relevant.

Management Accounting in Nonprofit Organizations

Many books discuss management accounting in nonprofit organizations, especially in health care. Four examples are

- Anthony, R. N., and D. W. Young, Management Control in Nonprofit Organizations, 6th ed. Homewood, IL: Irwin, 1998.
- Brimson, J., and J. Antos, Activity Based Management for Service Industries, Government Entities, and Non-Profit Organizations. New York: Wiley, 1998.
- Herzlinger, R. and D. Nitterhouse, Financial Accounting and Managerial Control for Nonprofit Organizations. Cincinnati, OH: Southwestern Publishing Co., 1994.
- Neumann, B., and K. Boles, Management Accounting for Healthcare Organizations, 5th Ed. Precept Press, 1998.

BOOKS IN FINANCIAL ACCOUNTING

This book's companion volume, *Introduction to Financial Accounting*, provides an expansion of the financial accounting material (Chapters 16–19). A more detailed coverage of the topics can be found in books entitled *Intermediate Accounting* including that by D. Kieso, J. Weygandt, and T. Warfield (John Wiley, 2000).

Opinions of the Accounting Principles Board are available from the American Institute of CPAs, 1211 Avenue of the Americas, New York, NY 10036-8775. The institute also has a series of research studies on a variety of topics. The pronouncements of the Financial Accounting Standards Board are available from the board's offices, 401 Merritt 7, P.O. Box 5116, Norwalk, CT 06856-5116.

Financial accounting has such an extensive literature that it is impossible to provide a short list of books that adequately covers the field. However, we will mention a couple of books that cover a wide range of issues. For a perspective on the large firms practicing accounting, see two books by M. Stevens, *The Accounting Wars* (Macmillan, 1985) and *The Big Six* (Touchstone Books, 1992). The interaction of financial reporting and management's economic incentives is covered in text and readings in R. Ball and C. Smith, *The Economics of Accounting Policy Choice*, New York: McGraw-Hill, 1992. Application of this research to financial statement analysis is provided in C. Stickney, and P. Brown *Financial Statement Analysis*, 4th Ed. (Harcourt Brace, 1999).