

COST AND ACCOUNTING MANAGERIAL

JACK GRAY • DON RICKETTS

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COST AND MANAGERIAL ACCOUNTING

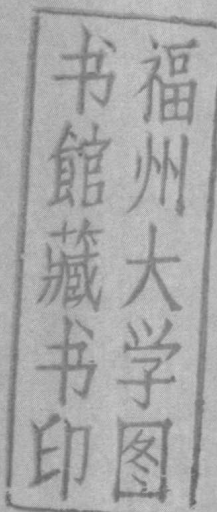
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COST AND MANAGERIAL ACCOUNTING

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CONTENTS

Preface	xiii
1 COST ACCOUNTING AND MANAGERIAL ACCOUNTING	1
Cost Accounting Systems	3
<i>Managerial accounting Cost accounting</i>	
Cost-Benefit of Information	10
The Common Data Base for Cost and Managerial Accounting	11
Summary	13
<i>Glossary Questions and problems</i>	
2 COST CLASSIFICATIONS AND FLOWS	16
Product Costs and Period Costs	17
<i>Product costs in a merchandising company Product costs in a manufacturing company Classifying manufacturing product costs</i>	
Flow of Costs through the Accounts	24
<i>Statement of cost of goods manufactured and sold Total costs and unit costs</i>	
Cost Behavior	27
<i>Variable costs Fixed costs Mixed costs Step costs</i>	
Product Costing Systems	37
<i>Types of manufacturers</i>	
Summary	39
<i>Review problem Solution Glossary Questions and problems</i>	
3 MANUFACTURING OVERHEAD COST ACCOUNTING FOR PRODUCT COSTING	49
Predetermined Overhead Rates	50
<i>Seasonal variations in overhead costs and production volume The impact of joint overhead costs on predetermined overhead rates Predetermined overhead rates illustrated Over- or underapplied overhead Selection of a production volume for the predetermined overhead rate</i>	

Plantwide versus Departmental Predetermined Overhead Rates	60
<i>Department predetermined overhead rates</i>	
Allocation of Service Department Costs to Producing Departments	62
<i>Selecting a basis for allocating service department costs to production departments Determination of production department overhead rates Three methods to allocate service department cost to producing departments</i>	
Summary	70
<i>Review problems Solutions Glossary Questions and problems</i>	
4 JOB ORDER COSTING	85
Job Order Costing and Process Costing	86
Manufacturing Cost Flows—Job Order Costing	87
<i>Computing the average cost per unit in job order costing Material accounting Manufacturing labor accounting Manufacturing overhead accounting Calculating the average cost per unit Cost of goods completed Cost of goods sold Summary: Cost flows and documents</i>	
Overapplied or Underapplied Overhead	109
<i>Closed to cost of goods sold Allocation between work in process, finished goods, and cost of goods sold</i>	
Summary	114
<i>Review problem Solution Glossary Questions and problems</i>	
5 PROCESS COST ACCOUNTING	128
Cost Flows in Process Costing	129
<i>Job order costing: a reprise And now: process costing Product flows in process costing Cost per unit calculations</i>	
The Impact of Partially Completed Units in the Ending Work in Process	133
<i>Equivalent finished units Cost calculations with partially completed units in the ending work in process</i>	
The Impact of Partially Completed Units in the Beginning Work in Process	139
<i>Average cost calculations FIFO cost flows</i>	
Cost Flow Summary	147
Summary	147
<i>Review problem Solution Glossary Questions and problems</i>	
6 ACCOUNTING FOR DEFECTIVE PRODUCTS	159
Defective Units in General	160
<i>Normal spoilage Abnormal spoilage Rework</i>	
Accounting for Defective Units in Job Order Costing	162
<i>Disposal value for spoiled units Job-related normal spoilage Rework</i>	

Accounting for Defective Units in Process Costing	165
<i>Average cost method FIFO cost method</i>	
Scrap	170
Summary	170
<i>Review problems Solutions Glossary Questions and problems</i>	
 7 JOINT PRODUCTS AND BY-PRODUCTS	 185
Allocating Joint Costs to Joint Products	188
<i>Physical measure method Relative market value method</i>	
<i>Additional processing costs Approximating a market value at the split-off point</i>	
Accounting for By-Products	194
<i>Separable manufacturing costs for by-products</i>	
Joint Costs and Management Decisions	196
Summary	197
<i>Review problems Solutions Glossary Questions and problems</i>	
 8 STANDARD COSTS: DIRECT MATERIALS AND DIRECT LABOR	 212
Standard Cost per Unit of Finished Product	213
Objectives of Standard Costs	215
<i>Standard costs and cost accounting Standard costs and managerial accounting</i>	
Types of Standard Costs	218
<i>Historical standard Theoretical standard</i>	
<i>Currently attainable standard</i>	
Direct Materials Standards	220
<i>Establishing the quantity standards for direct materials</i>	
<i>Establishing the price standards for direct materials</i>	
<i>Calculating variances for direct materials</i>	
Direct Labor Standards	225
<i>Establishing the quantity standards for direct labor</i>	
<i>Establishing the price standards for direct labor</i>	
<i>Calculating variances for direct labor</i>	
Standard Costs in the General Ledger	229
Graphical Analysis of Variances: Direct Materials and Direct Labor	230
Summary	232
<i>Review problem Solution Glossary Questions and problems</i>	
 9 STANDARD MANUFACTURING OVERHEAD COSTS	 245
Flexible Overhead Budgets	246
<i>Uses of flexible overhead budgets Departmental flexible budgets</i>	
<i>Selecting the activity base</i>	
Manufacturing Overhead Standards	249
<i>Predetermined overhead rate Applied manufacturing overhead: Standard cost Calculating the standard manufacturing overhead cost per unit of product Using the predetermined overhead rate in</i>	

	<i>standard product costing Calculating variances for manufacturing overhead Summary: Variances in manufacturing overhead</i>	
	Standard Manufacturing Overhead Costs in the General Ledger	263
	Summary	264
	<i>Review problem Solution Glossary Questions and problems</i>	
10	STANDARD COST VARIANCES: WHAT TO DO WITH THEM AND HOW TO REPORT WHAT YOU DID	275
	Standard Costs and Variances: Putting It All Together	276
	<i>Standard cost of production Computation of standard cost variances Journal entries in the general ledger</i>	
	Manufacturing Variances: What to Do with Them for Calculating Operating Income	282
	<i>Closing all manufacturing cost variances to cost of goods sold Allocation of manufacturing variances between the inventory accounts on the balance sheet and the cost of goods sold account on the income statement Summary of variance allocation and journal entries</i>	
	Interim Financial Reports	292
	Summary	293
	<i>Review problem Solution Glossary Questions and problems</i>	
11	DIRECT COSTING	307
	Calculating Net Income: Direct Costing and Absorption Costing	308
	<i>Accounting for fixed manufacturing costs Net income computations Net income differences between direct costing and absorption costing The influence of production volume on net income</i>	
	Direct Costing for Financial Reporting	317
	Direct Costing and Managerial Accounting	318
	Summary	318
	<i>Review problem Solution Glossary Questions and problems</i>	
12	PLANNING AND CONTROL: THE MASTER BUDGET	331
	Planning and Control: The Master Budget	332
	The Planning Process	332
	<i>Goals and objectives Formulate programs Establishing budgets</i>	
	The Master Budget	336
	<i>Master budget time periods</i>	
	The Master Budget Illustrated	338
	<i>Sales budget Production budget Manufacturing cost budgets Ending inventory budget Cost of goods sold budget Selling and administrative expense budget Budgeted income statement Cash budget Budgeted balance sheet Master budget summary</i>	
	Summary	351
	<i>Review problem Solution Glossary Questions and problems</i>	

13	RESPONSIBILITY ACCOUNTING	371
	Patterns of Delegation	372
	<i>Business functions Product lines Geographical regions</i>	
	Responsibility Accounting Systems	374
	<i>Types of responsibility centers Controllability An illustration of responsibility accounting Management by exception Summary: responsibility accounting</i>	
	Budgets and Human Behavior	381
	<i>Motivation Goal congruence The role of budgets</i>	
	Summary	383
	<i>Review problem Solution Glossary Questions and problems</i>	
14	COST-VOLUME-PROFIT ANALYSIS	391
	Basic Concepts of Cost-Volume-Profit Analysis	392
	<i>Equation method Contribution margin per unit method Contribution margin ratio method</i>	
	Managerial Uses of Cost-Volume-Profit Analysis	396
	<i>Target profit Change in the selling price Change in variable expense Change in fixed expense Multiple changes</i>	
	The Impact of Taxes on Cost-Volume-Profit Analysis	400
	Multiple Products and Cost-Volume-Profit Analysis	401
	<i>Change in the sales mix</i>	
	Margin of Safety	405
	Cost-Volume-Profit Analysis: Assumptions	405
	Cost-Volume-Profit Analysis: Graphic Approach	406
	<i>Profit-volume graph</i>	
	Summary	409
	<i>Review problem Solution Glossary Questions and problems</i>	
15	RELEVANT COSTS AND NONRECURRING DECISIONS	425
	Relevant Costs	426
	Special Orders and Capacity Utilization	427
	<i>Alternative reporting format Beware of unit fixed expense Other factors in the decision</i>	
	Make or Buy Decisions	430
	<i>Qualitative factors</i>	
	Adding or Dropping Products	434
	Multiple Product Decisions	435
	<i>Sell at split-off point? Or process further? Decisions affecting all multiple products</i>	
	Summary	440
	<i>Review problems Solutions Glossary Questions and problems</i>	
16	COST CONTROL: ANALYSIS AND REPORTING	453
	Engineered, Managed, and Capacity Costs	455
	<i>Engineered costs Managed costs Capacity costs</i>	

Engineered Costs: Direct Materials and Direct Labor	459
<i>Efficiency versus effectiveness Reporting for control of engineered costs</i>	
Summary	466
<i>Review problem Solution Glossary Questions and problems</i>	
17 COST CONTROL: ANALYSIS AND REPORTING CONCLUDED	476
Flexible Budgets	477
<i>Flexible budgets illustrated Variance computation Causes of overhead variances</i>	
Application of Flexible Budgets to Nonmanufacturing Activities	484
Managed Costs	486
<i>Developing output measures for components of a managed cost Control of managed costs through the budgeting process</i>	
Capacity Costs	492
Summary	493
<i>Review problem Solution Glossary Questions and problems</i>	
18 REVENUE VARIANCES AND INCOME ANALYSIS	508
Profit Analysis Procedure	510
Computing the Variances	511
<i>Sales volume variance Sales price variance Expense variances Sales mix variance</i>	
Analysis of Profit Center Results in a Multiproduct Firm	520
<i>Sales volume and sales mix variances Price and expense variances</i>	
Analysis of Products and Sales Territories	525
<i>Product analysis Territory analysis</i>	
Interpreting the Variances	528
Summary	529
<i>Review problem Solution Glossary Questions and problems</i>	
19 DIVISIONAL PERFORMANCE ANALYSIS	546
Return on Investment and Residual Income	549
<i>Return on investment Residual income</i>	
Measuring Profit	556
Measuring the Investment Base	556
<i>Valuing fixed assets for investment center reporting</i>	
Other Performance Measures	559
Summary	559
<i>Review problem Solution Glossary Questions and problems</i>	
20 TRANSFER PRICING	570
The Need for a Transfer Price	571
<i>Participants in establishing transfer prices Transfer pricing policies</i>	

Market Based Transfer Prices	574
<i>Arbitrated transfer prices</i>	
Cost Based Transfer Prices	576
<i>Standard versus actual costs Full cost versus variable costs</i>	
Summary	578
<i>Review problem Solution Glossary Questions and problems</i>	
21 DECISION MAKING AND MANAGERIAL ACCOUNTING	587
Decisions with Certainty	589
Decisions with Uncertainty	589
<i>Decision making with uncertainty without probabilities Decision making with uncertainty with probabilities</i>	
Decision Alternatives with Different Probabilities	597
<i>Expected value Coefficient of variation</i>	
Summary	599
<i>Review problem Solution Glossary Questions and problems</i>	
22 MEASURING THE SIGNIFICANCE OF VARIANCES	612
Expected Value Approach	614
<i>Probability estimates Expected value formulation</i>	
<i>An example of the expected value approach</i>	
Statistical Quality Control Approach	619
<i>Control chart computations</i>	
Managerial Judgment Approach	624
Summary	626
<i>Review problem Solution Glossary Questions and problems</i>	
23 COST ESTIMATION	632
An Engineering Approach to Cost Estimates	634
Cost Estimation from Historical Data	634
<i>Identification of causal factors Graphic approach High-low approach Regression approach</i>	
Additional Useful Statistics from Regression Analysis	642
<i>Standard error of the estimate Coefficient of determination</i>	
<i>Standard error of the regression coefficient and its t value</i>	
Multiple Regression	649
The Assumptions of Regression Analysis	650
<i>Linearity Constant variance Normality Autocorrelation</i>	
<i>Multicollinearity</i>	
Learning Curves	654
Summary	656
<i>Review problem Solution Glossary Questions and problems</i>	
24 LINEAR PROGRAMMING	677
Linear Programming Example	679
<i>Problem formulation Graphic solution of the linear programming problem</i>	

The Simplex Method	683
<i>Problem formulation for the simplex method</i>	
<i>Postoptimality analysis</i>	
Summary	689
<i>Review problems Solutions Glossary Questions and problems</i>	
 25 PLANNING CAPITAL EXPENDITURES	 705
Defining Capital Expenditures	706
<i>Cash returns Practical limitations of the definition</i>	
Capital Expenditure Analysis—Present Value	709
<i>Present value concepts and calculations</i>	
A Framework for Capital Expenditure Analysis	714
<i>Determine net future cash returns Determine the present value of</i>	
<i>the net future cash returns Estimate the net present cash outlay</i>	
<i>Report the results of the analysis</i>	
Organizing the Computations in Capital Expenditure	
Analysis	719
Summary	719
<i>Review problem Solution Glossary Questions and problems</i>	
 26 ADVANCED CONSIDERATIONS IN CAPITAL EXPENDITURES	 730
Income Tax and Capital Expenditure Decisions	731
<i>Income tax payments and other cash flows Income tax payments</i>	
<i>and depreciation Income tax and the present cash outlay</i>	
<i>Accelerated depreciation and income taxes</i>	
Capital Rationing	737
Risk in Capital Expenditure Analysis	738
<i>Three-point estimates Time-adjusted payback</i>	
<i>Unadjusted payback</i>	
Other Considerations	742
Summary	743
<i>Review problem Solution Glossary Questions and problems</i>	
Appendix	755
Index	758

1

COST ACCOUNTING AND MANAGERIAL ACCOUNTING

AFTER COMPLETING YOUR STUDY OF THIS
CHAPTER, YOU SHOULD HAVE LEARNED:

- 1** The differences and similarities between cost accounting and managerial accounting. You will find that the primary difference is associated with the use of the data by managers.
- 2** How managerial accounting relates to planning and control decisions, and how cost accounting relates to the preparation of income statements and balance sheets.
- 3** The importance of evaluating alternative accounting procedures from a cost-benefit viewpoint.
- 4** How cost accounting and managerial accounting rely on a common data base to accomplish their objectives.

2

COST ACCOUNTING AND MANAGERIAL ACCOUNTING

The first chapter of a textbook is often the hardest chapter to write. When authors begin a book, there is so much to say it is difficult to know where to start or when to stop. We have tried to make our beginning chapter worth reading and studying. The things you can expect to learn have been suggested in the list of objectives which begins each chapter. We use these objectives to help you know in advance what you can expect to learn by studying each chapter.

Here is a list of questions which are answered through the use of cost accounting and managerial accounting:

Questions cost and management accounting can help answer.

- 1 If McGraw-Hill Book Company has 8,000 copies of this book in inventory at year-end, at what cost will they be reported in the company balance sheet?
- 2 How many copies of this book must McGraw-Hill sell before a profit is made?
- 3 What does it cost a company when its union goes on strike?
- 4 What does it cost a company to stop polluting the air?
- 5 What will it cost Ford Motor Company to meet the minimum fuel economy standards for 1985?
- 6 If a university is considering offering a new Master of Accounting degree, what will it cost?
- 7 What does it cost to audit the financial statements of New York City?

This book is about accounting methods which can be used to answer these and many other similar questions.

Cost defined.

The word "cost" was used in all questions except number 2, which used the word "profit." **Cost** is defined as the resources consumed to accomplish a specific objective. McGraw-Hill Book Company consumed several different types of resources in publishing this book. They consumed dollars by paying wages to people who worked to make this the best book possible. They also consumed paper, ink, and partially consumed (wore out) machinery in the setting and printing of the book.

Profit defined.

Profit is the difference between sales revenues and the expired costs (or, more technically, expenses) of earning those revenues. Thus, cost must be measured to answer each question, including the question that mentioned profit rather than cost.

You calculate the cost of something with a specific purpose in mind.

Notice that the definition of cost referred to accomplishing a "specific objective." Each of the questions implies a specific objective or purpose. Question 1 implied the purpose of preparing a balance sheet for McGraw-Hill Book Company. Question 2 implied a purpose of deciding whether it would be profitable to produce and sell this book. (Neither McGraw-Hill nor the authors would have put the required amount of effort into preparing this book for literary recognition alone.) Exhibit 1-1 lists the implied specific purposes of each question.

COST ACCOUNTING SYSTEMS

Cost accounting system defined.

A **cost accounting system** is used to record, summarize, and report cost information. Some cost information is reported in income statements and balance sheets which are presented to external users such as shareholders and creditors. Other cost information is given in special reports to managers within the firm for use in

EXHIBIT 1-1
The Purpose of Cost Information

Question Number	Implied Specific Purpose
1	Prepare a balance sheet.
2	Will producing the book be profitable?
3	Should the company offer a higher settlement to avoid a strike?
4	Should the company close the plant or install pollution control equipment?
5	How will Ford Motor Company obtain the needed resources?
6	Will the new degree produce enough tuition to make it feasible?
7	Is improved quality of information worth the cost of an audit?

deciding how to operate the organization. Those *decisions* are simply the choices managers make about how their organizations should do things.

Managerial accounting provides cost information to managers to assist them in making decisions.

Exhibit 1-1 shows that most of the implied specific objectives are decisions or choices to be made by managers. Providing cost information to managers to assist them in making decisions is the part of accounting called **managerial accounting** or **management accounting**. Providing cost information for income statements and balance sheets is called **cost accounting**.

Cost accounting systems were developed many years ago to meet the needs of cost information for income statements and balance sheets. Only later did the development of more complex organizations demand that cost information also be collected and reported for management decisions. Cost accounting systems have evolved so that today they provide cost information for both cost accounting (for income statements and balance sheets) and managerial accounting.

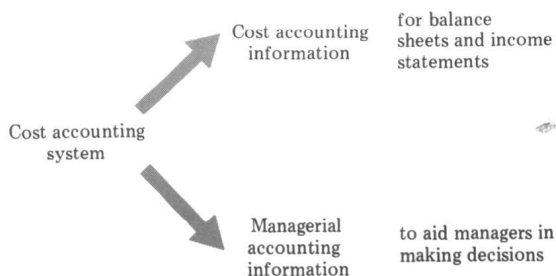
The kind of information provided has also expanded so that in addition to cost information it may include sales and production information in dollars and units. We will continue to use the term "cost information" because it is convenient, but you should remember that for some decisions it will also include revenue (sales) information.

Cost-accounting means developing cost data for income statements and balance sheets.

Let us make the distinction again. When we use the term "cost accounting" we mean developing cost data for use in income statements and balance sheets, the kind of data suggested in question 1 above. When we use the term "managerial accounting" we mean data prepared specifically for managers within the organization to help them make the decisions or choices which are needed for their part of the organization to achieve its objectives. But a cost accounting *system* provides cost data for both cost accounting and managerial accounting.

The reason for distinguishing between cost accounting and managerial accounting is that in many situations different information is needed for each. You may make mistakes if you use cost accounting reports for management decisions. A good example of this is sales orders. Marketing managers and production managers want to know about sales orders as they are received (before the products are shipped). Orders received help the marketing manager decide if sales are being made on schedule or whether increased sales efforts are needed. Orders received help the production manager decide what products and how many units of product should be produced. Are orders received managerial accounting or cost accounting information? If you chose managerial, you were right, because this information is being used by managers within the organization to make decisions. When the sales orders are shipped to the customers they influence cost accounting. The cost of the order is

EXHIBIT 1-2 The Relation between Cost Accounting Systems, Managerial Accounting, and Cost Accounting



deducted from the sales revenue in the income statement. Thus, the shipment of the order is important to cost accounting.

If a production manager made production decisions based only on amounts of products shipped rather than orders received, the wrong products might be produced. The production department would be producing products needed last month for shipment to customers, but it might not be producing the products which customers will need this month and next month. A production manager needs managerial accounting information. This discussion can be summarized graphically as shown in Exhibit 1-2.

We shall next discuss managerial accounting and then cost accounting in more detail.

Managerial Accounting

In managerial accounting the accountant accumulates, summarizes, and reports information which managers need to make specific decisions; thus the name managerial accounting.

Planning decisions
defined.

Control decisions
defined.

Planning and Control The decisions managers are concerned with can be categorized as *planning* and *control* decisions. Planning decisions establish goals for the organization and choose plans (feasible sets of actions) to accomplish the goals. Control decisions result from implementing the plans and monitoring the actual results to see if goals are being achieved. If goals are not being achieved, control decisions must be made either to do things differently or to alter plans or goals to attainable levels.

Typical planning decisions for which managerial accounting information is needed include:

- Should a new product line be marketed?
- Should the production and sale of an existing product line be terminated?
- How many units of each product should we produce this year?

Examples of planning
decisions.

Examples of the
difference between
cost accounting and
managerial
accounting
information.

5

COST ACCOUNTING SYSTEMS

Planning is based on estimated future costs and revenues, but often historical data provides a good base for the estimates.

Examples of control decisions.

Control decisions involve comparing actual results with expected results.

Illustrations of control decisions.

- Should our production facilities be expanded? Contracted?
- What are our cash needs for the year? Should we negotiate a revolving line of credit with the bank?
- How much should we spend on advertising? Research and development?
- Is it more economical to purchase a part from an outside supplier or to manufacture it in our own production facilities (the make or buy decision)?

All the planning decisions listed above will require *estimates* of future costs and in some cases *estimates* of future revenues. Planning decisions establish the course of action the organization will follow to accomplish its goals. These decisions are based on what management *expects* to occur in the future, not what has occurred in the past. However, we will learn that the historical cost data provides a good base to estimate the future costs.

Typical control decisions for which cost accounting data are needed include:

- What can be done to make actual sales equal to budgeted sales?
- How can labor be used more efficiently so that actual costs do not exceed planned costs?
- Is a change in research and development projects needed to achieve planned results?
- Does actual production volume need to be changed to equal planned volume?

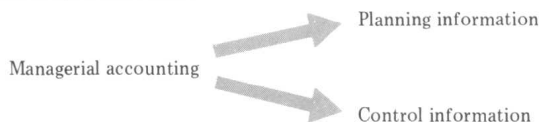
All the control decisions listed above require the comparison of actual results with expected results where the expected results are developed from the planning decisions made by management. The actual results represent data collected by the cost accounting system from the actual events that have occurred during the implementation of the plans. This comparison of actual and expected results may necessitate *additional management* decisions to assure that either the original plan is attained or that modifications are made to the original plan in an acceptable way in order to match the actual conditions being encountered.

To illustrate, Melia Company planned to introduce a new product because managerial accounting analysis suggested that the new product could be produced for \$3 per unit. Marketing managers believed that 1,000 units of product could be sold each month for \$5 per unit. Melia's top management believed that these plans would lead to a satisfactory return on investment so the plan was accepted.

Implementation began but it was found that the cost of producing each unit was \$3.50. The higher cost meant lower profit and return on investment. Melia was faced with control decisions. Some of the choices considered were:

- 1 Can different production methods be used to bring the cost per unit down to \$3?
- 2 Can the product be sold for \$5.50 per unit so that the profit per unit will be as planned even with the higher cost per unit?
- 3 Can the product be redesigned with less expensive materials so that the cost will be \$3 per unit?
- 4 Can more than 1,000 units be sold per month so that even with the planned \$5 selling price and the \$3.50 cost, the total profit will yield a satisfactory return on investment?

EXHIBIT 1-3
The Two Parts of Managerial Accounting



The methods of obtaining the needed information will be discussed in later chapters of this book, but seeking answers to questions like these is the essence of control. Graphically, the parts of managerial accounting are shown in Exhibit 1-3.

Relevance As you study this textbook you will learn that a great variety of accounting information is available to managers. For example, we previously learned that sales orders received and sales orders shipped are used for different purposes. How does an accountant know what information should be reported to managers to aid them in making their planning and control decisions? The accountant chooses information to be reported to a manager by (1) identifying the specific purpose, decision model, or technique the manager will use to make the decision and then (2) determining the **relevant information**.

The first part of the process, identifying the specific purpose, decision model, or technique in which the information will be used, was discussed earlier. Information that is important to one decision may not be important to another decision. This is why it is crucial to know the specific purpose or decision to be made before information is gathered.

The main topic of this section is relevance of information. Only relevant information can improve a decision. Information is *relevant* if it:

Relevant information
(1) affects the
accomplishment of
objectives, and
(2) will change as a
result of the decision.

- 1 Affects the accomplishment of the objectives of the decision maker
- 2 Will change as a result of the decision or choice made by the decision maker

Relevance is important in managerial accounting because it is the main determinant of what the accountant will do and what information will be collected and reported. We will illustrate relevance with a personal example and then with a business example.

A personal illustration
of the meaning of
relevance.

Suppose that the specific decision to be made is to choose a pair of shoes to purchase. In the first illustration let us assume that the shoes are to be used for job interviews. Also assume that the shoestore at which we are shopping has a big rack of shoes available for a single price, \$60 per pair. We are sure we can find a suitable pair on the rack. Since we are choosing shoes to be used in an interview, appearance and color are both very important. We want to project a well-dressed appearance so we will rule out casual shoes. The style of the shoe is *relevant* because we must avoid certain styles if we are to appear well dressed. The color is relevant because it must coordinate with the rest of the clothes we expect to wear in the interview.

In this special case the price of the shoes is not relevant.¹ Regardless of which pair we select, the price will be \$60. So we ignore price in making this decision and consider only color and style. The information we use in making the choice is the relevant information.

¹ We have asked you to assume that all the shoes are the same price. This may seem somewhat unrealistic, but we ask you to do so to make an important point.