MANAGERIAL ACCOUNTING

CONCEPTS FOR PLANNING, CONTROL, DECISION MAKING

REVISED EDITION

RAY H. GARRISON

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Concepts for planning, control, decision making

RAY H. GARRISON, D.B.A., C.P.A.
Brigham Young University

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Preface

This text is designed for a one-term course in managerial accounting, to be used by students who have already completed one or two terms of basic financial accounting. Its emphasis is on uses of accounting data internally by managers in directing the affairs of organizations, both business and nonbusiness. As in the first edition, the revised edition of *Managerial Accounting* is consistently managerial in thrust, looking at accounting data through the eyes of those who must use it in setting plans and objectives, in controlling operations, and in making the myriad of decisions involved with the management of an enterprise. Looking at accounting data from this perspective provides a solid managerial base on which to build concepts. It also makes it easier for the instructor to portray the internal accountant in his true role—that of a key participant in the basic functions of management.

Although the emphasis of the book is on uses of accounting data, care has been taken to not sacrifice the student's need for basic technical understanding. To this end, topics are covered in enough depth to insure full comprehension of basic concepts. The student is then able to proceed with confidence and understanding in the application of these concepts to organizational problems.

A paramount objective in writing this book has been to make a clear and balanced presentation of relevant subject material. Effort has been made to draw examples and homework problems, where appropriate, from service-oriented as well as from profit-oriented situations, and from nonmanufacturing as well as from manufacturing situations.

New in this edition

In the revision process, great care has been taken to retain all of the strengths favorably commented upon by users of the first edition. The book has been thoroughly updated, however, with about 70 percent of the exercise and problem material either completely new or thoroughly revised. In addition, users will find more problem material in this edition, as well as a greater range of problems in terms of level of difficulty.

Other additions or changes include:

1. A section titled "Key Terms for Review" has been added at the end of each chapter. Altogether, over 250 key terms are thus highlighted for the reader.

2. The book has been shortened from 19 to 17 chapters.

a. Old Chapter 16, Inventory Planning and Control, has been eliminated. That material in old Chapter 16 which dealt with the Economic Order Quantity and with the Reorder Point has been condensed and placed in an appendix to Chapter 7, Profit Planning. This is a more logical placement, since it permits the EOQ material to be integrated with other budgeting concepts.

b. Old Chapter 17, Quantitative Decision Techniques, has also been eliminated. That material in old Chapter 17 which dealt with linear programming has been condensed and placed in an appendix to Chapter 11, Relevant Costs in Nonroutine Decisions. Again, this is a more logical placement, since it allows the instructor to integrate linear programming with other decision making concepts, if desired.

3. Old Chapter 4, Cost Allocation for Planning and Control, has been completely rewritten, retitled "Service Department Cost Allocations," and moved to Chapter 15 in the text. Great care has been taken to retain the strengths of old Chapter 4, but the material has been clarified and integrated more fully with flexible budgets and other managerial accounting tools. Moving the chapter toward the end of the text makes it easier for those instructors who prefer to omit this chapter, while at the same time makes it more convenient for those instructors who prefer to cover this material after covering basic budgeting concepts.

4. Old Chapter 6, Cost-Volume-Profit Relationships, has been largely rewritten to focus more directly on contribution analysis. The material in its rewritten form has been extremely well received by students in classroom testing. This chapter becomes Chapter 5 in the revised edition.

5. Old Chapter 9, Control through Standard Costs, has been largely rewritten to include more material on the setting of standards. In addition, a columnar approach to variance analysis is used in this edition, along with the formula approach, to permit the instructor to focus more directly on input/output analysis, if desired. Also, an appendix illustrating journal entries for the recording of variances has been added, for those instructors who wish to cover this material.

6. Old Chapter 19, How Well Am I Doing?—Statement of Changes in Financial Position, becomes Chapter 17 in the revised edition. This chapter has been rewritten to clarify the material and to tie it to actual funds statements extracted from annual reports. An appendix has been added to the chapter illustrating the adjustment of the income statement to a cash

basis, for those instructors who prefer this approach to preparing a cash flow statement.

7. Behavioral issues have been given more consideration in both text and problem material.

Using the text

Flexibility in meeting the needs of courses varying in length, content, and student composition has been a prime concern in the revision process. Sufficient text material is available to permit the instructor to choose topics and depth of coverage as desired. Appendixes, parts of chapters, or even whole chapters can be omitted without adversely affecting the continuity of the course. An instructor's manual is available which gives a number of alternate assignment outlines, and which gives suggestions as to the problems to be assigned from the various chapters.

Although the book has been shortened by two chapters, the question, exercise, and problem material has been expanded to some 700 items in the revised edition. A study guide is available, as is a test bank containing both objective and problem-type questions.

Acknowledgments

Ideas and suggestions have been received from many faculty members who used the first edition of the book. Each has my thanks, since the book is a better product as a result of their insightful comments.

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of Management Accountants of Canada to incorporate its examination questions in this text. Problems from the examinations administered by the Society of Management Accountants of Canada are designated (SMA).

Finally, my thanks to Standard Brands Incorporated and Pet Incorporated for permission to use excerpts from their annual reports.

January 1979 **Ray H. Garrison**

Contents

Chapter 1

Managerial accounting — A perspective

Managerial accounting is concerned with providing information to *managers;* that is, to those who are *inside* of an organization and who are charged with directing and controlling its operations. Managerial accounting can be contrasted with financial accounting, which is concerned with providing information to stockholders, creditors, and others who are *outside* of an organization.

Because it is manager oriented, any study of managerial accounting must be preceded by some understanding of the management process and of the organizations in which managers work. Accordingly, the purpose of this chapter is to examine briefly the work of the manager, and to look at the characteristics, structure, and operation of the organizations in which this work is carried out. The chapter concludes by examining the major differences and similarities between financial and managerial accounting.

ORGANIZATIONS AND THEIR OBJECTIVES

An organization can be defined as a group of people united together for some common purpose. A bank providing financial services is an organization, as is a university providing educational services, and the General Electric Company producing appliances and other products. An organization consists of *people,* not physical assets. Thus, a bank building is not an organization; rather, the organization consists of the people who work in the bank and who are bound together for the common purpose of providing financial services to a community.

The common purpose toward which an organization works is called its *objective.* Not all organizations have the same objective or objectives. For some organizations the objective is to produce a product and earn a profit. For other organizations the objective may be to render humanitarian service (the Red Cross), to provide aesthetic enrichment (a symphony orchestra), or to provide government services (a water department). To assist in our discussion, we will focus on a single organization, the Discount Furniture Marts, Inc., and look closely at this organization's objectives, structure, and management and at how these factors influence its need for managerial accounting data.

Setting Objectives

The Discount Furniture Marts, Inc., is a corporation, and its owners have placed their money in the organization with the thought in mind of earning a return, or profit, on their investment. Thus, one objective of the company is to earn a profit on the funds committed to it. The profit objective is tempered by other objectives, however. The company is anxious to acquire and maintain a reputation for integrity, fairness, and dependability. It also wants to be a positive force in the social and ecological environment in which it carries out its activities.

The owners of the Discount Furniture Marts, Inc., prefer not to be involved in day-to-day operation of the company. Instead, they have outlined the broad objectives of the organization, and have selected a president to oversee the implementation of these objectives. Although the president is charged with the central objective of earning a profit on the owners' investment, he[1] must do so with a sensitivity for the other objectives which the organization desires to achieve.

Strategic planning

The implementation of an organization's objectives is known as strategic planning. In any organization strategic planning occurs in two phases:

1. Deciding on the products to produce and/or the services to render.
2. Deciding on the marketing and/or manufacturing methods to employ. That is, deciding on the best way to get the intended product and/or service to the proper audience.

The set of strategies emerging from strategic planning is often referred to as an organization's *policies,* and strategic planning itself is often referred to as *setting policy.*[2]

PHASE ONE STRATEGY. In deciding on the products to produce or the services to render, there are several strategies that the president of the Discount Furniture Marts, Inc., could follow. The company could specialize in office furniture. It could specialize in appliances, it could be a broad "supermarket" type of furniture outlet, or it could employ any one of a number of other product and/or service strategies.

After careful consideration of the various strategies available, a decision has been made to sell only home furnishings, including appliances. The president, for one reason or another, has rejected several other possible strategies. He has decided, for example, not to service appliances. He has also decided not to sell office furniture, or to deal in institutional-type furnishings.

PHASE TWO STRATEGY. Having decided to concentrate on home furnishings, the president of the Discount Furniture Marts, Inc., is now faced with a second strategy decision. Some furniture companies handle only the highest quality home furnishings, thereby striving to maintain the

[1] The English language lacks a generic singular pronoun signifying he *or* she. For this reason the masculine pronouns he and his are used to some extent in this book for purposes of succinctness and to avoid repetition in wording. As used, these pronouns are intended to refer to both females and males.

[2] For an expanded discussion of strategic planning, see Harold Koontz and Cyril J. O'Donnell, *Management,* 6th ed. (New York: McGraw-Hill Book Co., 1976); and William H. Newman and E. Kirby Warren, *Process of Management,* 4th ed. (Englewood Cliffs, N.J.: Prentice-Hall, Inc., 1977).

image of a "quality" dealer. Markups are usually quite high, volume is quite low, and promotional efforts are directed toward a relatively small segment of the public. Other furniture dealers operate "volume" outlets. They try to keep markups relatively low, with the thought that overall profits will be augmented by a larger number of units sold. Still other dealers may follow different strategies. The selection of a particular strategy is simply a matter of managerial judgment; some companies make a profit by following one strategy, while other companies are equally profitable following another. In the case at hand, the Discount Furniture Marts, Inc., has decided to operate "volume" outlets, and to focus on maintaining a "discount" image.

, Every organization must make similar strategy decisions. The set of strategies resulting from these decisions may not be written down, but they exist nonetheless and are a central guiding force in the organization's activities and in its need for accounting information.

The work of management

The work of management centers around what is to be managed—the organization itself. Essentially, the manager carries out four broad functions in an organization:

1. Planning.
2. Organizing and directing.
3. Controlling.
4. Decision making.

These activities are carried on more or less simultaneously and often under considerable stress, urgency, and pressure. Rarely (if ever) will managers stop to examine which function they are engaged in at that particular moment. Perhaps they couldn't tell even if they tried, since a specific action might touch on all four.

PLANNING. In planning, the managers outline the steps to be taken in moving the organization toward its objectives. We saw the planning function in operation in the Discount Furniture Marts, Inc., as the president decided on a set of strategies to be followed. The president's next step will be to develop further, more specific plans, such as store locations, methods of financing customer purchases, hours of operation, discount policies, and so forth. As these plans are made they will be communicated throughout the organization, and will serve to coordinate, or to meld together, the efforts of all parts of the organization toward the company's objectives.

ORGANIZING AND DIRECTING. In organizing, the managers decide how best to put together the organization's human and other resources in order to carry out established plans. As a customer enters one of the Discount Furniture Marts, Inc.'s stores, the results of the managers' organizational efforts should be obvious in several ways. Certain persons will be performing specific functions, some directly with the customer, and some not. Some persons will be overseeing the efforts of other persons. The store's physical assets will be arranged in particular ways, and certain procedures will be followed if a sale is made. These and a host of other things, seen and unseen, will all exist to assure that the customer is assisted in the best way possible, and that the company moves toward its profit objectives.

In sum, the organization that is apparent in most companies doesn't simply happen; it is a result of the efforts of the manager who must visualize and fit together the structure that is needed to get the job done, whatever the job may be.

In directing, managers oversee day-to-day activities, and keep the organization functioning smoothly. Employees are assigned to tasks, disputes between departments or between employees are arbitrated, questions are answered, on-the-spot problems are solved, and numerous small routine and nonroutine decisions are made involving customers and/or procedures. In effect, directing is that part of the managers' work which deals largely with the routine and with the here and now.

CONTROLLING. In controlling, managers take those steps that are necessary to ensure that every part of the organization is functioning at maximum effectiveness. To do this they study the accounting and other reports coming to them, and compare these reports against the plans set earlier. These comparisons may show where operations are not proceeding effectively, or where certain persons need help in carrying out their assigned duties. Control, in large part, is a function of obtaining useful *feedback* on how well the organization is moving toward its stated objectives. This feedback may suggest the need to replan, to set new strategies, or to reshape the organizational structure. It is a key ingredient to the effective management of any organization. As we shall see in chapters following, the generation of feedback to the manager is one of the central purposes of internal accounting.

DECISION MAKING. In decision making, the manager attempts to make rational choices between alternatives. Decision making isn't a separate management function, per se; rather, it is an inseparable part of the *other* functions already discussed. Planning, organizing and directing, and controlling all require that decisions be made. For example, when first establishing its organizational strategies, the Discount Furniture Marts, Inc., had to make a decision as to which of several available strategies would be followed. Such a decision is often called a *strategic decision,* because of its long-term impact on the organization. In organizing and in directing day-to-day operations, as well as in controlling, the manager must make scores of lesser decisions, all of which are important to the organization's overall well-being.

All decisions are based on *information.* In large part, the quality of