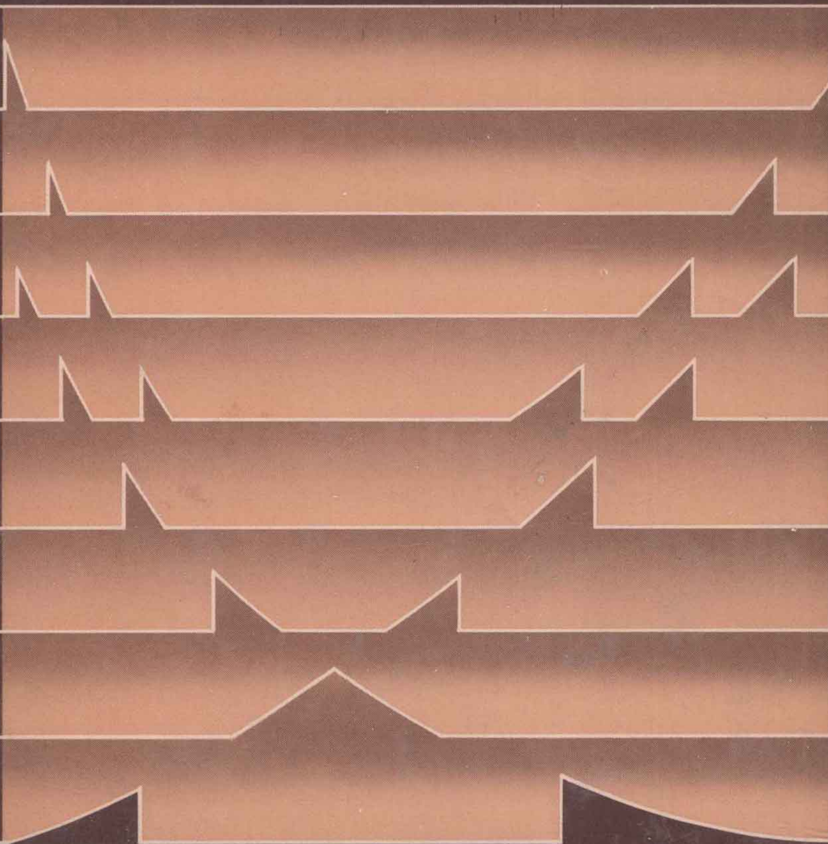
MANAGERIAL ACCOUNTING

THIRD EDITION



Ray H. Garrison

MANAGERIAL ACCOUNTING

Concepts for planning, control, decision making

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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. A companion volume for the financial accounting sequence is *Financial Accounting* by Roger H. Hermanson, James Don Edwards, and Ray H. Garrison.

The emphasis of *Managerial Accounting* is on uses of accounting data internally by managers in directing the affairs of organizations, both business and nonbusiness. As in the first two editions, the third 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 or her 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 ensure 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 two editions. The book has been updated where needed, however, with a large amount of the assignment material either thoroughly revised or new to this edition. As in the prior edition, users will find a wide range of problems in terms of level of difficulty.

Other changes or additions include:

1. Learning objectives have been placed at the beginning of each chapter to guide the student in his or her study of the chapter material.

2. The book has been updated to include the new Accelerated Cost Recovery System (ACRS) depreciation rules enacted by Congress in August 1981. (Old depreciation methods are now obsolete for income tax and capital budgeting purposes, since the new ACRS rules must be used on all assets placed into service after January 1, 1981.) The new ACRS rules have been integrated into the capital budgeting material in Chapter 15, along with the new investment credit rules enacted by Congress. This makes the book completely up-to-date with the new tax law.

3. The material on process costing has been removed from the Appendix to Chapter 3 ("Job Order Costing") and placed in a chapter by itself. The material included in this new chapter has been completely rewritten, with the new chapter titled, "Systems Design: Process Costing." It becomes Chapter 4 in this edition.

4. Material has been added to Chapter 10 ("Flexible Budgets and Overhead Analysis") to show how variances are presented on the income statement for management's use.

5. The material on transfer pricing in Chapter 11 ("Control of Decentralized Operations") has been completely rewritten. This material now includes a general formula for computing the transfer price, which students will find very helpful.

6. The sequence of the chapters on relevant costs and pricing has been reversed. The chapter on relevant costs (Chapter 13) now comes after the chapter on pricing rather than before it. This will permit the instructor to move from relevant costs right into the chapters on capital budgeting with no intervening material to cover.

In addition to the above, scores of small "polishing" changes have been made throughout the book in an effort to further improve flow, comprehension, and readability. In no case, however, has change been made simply for the sake of change (other than in the assignment material). Rather, the revision has been completed with a single objective in mind—to make the third edition of *Managerial Accounting* the most teachable book of its kind available anywhere.

Using the text

As in the prior editions, flexibility in meeting the needs of courses varying in length, content, and student composition continues to be a prime concern in the organization and content of the book. 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 suggestions as to the problems to be assigned from the various chapters.

The book contains over 700 questions, exercises, and problems for in-class use or for homework assignment. In addition, 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 revised edition of the book. Each has my thanks, since the book is a better product as a result of their insightful comments.

The following professors spent considerable time providing in-depth reviews of the prior edition: Lee Dexter, Moorhead State University; Clarence Fries, University of Arkansas; Phillip A. Jones, Sr., University of Richmond; Edward H. Julius, California State University, Northridge; Franklin Lowenthal, California State University, Hayward; Morton Nelson, University of Windsor; Thomas J. O'Neil, American International College; and Murat Neset Tanju, The University of Alabama in Birmingham.

My appreciation is extended to the National Association of Accountants and to the American Institute of Certified Public Accountants for permission to quote from their publications. Selected materials from the Uniform CPA Examinations, copyright © 1966 through 1980 by the American Institute of Certified Public Accountants, Inc., are used (or adapted) by permission. These problems bear the notation (CPA) in the text. Material from the Certificate in Management Accounting Examinations, copyright © 1973 through 1980 by the National Association of Accountants, is reprinted (or adapted) by permission. These problems bear the notation (CMA) in the text. I also acknowledge, with appreciation, permission from the Society of Management Accountants of Canada, from the Canadian Institute of Chartered Accountants, and from the Canadian Certified General Accountants' Association for permission to use selected problems from their examinations in the text. These problems bear the notations SMA, CICA, and CCGA, respectively.

Finally, my thanks to The Pillsbury Company and to West Point-Pepperell, Inc., for permission to use excerpts from their annual reports.

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Concepts for planning, control, decision making

MANAGERIAL ACCOUNTING—A PERSPECTIVE

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Learning objectives

After studying Chapter 1, you should be able to:

Explain what is meant by an organization and describe the work done by management in organizations.

Name the steps in the planning and control cycle and explain how each impacts on the work of management.

Prepare an organization chart and explain its purpose.

Distinguish between line and staff responsibilities in an organization.

Name the three groups into which organizations can be classified and discuss the ways in which these organizations are similar.

Describe the three broad purposes for which the manager needs accounting information.

Identify the major differences and similarities between financial and managerial accounting.

Define or explain the key terms listed at the end of the chapter.

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. 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 Bestway Furniture Company, 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 Bestway Furniture Company 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 of 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 Bestway Furniture Company 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 strategy to follow in getting the intended product 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 Bestway Furniture Company 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 had 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 Bestway Furniture Company is now faced with a second strategy decision. Some furniture companies handle only the highest quality home furnishings, thereby striving to maintain the 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

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[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, 1976); and William H. Newman and E. Kirby Warren, *Process of Management*, 4th ed. (Englewood Cliffs, N.J.: Prentice-Hall, 1977).

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 Bestway Furniture Company 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 Bestway Furniture Company 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 Bestway Furniture Company'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 to assure that the company moves toward its profit objectives. In short,