CHAPTER 1
INTRODUCTION TO COST MANAGEMENT

DISCUSSION QUESTIONS

1. Cost management is concerned with assigning costs and using information for planning, controlling, continuous improvement, and decision making. It encompasses cost accounting and management accounting but has a broader focus than the usual roles assigned to cost accounting and management accounting. Cost accounting is concerned with assigning costs to various cost objects such as products, services, and activities. Cost management broadens this focus by emphasizing accuracy of assignments based on causal relationships. Management accounting is concerned with planning, controlling, and decision making. Cost management broadens this focus by emphasizing continuous improvement and expanding planning, control, and decision making to include such factors as processes, value chain, life cycle analyses, strategic considerations, and environmental costs.

2. Cost management differs from financial accounting in the following major ways: (1) an internal focus, (2) an emphasis on the future, (3) freedom from GAAP and other mandatory rules, (4) a multidisciplinary scope, (5) an evaluation of individual segments within the firm, and (6) the provision of more detailed information.

3. Factors affecting the focus and practice of cost management are global competition, service industry growth, advances in information technology, advances in the manufacturing environment, customer orientation, new product development, total quality management, time as a competitive factor, and efficiency. Global competition means that companies are now competing with the best of the best. Accurate, timely, and relevant accounting data are crucial in appropriately managing costs. Service industry growth has led to the need for increased management accounting information to improve productivity and quality. The advances in information technology have led to the creation of integrated relational databases that allow a variety of users to develop their own reports based on their particular needs.

It has also fostered the implementation and use of more sophisticated accounting systems such as activity-based costing. Customer orientation, new product development, total quality management, time as a competitive factor, and efficiency require the accountant to create and track financial and nonfinancial measures of customer satisfaction, quality improvement, responsiveness, cycle time, target costs, cost, and productivity. Advances in the manufacturing environment are characterized by practices such as the theory of constraints, just-in-time, and automation. These changes are affecting such practices as inventory management and product costing.

4. A flexible manufacturing system is a computerized system that allows different product lines to be manufactured on the same equipment. The equipment can be reconfigured simply by calling up different programs.

5. The controller is responsible for both internal and external accounting. These responsibilities usually include such diverse activities as taxes, SEC reports, cost accounting, budgeting, internal auditing, financial accounting, and systems accounting.

6. A line position has direct responsibility for carrying out the basic missions of an organization. A staff position has indirect responsibilities for the basic missions and provides a supportive role for line activities.

7. For most organizations, the controller should be a member of the top management staff. The controller is the financial expert of an organization and can provide critical advice and insight. Furthermore, the current tendency of having a cross-functional management team increases the likelihood that the controller will be included as part of the management staff.

8. Planning establishes performance standards, feedback compares actual performance with planned performance, and control uses feedback to evaluate deviations from plans.

9. Cost management has the role of providing information to help identify opportunities for improvement and also provides an evaluation of the progress made in implementing the actions designed to create improvement.

10. Performance reports compare actual costs and revenues with planned costs and revenues and thus provide signals to managers that allow them to take corrective actions.

11. Business ethics is concerned with making the right choices and usually involves sacrificing individual self-interest for the well-being of others. It is possible to teach ethical behavior in virtually any course. By introducing ethical dilemmas in management accounting, students can become aware of the behavior that is expected in the business world and, in particular, for management accountants.

12. Yes. There is some evidence that ethical behavior actually is good business. It improves society, helps align individual goals with firm goals, enhances a firm's public image, and even seems to be related to better financial performance. The market and consumers appreciate ethical behavior and are willing to reward those who adopt it.

13. Yes. As management accountants become more informed about what behavior is acceptable and what is not, support should increase for ethical behavior. The code also recommends solutions to ethical dilemmas that might not have been obvious to the practicing management accountant.

14. The three forms of certification are the CMA, the CPA, and the CIA certificates. Although each certification can prove to be valuable for management accountants, the CMA designation is tailored to fit the needs of management accountants. The CPA designation has a public accounting orientation, and the CIA designation has an internal auditing orientation. Only the CMA designation specifically addresses the professional requirements of a management accountant.

15. The four parts are (1) business analysis; (2) management accounting and reporting; (3) strategic management; and (4) business applications. The parts reveal the interdisciplinary nature of management accounting.

EXERCISES

Exercise 1–1

a. CMS
b. FS
c. CMS
d. FS
e. CMS
f. CMS
g. FS
h. FS
i. CMS
j. FS
k. FS
l. CMS

Exercise 1–2

a. Input
b. Process
c. Input
d. Input
e. Output
f. User action
g. Input
h. Input
i. User action
j. Process
k. Process
l. User action
m. User action
n. Output
o. Process

Exercise 1–3

1. Customers can be internal or external. Users of the component produced by John's department are his customers. This includes the Assembly Department and the Rework Department. In a sense, those who buy the MP3 players are his customers, too—after all, the functionality of the MP3 player is affected by the quality and reliability of its components.

Exercise 1–3 (Concluded)

2. John's department is producing a low-quality component. One out of every 50 units is a high defect rate and is causing a lot of rework. Being sensitive would require a dramatic reduction in the defect rate. A reduction in the defect rate would decrease cycle time, lower the rework rate, and decrease costs. This creates the potential to increase value for external customers and makes the life of internal customers much easier.

3. Cost management can provide information concerning quality—both financial and nonfinancial. Defect rates can be tracked over time. Rework costs attributable to defective components from John's department can be measured and tracked over time. Cycle time reductions due to improved quality can be measured and reported. Product cost reductions attributable to improved quality can be reported.

Exercise 1–4

a. Planning and control
b. Costing of service
c. Costing of product/activity
d. Decision making
e. Planning and control
f. Costing of development project
g. Decision making
h. Planning and control
i. Decision making
j. Costing of service
k. Costing of an object (department)
l. Planning and control
m. Decision making

Exercise 1–5

The manager is clearly considering unethical behaviors, especially the decisions associated with reducing maintenance and promotional salaries. Extending asset life for depreciation has less clear ethical implications. Reducing maintenance may not hurt much in the short run but will have long-run negative financial consequences. Furthermore, the decision for promotions has been made with a given set of financial expectations, and reducing the salary increases by 50 percent for deserving employees is obviously unfair to them. Although the manager is not a cost or management accountant, he is violating the ethical standard under Integrity that requires him to "refrain from engaging in any conduct that would prejudice carrying out duties ethically." (III-3).

The reduction in promotional salary increases is particularly egregious in that he is reducing the salaries of others so that he may benefit. In effect, he is stealing from his subordinates. The reduction in maintenance budget is also a form of stealing—robbing future service potential to produce a current personal benefit.

An ethical dilemma does exist if the manager carries through with his plans. The dilemma exists because the manager wants to manipulate income to achieve personal financial gain. A company code of ethics and compliance monitoring is one recommendation. An internal audit could be used to detect and deter such questionable behavior. Furthermore, a company policy requiring managers to justify any expenditure reductions in writing to both the employees and higher management could discourage behavior like the manager's. The best control, however, is hiring managers with the integrity to do the right thing even when faced with the opportunity to cheat or steal.

Exercise 1–6

1. The controller wants a written record of spoiled material in order to more closely control it. From a behavioral perspective, the formal record keeping of spoilage will make it seem more important to individuals on the factory floor. If the company has a total quality management program in effect, keeping track of spoilage can make it easier to note trends and ensure that spoilage is being reduced over time. Additionally, the formal reporting of spoilage may make it easier to pinpoint the areas in which spoilage occurs and may enable management to improve the system to eliminate spoilage. Employees should be made aware that the purpose of tracking spoilage is to eliminate it, not to fix blame.

Exercise 1–6 (Concluded)

It is possible that everybody doesn't know what the spoilage rate is. Some people may think it is high; others may think it is low. A written record of spoilage will prevent a certain amount of pointless arguing about this. For example, the plant manager will not be forced to rely on the production manager's assessment of spoilage. Instead, both managers can rely on the recorded spoilage to determine how much is occurring and how it can best be reduced.

2. Bill correctly sees that keeping track of spoilage is additional work. This will cost the plant in one way or another. Even if an additional worker need not be hired, the workers who do record spoilage, by definition, will not be doing something else. Bill should work together with the controller to see that the costs of recording spoilage do not exceed the benefits. He should also attempt to make the recording as easy as possible and concentrate on the "expensive" spoilage. Finally, Bill's remark indicates that workers may hide spoilage to avoid responsibility. They may "steal" it and then dispose of it, or they may simply pass on a bad unit to the next process. Either approach is costly and not in harmony with the goal of improving quality. These problems can be avoided by training, education, and the installation of controls.

Exercise 1–7

1. *Planning*. The management accountant gains an understanding of the impact on the organization of planned transactions (i.e., analyzing strengths and weaknesses) and economic events (both strategic and tactical) and sets obtainable goals for the organization. The development of budgets is an example of planning.

   Control and evaluation. The management accountant ensures the integrity of financial information, monitors performance against budgets and goals, and provides information internally for decision making. Comparing actual performance against budgeted performance and taking corrective action where necessary is an example of control and evaluation.

   Continuous improvement. The management accountant helps identify opportunities for improvement, measures the projected costs and benefits, and reports on the actual outcomes.

   Decision making. The management accountant helps in the analysis of various alternatives and in the choice of the optimal course of action.

Exercise 1–7 (Concluded)

2. a. Planning; expected price and cost information are needed
   b. Continuous improvement; cost savings from improved order entry quality and improved customer satisfaction
   c. Control and evaluation; a performance report triggered the investigation that led to corrective action
   d. Planning; forecasting of financial effects is necessary
   e. Decision making; accounting must analyze cost-volume-profit effects
   f. Continuous improvement; before-and-after costs are needed
   g. Decision making; cost information for an outsourcing decision is needed
   h. Continuous improvement; cost information for setups and materials waste

Exercise 1–8

Kaylin Hepworth is a line manager with direct responsibility for producing a major component of the plant's products. The basic objective of the plant is to produce speakers, and Kaylin plays a direct role in achieving this objective.

Joseph Henson is a line manager with direct responsibility for producing speakers. This is the basic objective of the plant. Thus, Joseph has direct responsibility for a basic objective and holds a line position.

Leo Tidwell is staff. He is in a support role—he prepares reports and helps explain and interpret them. His role is to help the plant manager and other line managers more effectively carry out their responsibilities.

PROBLEMS

Problem 1–9

Dear Lily,

I am pleased that you are considering taking an accounting course to complement your hotel and restaurant major. You will find that a basic knowledge of accounting will place you in good stead in dealing with the business aspects of hotel management.

Financial accounting is primarily aimed at outside parties. It involves generating financial statements that describe the assets and liabilities of a business and the periodic income earned. You will find that investors, lenders, the IRS, and other local, state, and federal regulatory and licensing agencies will appreciate a good solid financial accounting system.

Cost management is concerned with determining the costs of things like products, services, and activities. It is also concerned with using financial and non-financial information for planning, controlling, continuous improvement, and decision making. In your case, you will want to budget and control costs for a hotel. You may want to determine the costs and revenues of different services. For example, is it worthwhile to offer a Sunday brunch for hotel guests?

As you might guess, courses in both financial and cost management would be of value. If you cannot afford the time to take both accounting courses, a good solid background course in cost and management accounting would be best. Good luck with your goal of becoming a hotel manager!

Sincerely,

Problem 1–10

At first glance, this seems simple. Couldn't John simply mention that Patty had already accepted a position as controller in another company? Since the decision was a close one between the two, this information would likely tip the balance in favor of John. However, some ethical issues should be considered. First, the information that Patty gave was likely given in confidence, and John should not disclose this confidential information without her permission. Second, disclosing the confidential information may provide a personal benefit to John. Third, it may be that Patty will change her mind about the position she has accepted (assuming she can withdraw honorably from the acceptance) once she is officially aware of the promotion. This decision and its consequences should be Patty's and not John's. If I were John, I would leave the response to the promotion entirely in Patty's hands. Once offered the position, she may simply indicate that she cannot accept it because she is committed to another job. This may then cleanly open up the position for John.

Problem 1–11

1. **Emily should not implement the suggested accounting procedures because they conflict with generally accepted accounting principles and violate Sections I and III of the Standards of Ethical Conduct for Management Accountants. It raises serious ethical questions in the areas of competence and integrity; e.g., Emily is not able to "perform professional duties in accordance with relevant laws, regulations, and technical standards" or "communicate information fairly and objectively."**

2. **Emily should discuss the problem with the next highest management level (if the divisional manager's mind cannot be changed). This could be, for example, the corporate controller or the CEO. She could also discuss the matter with an objective advisor to assess possible courses of action. In some firms, ethical hotlines exist that will allow the dilemma to be analyzed. If no resolution is obtained, then resignation may be called for.**

Problem 1–12

The proposed changes violate the following ethical standards:

***Competence*. Top management's request for Larry Stewart to account for the company's information in a manner that is not in accordance with generally accepted accounting principles violates the standard to "perform professional duties in accordance with relevant laws, regulations, and technical standards." (I-2)**

***Confidentiality*. Top management has violated the ethical standard of "refrain[ing] from using confidential information for unethical or illegal advantage." (II-3)**

***Integrity*. Top management has violated the standard to avoid actual or apparent conflicts of interest and advise all appropriate parties [other shareholders] of any potential conflict. (III-1)**

The motivation for top management in this circumstance may be reinforced by the favorable bonus situation, which is in violation of the standard to "refuse any gift, favor [bonus], or hospitality that would influence their actions."

***Credibility*. Top management's restriction and distortion of Silverado's financial information violates the standard to "communicate information fairly and objectively." (IV-1)**

By telling Larry to restrict the disclosure of the changes, top management is clearly in violation of the standard to "communicate unfavorable as well as favorable information."

To resolve the ethical dilemma, Larry should first determine if the company has an established policy. If so, he should follow the prescribed policies in resolving the ethical conflict. If there is no policy, then the specific steps are as follows:

a. To confront top management about the unethical behavior unless Larry feels that they are involved, in which case the problem should be presented to the next higher level, the chairman of the board of directors. If this fails, then the issue can be taken to the audit committee and the board of directors.

b. To clarify relevant concepts by confidential discussion with an objective advisor to obtain possible courses of action.

c. To resign and submit an informative memorandum to the chairman of the board of directors, if all levels of internal review have been exhausted and the conflict still exists.

Problem 1–13

By discussing the possible sale of Emery's common stock with members of the troubleshooting team, Gus Swanson has violated the following standards of ethical conduct:

***Competence (I)*. Gus has an obligation to perform his duties in accordance with relevant laws and regulations. By discussing the information he overheard, he may have violated laws regulating the use of inside information.**

***Confidentiality (II)*. Gus has disclosed confidential information acquired in the course of his work that he has not been authorized to share with peers and others within the organization. In addition, he has not informed subordinates of the confidential nature of the information nor has he attempted to prevent the further distribution of this information.**

***Integrity (III)*. By discussing this information, Gus has engaged in an activity that would discredit his profession and prejudice his ability to carry out his duties ethically.**

***Credibility (IV)*. Gus has violated the requirement to communicate all information fairly and objectively.**

Problem 1–14

1. **Assuming the controller did not inform the CEO and CFO of the situation, the ethical considerations of the controller's apparent lack of action, as covered in the Standards of Ethical Conduct for Management Accountants, are as follows:**

   ***Competence (I)*. Management accountants have a responsibility to perform their professional duties in accordance with the relevant laws, regulations, and technical standards. The controller's apparent lack of action regarding the overstatement of inventory and lack of provision for potential purchase commitment losses do not comply with generally accepted accounting principles.**

   ***Integrity (III)*. Management accountants have a responsibility to avoid conflicts of interest, refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically, and refrain from engaging in any activity that would discredit their profession.**

   ***Credibility (IV).* Management accountants have a responsibility to communicate information fairly and objectively and to fully disclose information that could influence an intended user's understanding of the reports.**

Problem 1–14 (Concluded)

2. The recommended course of action that Marian Nevins should take, as described in the Standards of Ethical Conduct for Management Accountants, is as follows:

   Consult company policies and procedures regarding ethical conflict. If the company does not have adequate procedures in place to resolve the conflict, then Marian should discuss the problem with her immediate superior, the controller. However, as the controller is apparently involved in the matter and she has already spoken to him, it would not be necessary to inform him that she is taking the situation to the CFO.

   Since the issue is still not resolved, she should consult the next higher level of management, the CFO, particularly since he or she will be one of the signers of the representation letter.

   During this process, Marian could clarify relevant concepts by confidential discussion with an objective advisor to obtain an understanding of possible courses of action. (The IMA maintains a toll-free ethics hotline for members experiencing ethical conflicts.)

   If the issue remains unresolved, Marian should continue to take the problem to the next higher levels of authority, which may include the audit committee, executive committee, and/or the board of directors.

   If the ethical conflict still exists, after exhausting all levels of internal review, Marian should resign and submit an informative memorandum to an appropriate representative of the organization.

   Except where legally prescribed, communication of these issues to outsiders (the media, regulatory bodies, etc.) by Marian is not considered appropriate.

3. The actions that Heart Health Procedures can take to improve the ethical situation within the company include:

   Setting the tone at the top for control consciousness of the people in the organization.

   Establishing an audit committee within the board of directors and providing an avenue for communication free of reprisals within the company.

   Adopting performance-based, long-term financial incentive plans.

CYBER RESEARCH CASE

1–15

Answers will vary.

The Collaborative Learning Exercises can be found on the product support site at www.cengage.com/accounting/hansen.