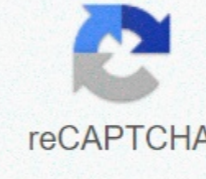




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Identify the area of accounting that is most involved in each of the following responsibilities.

Dana Matthews is the president of Sportswear Company, a manufacturer of hats and sweaters for fans of various professional sports teams. Imagine being the accountant responsible for all the accounting functions at Sportswear. Dana has just reviewed the financial statements for the most recent financial year for the first time and has the following conversation with you:

Learning Objective Compare characteristics of financial and management accounting. **Question:** The issue facing the president at Sportswear is a common issue. Companies prefer not to provide more information than is required by U.S. GAAP, but they want to have more detailed information for internal decision-making and performance evaluation purposes. That is why it is important to distinguish between financial and administrative accounting. What is the difference between information prepared by financial auditors and information prepared by auditors? **Answer:** Financial accounting Provides historical financial information to external users. focuses on providing historical financial information to external users. External users are those outside the company, including owners (e.g. shareholders) and creditors (e.g. banks or bondholders). Financial accountants who report to external users are required to follow the U.S. Generally accepted accounting principles (U.S. GAAP)A set of accounting rules that must be followed to provide consistency in reporting financial information to third-party users., a set of accounting rules that requires consistency in recording and reporting financial information. This information typically summarizes the overall operating results and does not provide detailed information. Management accountingFocus focuses on internal users, including executives, product managers, sales managers and other staff in the organization who use accounting information for decision making. focuses on internal users: executives, product managers, sales managers, and all other employees within the organization who use accounting information to make important decisions. Management accounting information does not have to be consistent with U.S. GAAP. In fact, compliance with U.S. GAAP can be a deterrent to obtaining useful information for internal decision-making purposes. For example, when compiling inventory costs for one or more units of product (each sweater or hat produced at Sportswear Company), U.S. GAAP requires that the cost of production costs, such as factory rent and factory costs, be included. For internal decision-making purposes, however, make more sense to include non-production costs directly related to the product, such as sales commissions or administrative costs. **Question:** It is clear that financial accounting focuses on reporting to external users, while management accounting focuses on reporting to internal users. What specifics would we expect in management accounting information? **Answer:** Management accounting often focuses on making future forecasts for segments of a business. Let's say Sportswear Company is considering introducing a new line of coffee mugs with team logos on each mug. Management would certainly need detailed financial forecasts for sales, costs and resulting profits (or losses). While historical financial accounting data from other product lines would be useful, preparing projections for the new line of mugs would be a managerial accounting function. Another feature of management accounting data is the high level of detail. As noted in the opening dialogue between the President and the Accountant of Sportswear Company, the financial information in the annual report provides a general overview of the company's financial results, but does not provide detailed information about each product. Information, such as product reliability, would come from the management accounting function. Finally, administrative accounting information often takes the form of non-financial measures. For example, Sportswear Company can measure the percentage of defective products or the percentage of on-time deliveries to customers. This type of non-financial information comes from the managerial accounting function. Table 1.1 Comparison of financial and administrative accounts gives an overview of the characteristics of both management and financial accounts. Table 1.1 Comparison of Financial and Managerial Accounting Managerial Accounting Financial Accounting Users Inside the organization Outside the organization Accounting rules None U.S. Generally Accepted Accounting Principles (U.S. GAAP) Time horizon Future projections (sometimes historical as in detail) Historical information Detail level Often presents segments of an organization (e.g. products, divisions, divisions) Presents general business information in accordance with U.S. GAAP Performance Measures Financial and non-financial demand : What has the President of Sportswear Company learned about the profitability of the product of the information provided by the executive accountant? **Answer:** The president of Sportswear, Dana Matthews, learned that the hats product line was much more profitable than expected, accounting for 55 percent of the company's profits, although initial estimates were that the hat segment would account for 40 percent of the company's profits. Conversely, the sweaters product line was much less profitable than expected, accounting for 45 percent of the company's profits. There are many problems with determining the profitability of the product, including how to allocate costs that are not easily traced back to each product and product revenue and cost information is accurate enough to make important management decisions. These important issues will be addressed throughout the Key Takeaway Financial accounting provides historical financial information for third-party users in accordance with U.S. GAAP. The administrative accounts provide detailed financial and non-financial information for internal users who use the information for decision-making, planning and control purposes. Let's say you're the co-owner and manager of a store that sells and repairs mountain bikes. Give an example of a financial accounting report that would be useful to you and your co-owner. Give two examples of management accounting reports that would be useful to you as a manager. Give two examples of non-financial measures used by a pizza restaurant that serves food in the restaurant and offers delivery services. For each report in the following report, indicate whether it is financial or administrative accounting. Put the reasoning behind your answer for each item. Expected net income for the next quarter by Division Defective Goods produced as a percentage of all produced goods Earnings account for the most current year, prepared in accordance with U.S. GAAP Monthly Sales broken down by geographic region Production department budget for the next quarter Balance sheet at the end of the current year, prepared in accordance with U.S. GAAP Solution to revise issue 1.1 Financial accounting reports provided to owners typically include the income account , overview of the equity, balance sheet and state of cash flows. All are prepared in accordance with U.S. GAAP. Management accounting reports prepared for managers can include a quarterly budget for revenue and expenses for each segment of the business (for example, bike sales and bike repairs), returns for defective goods as one percent of total monthly sales, revenue forecasts used in deciding to open a new store, and expected sales for each bike model. (There are many correct answers to this problem. Use Table 1.1 Comparison of financial and administrative accounts as a guide to determining the accuracy of your answer.) Examples of non-financial measures include percentage of on-time deliveries, percentage of burned pizzas, average time needed to prepare pizza for restaurant customers (from taking a customer's order to delivering the pizza to the customer's table), and results of customer satisfaction surveys. (These are just a few examples. There are many correct answers to this problem.) The answers are displayed as follows. Make sure you've explained your answers. Management accounting information is for future projections and includes segments of the administration the manager's non-financial detailed measurement of defective products Financial accounting — historical information prepared in accordance with the U.S. GAAP managerial accounting records — detailed information provided monthly on the accounting of managerial data — information is for future projections and includes a segment segment of the Company Financial Accounting — Historical information prepared in accordance with the U.S. GAAP Learning Objective Describe the planning and control functions performed by managers. **Question:** Managers of most organizations are constantly planning for the future, and after the plan is implemented, managers assess whether they have achieved their goals. What are the two functions that enable management to implement the process of continuous planning and evaluation? **Answer:** The two key functions that enable management to continuously assess plans for the future and implementation are called planning and control. PlanningThe process of setting goals and communicating these goals to employees of the organization. is the process of setting goals and communicating these goals to employees of the organization. The auditThe process to evaluate whether the organization's plans were effectively implemented. function is the process of evaluating whether the organization's plans have been effectively implemented. **Question:** Constantly planning for the future is an important quality of many successful organizations, such as Southwest Airlines (discussed in Note 1.1.1 Business in Action 1.1). How do organizations formalize their strategic plans? **Answer:** Organizations formalize their strategic plans by budgetA set of reports used to quantify an organization's plan for the future., a series of reports used to quantify an organization's plans for the future. For example, Ernst & Young, an international accounting firm, plans for the future by setting a budget that indicates the working hours needed to perform specific services for each customer. The process of creating a budget for each customer allows the company to plan for future workforce needs and communicate these needs to company employees. Instead of hoping that it will work out in the end, Ernst & Young projects the working hours needed in the future, hires accounting staff based on these forecasts and plans the staff needed for each customer. A budget can take different forms. A budgeted profit and loss account indicates a profit plan for the future. A capital budget shows the long-term investments planned for the future. A cash flow budget outlines the cash inflows and outflows for the future. In later chapters, we'll provide more information on how budgets can be used for planning purposes. Plans for the Future Review the annual report or 10K for just about any company, and you are likely to find information about the plans for future. Here are some examples: Southwest Airlines. A low-fare, short-haul carrier that focuses on business commuters and vacationers states in its annual report, we are focused on four major initiatives: the AirTran integration, the All-New Rapid Rewards program, the addition of the Boeing 737-800 in 2012, and the replacement of our our System. Sears Holdings Corporation. A multiline retailer that offers a wide range of merchandise and related services states in its 10K report, we will continue to invest in our online properties. By integrating our extensive store network with our online properties, we believe Sears Holdings will succeed in the rapidly evolving retail environment. Nordstrom, Inc. A fashion specialty retailer indicates in its 10K report that its strategic growth plan includes opening new Nordstrom full-line and Nordstrom Rack stores, with 6 announced Nordstrom full-line and 18 announced Nordstrom Rack store openings, the majority of which will take place in 2012. As these companies go through the process of making decisions about the future, developing plans based on their decisions and monitoring the implementation of their plans, management accounting information will play an important role in all phases of the process. **Question:** While planning for the future is important, plans are only effective if executed properly. How do organizations assess the implementation of their plans? **Answer:** The audit function evaluates whether an organization's plans have been implemented effectively and often leads to recommendations for the future. Many organizations compare actual results with the original plan (or budget) to evaluate the performance of employees, departments, or the entire organization. For example, suppose Ernst & Young creates a budget that specifies the working hours needed to perform tax services for a particular customer (this is the scheduling function). After the work is completed, the actual working hours are used to complete the work compared to budgeted working hours. This analysis is then used to assess whether employees were able to complete the work within the budgeted time and often results in recommendations for the future. Recommendations may include the need to add more work hours to the budget or obtain better customer support documents. Operation planning and monitoring are essential functions across most organizations. In today's business environment, effective management planning and control can be the key to survival. Key Takeaway Managers constantly plan and monitor operations within organizations. Planning includes setting goals and communicating these goals to organization employees. The audit function assesses whether goals have been achieved and is often used to evaluate the performance of employees, departments, and the organization as a whole. Let's say you're preparing a personal budget of all income and expenses for next month. Describe planning and control functions this process. What benefits can be gained from performing the planning and control functions for a personal budget? **Problem 1.2 Problem 2.2** The planning feature would include setting revenue and expense targets for next month. withhold. sources of income are wages, scholarships, or student loans. Costs can include rent, textbooks, tuition, food, entertainment and transportation. The audit function takes place after the end of the month and includes comparing actual income and expenses with budgeted income and expenses. This makes it possible to assess whether the benefit and burden targets have been achieved. There are several advantages to using a planning and control process. The planning function sets income and expense targets and helps identify any deviations from these goals. For example, the planned expenditure is clearly described in the budget and provides guidance for spending decisions during the month. Without clear guidelines, money can be spent on items that are not needed. The control feature allows an evaluation of how well you have achieved the goals set in the planning process. Perhaps some goals were achieved (for example, food spending was close to what was budgeted), while others did not (for example, transportation spending was higher than what was budgeted). The control function identifies these areas and leads to sophisticated goals in the future. For example, the decision could be made to carpool next month to save on transportation costs or to earn more revenue to pay for transportation by working extra hours. Learning objective Describe the functions of the most important financial and accounting staff. **Question:** From the previous discussion, we know that planning and control features are often designed to evaluate the performance of an organization's employees and departments. This often also applies to employees who monitor financial information. For example, it is important to understand how Drive Write, your response to the president's request would likely affect your reputation as a professional and your future as an accounting student. The unethical behavior at companies such as Xerox, Enron and WorldCom receives the most attention in the book. How do you think you should respond to the president's request? **Answer:** To help accountants resolve ethical conflicts, the Institute of Management Accountants (IMA) has prepared a Statement of Ethical Professional Practice, which appears in Figure 1.2 IMA Statement of Ethical Professional Practice. The standards set out in this statement are guidelines that can help auditors choose an ethically acceptable course of action. As you review Figure 1.2 IMA Statement of Ethical Professional Practice, note that the IMA specifies four core responsibilities (competence, confidentiality, integrity, and credibility) and guidelines for resolving ethical conflicts. The Ethical Conflict Resolution section provides specific guidelines for resolving the conflict at Drive Write. Figure 1.2 IMA Statement of Ethical Professional Practice **Question:** The IMA is just one of many professional accounting organizations. Do other professional accounting firms also provide accounting ethics guidelines? **Answer:** Yes, other professional organizations do offer ethical guidance. Some find as follows: The American Institute for Certified Public Accountants (AICPA) has a Code of Conduct (see). Financial Executives International offers a Code of Ethical Conduct for Financial Managers (see). The International Federation of Accountants has a Code of Ethics and Statement of Policy Implementation & Enforcement of Ethical Requirements (see). The Securities and Exchange Commission (SEC), in accordance with the Sarbanes-Oxley Act of 2002, requires a company to disclose whether it has a code of ethics (see). The Institute of Management Accountants even provides an ethical helpline to give financial professionals a resource guidance in making the right decisions (see). Because of alleged misconduct, such as the one in the Note 1.2.7 Business in Action 1.3, improving ethics is a top priority for most companies, as shown in the Note 1.2.8 Business in Action 1.4. As a result, professional organizations as we have cited have come to play an important role in providing ethical guidelines. Production Firm EmployeesCharged with Fraud The Securities and Exchange Commission (SEC) has filed three claims against Diebold, Inc., a manufacturer and seller of ATMs, for improperly inflating earnings over a five-year period. Three former employees, the CFO, the controller and the director of accounting, were accused of improperly inflating revenues on factory orders, misidentifying income from a lease transaction, manipulating reserves and overflowing items, falsely capitalizing expenses and falsely increasing the value of the stock. These actions allegedly resulted in more than 40 misstated annual, quarterly, and other reports filed with the SEC, along with numerous inaccurate press releases. The company agreed to pay a \$25 million civil fine, and the three former employees remain in litigation. Although the CEO was not accused of wrongdoing, he settled with the SEC and agreed to pay back cash bonuses, shares, and stock options received during the periods when the financial fraud was committed. The Code of Ethics at Home Depot and Hewlett-Packard Ethics policies are becoming increasingly important for organizations. Home Depot, Inc. has a code of ethics that provides the basics for employees to align business decisions with the Home Depot works and forms the basis for our ethical behavior. Hewlett-Packard Company has established business ethics led by enduring values. The company declares its commitment to the following principles: honesty, excellence, responsibility, compassion, citizenship, honesty and respect. Key Takeaway Should you encounter ethical conflicts during your career, use the resources provided by internal corporate policies, by professional organizations such as the IMA and AICPA, and by government organizations such as the SEC to guide ethical conduct and resolve ethical conflicts. **Solution to review problem 1.4** The four main standards in Figure 1.2 IMA Statement of Ethical Professional Practice are described as follows: Competence. IMA members must maintain an adequate level of skill to perform tasks in an accurate and professional manner. Confidentiality. Members of the IMA may not, for any reason, disclose information, unless required by law to do so. Integrity. Members of the IMA should avoid an actual or apparent conflict of interest, including receiving gifts or favors, and should not engage in any activity that would bring it into disrepute. Level of credibility. Members of the IMA must disclose all relevant information fairly and objectively. There are several options for resolving ethical conflicts. The IMA proposes the following directions of action: Follow the organization's policy on the resolution of ethical conflicts. If following the organization's policies doesn't effectively resolve the conflict, discuss the issue with your immediate supervisor, unless the supervisor is involved. If the direct superior cannot reach a satisfactory solution, the problem should be presented to the next higher level of management. If not all senior levels of management reach a satisfactory solution, an acceptable review authority can be a group, such as the audit committee, the executive committee, the board of directors, the supervisory board or the owners. Another option is to consult an objective advisor (e.g. IMA ethics counseling service or a lawyer). There are several options available. The IMA proposes first after the organization's policy regarding the resolution of ethical conflicts. If Drive Write has no policy of its own, then the organization's policies do not resolve the conflict, the next step is to consult the conflict with the direct supervisor. However, the chairman of Drive Write (the direct supervisor) is involved in the conflict, so approaching the president's superiors would be best. These can be the audit committee, the executive committee, the board of directors or the owners. If, after pursuing any of these various actions, the ethical conflict still exists, it may be appropriate to discuss the conflict with an objective advisor (e.g. the IMA helpline) and perhaps consult a lawyer about legal obligations and rights related to the ethical conflict. (Many would argue that regardless of the outcome, one would not want to work for a company where this kind of unethical behavior occurs at the top, or somewhere within the organization, and that dismissal is the best course of action.) Learning objective Understand how accounting systems can help organizations. **Question:** Many companies are growing out of their accounting systems today. Previously, accounting systems were primarily designed to track daily transactions and provide reports to external users on a monthly, quarterly or annual basis. But times have changed and companies now need more information to make good decisions. Currently, accounting systems are used for both external reporting (financial accounting) and internal reporting (management accounting). Even relatively small accounting packages, such as QuickBooks and Peachtree, offer features that are important for management accounting. Most however, agree that no accounting system will meet the needs of each organization and that two important factors should be considered when choosing a system. What are the two that should be considered when deciding on an accounting system? **Answer:** The two factors are (1) the size of the organization and (2) the information needs of the organization. Each factor is then discussed. Accounting software is designed to serve businesses of different sizes. The size of a company is often measured in sales. Experts give different opinions about what a small, medium or large company is. Some believe that small businesses sell to have \$10 million, midsize businesses have sales up to \$100 million, and large companies have a turnover greater than \$100 million. Others prefer different amounts. Regardless of the number used, the goal is to find an accounting system that best meets the needs of the organization, and the size of the organization plays a big role in finding the best fit system. Before selecting an accounting system, an organization must determine its accounting needs. Some organizations simply need the equivalent of a check register, which provides easy tracking of expense codes when checks are issued and makes bank reconciliations in an instant. Other organizations require more than one cheque register; they can require a system that can create invoices, process payroll and track inventory. More complex organizations want the ability to perform more advanced functions. Such organizations may need to customize reports (for example, create a profit and loss account by division or customer), change input screens, send financial reports by email, export reports to spreadsheet software such as Excel, and create reports with images (for example, tables, pie charts, and line charts). **Question:** It is clear that the size and information needs of a company will lead the selection of an accounting system for the company. As the need for accounting data has become more complex, accounting systems have been developed that perform a wide range of tasks. These systems are called enterprise resource planning systems. What is an enterprise resource planning system, and how does this system help companies with the use of accounting data? **Answer:** Enterprise Resource Planning (ERP) A system designed to record and share information in functional and geographic areas to meet the needs of internal and external users. systems are designed to record and share information in all functional areas (e.g. accounting, marketing, human resources and shipping) and in different geographic areas (for example, from a sales office in California to its headquarters in Hong Kong). ERP systems work information to provide real-time data to all users, and the data can be organized in different formats to meet the needs of internal and external users. For example, in his book Onward, Howard Schultz describes how, as CEO of Starbucks, he assesses comparative financial data Starbucks stores on a daily basis. This information comes from the ERP system at Starbucks. The idea behind ERP ERP and a central theme in management accounting, is that accurate and up-to-date financial information will help organizations make better decisions. Better decisions tend to lead to improvements in profitability, efficiency and customer satisfaction. ERP systems are expensive. The annual cost for large organizations can easily exceed \$10 million. However, smaller systems for medium-sized businesses are available at much lower cost. Most ERP software is offered in modules for functional accounting areas, such as debtors, debtors, payroll, inventory, and task costs. The more modules included, the higher the cost will be. Popular carriers of ERP systems include Microsoft, Oracle and SAP Corporation. When deciding whether or not to upgrade to an ERP system, organizations need to be sure that the benefits of using a new system's data outweigh the cost of implementing the system. If management does not intend to use the information to improve planning and decision-making, then dealing with a less advanced accounting system may be the better approach. **Question:** ERP systems often provide a means to download data to spreadsheets for further analysis. How can spreadsheet software help us analyze financial information? **Answer:** Since managers make extensive use of spreadsheets to organize and analyze data, most automated accounting systems are designed to export data to spreadsheet software programs such as Excel. For example, Figure 1.3 Excel Spreadsheet for Southwest Airlines shows how a spreadsheet was used to import data directly from Southwest Airlines' 2010 annual report. This makes it easier for the user to analyze the data. Note that in Figure 1.3 Excel Spreadsheet for Southwest Airlines the total operating income increased over the three years shown. We can use Excel to quickly determine the exact percentage increase from 2008 to 2009 and from 2009 to 2010. Figure 1.3 Excel Spreadsheet for Southwest Airlines **Question:** Let's assume you're asked to prepare a profit and loss account with earnings and expense forecasts for next year. How to use Excel to prepare your projections? **Answer:** You start exporting this year's results from the accounting system to an Excel spreadsheet. Then set up a new column to display estimates for next year. You'd probably discuss different aspects of the profit and loss account with different employees in the organization - making changes as you go - before you aphrodiasic your forecasts. Imagine the work involved if you computer use, but instead had to write down the information by hand. If there were changes to the information, you would make time-consuming calculations, and once the data are completed, you would be faced with the manual preparation of formal reports. With the relatively recent advances in business technology, the days of preparation manually over. Most organizations require their accounting and financial staff to have advanced computer spreadsheet skills. Our goal is to give you the ability to use spreadsheets in a way that reflects the real world. Key Takeaway This text teaches you about different methods for capturing, sorting, analyzing, and reporting financial information for internal users. Before you decide to implement any of these methods, ask yourself the following question: Will the benefits that result from a new system, such as an ERP system, exceed the cost of setting up the system? If the answer is yes, go for it! If the answer is no, consider other alternatives. Let's say you're the CFO of an electronics consulting firm with an annual revenue of \$30,000,000 and an annual profit of \$5,000,000. The current accounting system is used for basic functions, such as issuing cheques, creating invoices and processing payroll. The company is considering upgrading its accounting system by purchasing an ERP system. Describe the factors that the company should take into account when making this decision. **Solutions to Review Problem 1.5** This company is a medium-sized company with \$30 million in revenue, although some would argue that this is a small business. Going to an ERP system is probably not appropriate if management is just looking for a few reports that go beyond what most financial accounting systems can offer. If management needs more detailed and complex financial information, with the exception of processing checks, invoices and payroll, then a low-end ERP system may be appropriate. However, the benefits of such a system must outweigh the costs. Learning objective Understand the terms used for costing purposes. **Question:** Much of what we discuss in this book relates to companies that produce products, such as Nike and Apple, and terminology is an important part of accounting for manufacturing companies. The challenge is to correctly classify the costs for items such as production materials, production work, marketing department work,

