All businesses are concerned about revenues and costs. Managers must understand how revenues and costs behave. They use cost accounting information to make decisions related to strategy formulation, research and development, budgeting, production planning, and pricing, among others. Sometimes these decisions involve trade-offs. The following article shows how companies like Etisalat make those trade-offs to increase their profits.

Etisalat Marketing Strategy for International Calls: Prices Are Cut, but Revenues Are Up

Etisalat is the leading telecommunication company in the UAE and offers various telecom services, including mobile telecommunication. In late 2012, Etisalat offered per-second billing plans to its prepaid customers, providing savings on both local and international mobile calls. This initiative was intended to meet the growing competition from Du, another telecom company. Seeking to gain back its market share, managers at Etisalat decided to opt for the strategy of price-cutting to attract customers. Before taking this decision, managers had to evaluate the costs of the planned offers, particularly those relating to international calls that incur relatively higher costs than standard local services.

Despite lowering the marginal benefit of each minute consumed by customers on local and international mobile calls, Etisalat reported a 17% revenue increase and significant improvements in profits generated from the UAE market in the first quarter of 2013. Furthermore, it attributed a 7% growth in its active subscriber base to the promotional offers and the associated campaigns, thereby achieving its main objective of expanding its market share.

Following the success of the strategy, in mid-2013 Etisalat introduced new price-cutting offers to customers. These included reducing local call rates by up to 55% to Etisalat Wasel subscribers (prepaid plans) and also offering customers calls to 10 international destinations at local call rates.
The study of modern cost accounting yields insights into how managers and accountants can contribute to running businesses successfully. It also prepares for leadership roles. Many large companies, such as Kahramaa (Qatar) and Zain, have senior executives with accounting backgrounds.

The Controller and Financial Analysis

In business, it is not sufficient to simply make plans, companies need to follow up planning with continuous financial analysis so that managers understand how actual revenues and costs compare with the projected figures. This applies to businesses in all sectors, in real estate as in football, in fashion as well as fast food. Managers need to know how revenues and costs are actually behaving to avoid the risk of losing control of their operations. Most businesses therefore employ management accountants to generate accurate cost accounting information so that decisions related to the overall strategy of the company are made in accordance with the business plans. The controller (or chief accounting officer) has overall responsibility for the management accounting function.

Costs will be recorded in great detail, generating information not only about expenses such as the materials, labor, and overheads needed to carry out the plan, but other costs that contribute to the overall success of a new or continuing venture. These costs may include general administrative costs—management, accounting, supply line and production planning—and certainly marketing and selling costs, among others.

The focus of financial analysis is the comparison between projected revenues and costs and actual revenues and costs. Initially financial analysis begins by comparing the planned profit against the actual profit. This is a relatively simple exercise. A simple measure of profit is obtained by aggregating all revenues and aggregating all expenditures and calculating the excess of income over expenditure or, when plans are not working out, the excess of expenditure over income. Figure 1.1 illustrates this initial approach. Note that the management accountant preparing this report will also be providing explanations of any key departures from the original plan.

The revenue and expenditure report will be developed into a much more detailed income statement (see Figure 1.2). Note the changes. “Revenues” become “sales of goods or services of the main operation” and exclude other unrelated income. The cost of sales is now deducted from the sales income to provide the gross margin. While the revenue and expenditure report included all sources of revenue, the income statement focuses only on the revenue generated by the company’s core operations, the sale of its products and services. Then the cost of operations is deducted from the sales revenue and this provides the gross margin. The gross margin is an important metric since it provides managers with knowledge of the margin available from the company’s operations that can contribute towards paying for non-operational and other indirect costs. Managers will also hope that the gross margin is sufficiently large that it will include a profit element. This approach begins to segregate the key business factors that are incorporated in the plan. The income statement could also include trend analysis (such as changes in costs and revenues compared with previous accounting periods) and other performance data (such as cost of sales and selected overhead costs as a percentage of sales income). Again, note that commentary on the results presented in the statement will be an integral part of financial reporting. Whether negative or positive, significant departures from planned costs and forecast revenues will require explanation.
Chapter 1: The Manager and Management Accounting

**Figure 1-1** Revenue and expenditure report

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Revenues</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Sales</td>
<td>$1,000,000</td>
<td>100.0%</td>
<td>$1,099,123</td>
<td>100.0%</td>
<td>$9,123</td>
</tr>
<tr>
<td>4</td>
<td>Other income</td>
<td>25,000</td>
<td>2.5%</td>
<td>23,400</td>
<td>2.3%</td>
<td>(1,600)</td>
</tr>
<tr>
<td>5</td>
<td>Total revenues</td>
<td>1,025,000</td>
<td></td>
<td>1,032,523</td>
<td></td>
<td>7,523</td>
</tr>
<tr>
<td>6</td>
<td>Expenses</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Cost of sales</td>
<td>620,000</td>
<td>62.0%</td>
<td>648,750</td>
<td>64.3%</td>
<td>(28,750)</td>
</tr>
<tr>
<td>9</td>
<td>Selling expenses</td>
<td>80,000</td>
<td>8.0%</td>
<td>78,750</td>
<td>7.8%</td>
<td>1,250</td>
</tr>
<tr>
<td>10</td>
<td>Administrative expenses</td>
<td>71,000</td>
<td>7.1%</td>
<td>72,100</td>
<td>7.1%</td>
<td>(1,100)</td>
</tr>
<tr>
<td>11</td>
<td>Accounting expenses</td>
<td>56,000</td>
<td>5.6%</td>
<td>55,100</td>
<td>5.5%</td>
<td>900</td>
</tr>
<tr>
<td>12</td>
<td>Management expenses</td>
<td>120,000</td>
<td>12.0%</td>
<td>122,000</td>
<td>12.1%</td>
<td>(2,000)</td>
</tr>
<tr>
<td>13</td>
<td>Miscellaneous</td>
<td>10,000</td>
<td>1.0%</td>
<td>11,200</td>
<td>1.1%</td>
<td>(1,200)</td>
</tr>
<tr>
<td>14</td>
<td>Total expenses</td>
<td>957,000</td>
<td>95.7%</td>
<td>987,900</td>
<td>97.9%</td>
<td>(30,900)</td>
</tr>
<tr>
<td>15</td>
<td>Net income before tax</td>
<td>68,000</td>
<td>6.8%</td>
<td>44,623</td>
<td>4.4%</td>
<td>(23,377)</td>
</tr>
</tbody>
</table>

**Figure 1-2** Operating income statement

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Net sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Sales</td>
<td>$1,000,000</td>
<td>100.0%</td>
<td>$1,099,123</td>
<td>100.0%</td>
<td>$9,123</td>
</tr>
<tr>
<td>4</td>
<td>Cost of sales</td>
<td>620,000</td>
<td>62.0%</td>
<td>648,750</td>
<td>64.3%</td>
<td>(28,750)</td>
</tr>
<tr>
<td>5</td>
<td>Gross margin</td>
<td>380,000</td>
<td>38.0%</td>
<td>360,373</td>
<td>35.7%</td>
<td>(19,627)</td>
</tr>
<tr>
<td>6</td>
<td>Selling expenses</td>
<td>80,000</td>
<td>8.0%</td>
<td>78,750</td>
<td>7.8%</td>
<td>1,250</td>
</tr>
<tr>
<td>7</td>
<td>Administrative expense</td>
<td>71,000</td>
<td>7.1%</td>
<td>72,100</td>
<td>7.1%</td>
<td>(1,100)</td>
</tr>
<tr>
<td>9</td>
<td>Accounting expenses</td>
<td>56,000</td>
<td>5.6%</td>
<td>55,100</td>
<td>5.5%</td>
<td>900</td>
</tr>
<tr>
<td>10</td>
<td>Management expenses</td>
<td>120,000</td>
<td>12.0%</td>
<td>122,000</td>
<td>12.1%</td>
<td>(2,000)</td>
</tr>
<tr>
<td>11</td>
<td>Miscellaneous</td>
<td>5,000</td>
<td>0.5%</td>
<td>5,600</td>
<td>0.6%</td>
<td>(600)</td>
</tr>
<tr>
<td>12</td>
<td>Total expenses</td>
<td>332,000</td>
<td>33.2%</td>
<td>333,550</td>
<td>33.1%</td>
<td>(1,550)</td>
</tr>
<tr>
<td>13</td>
<td>Operating income</td>
<td>48,000</td>
<td>4.8%</td>
<td>26,823</td>
<td>2.7%</td>
<td>(21,177)</td>
</tr>
<tr>
<td>14</td>
<td>Other income</td>
<td>25,000</td>
<td>2.5%</td>
<td>23,400</td>
<td>2.3%</td>
<td>(1,600)</td>
</tr>
<tr>
<td>16</td>
<td>Other expenses</td>
<td>(5,000)</td>
<td>-0.5%</td>
<td>(5,600)</td>
<td>-0.6%</td>
<td>(600)</td>
</tr>
<tr>
<td>17</td>
<td>Income tax (10%)</td>
<td>6,800</td>
<td>0.7%</td>
<td>4,462</td>
<td>0.4%</td>
<td>2,338</td>
</tr>
<tr>
<td>18</td>
<td>Net income</td>
<td>61,200</td>
<td>6.1%</td>
<td>40,161</td>
<td>4.0%</td>
<td>(21,039)</td>
</tr>
</tbody>
</table>
The process of adding further detail continues and many companies will prepare separate income statements for different parts of the business. For example, they may produce separate operating income statements for the merchandizing operation and the manufacturing process. As companies grow larger, in terms of number of products and volume of materials, it is likely that they will move towards a standard costing approach and begin to report activity on the basis of variances from standards. At this stage it will be important to include comparative timeframes. Figure 1-3 shows an income statement produced using information based on standards. This statement shows the production variances in summary. Departmental managers would receive much more supporting data to explain the variances that relate to their area of responsibility. Thus, the managers responsible for the use of materials will be provided with a further analysis of the many material variances that together make-up the overall material price variance. All other variances listed in Figure 1-3 would also be totals of a range of individual variances. All variances would be monitored by managers so that a decision could be taken periodically on whether to change the standards for the individual material, labor and overhead variances.

The financial reporting process is further developed so that managers are provided with much more information than shown on the basic income statement in Figure 1-2. The next stage is to put the current reporting period in the context of historical and strategic plans. As Figure 1-4 shows a great deal of comparative information may be supplied including:

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Net sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Sales</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Cost of goods sold @ Std</td>
<td>$1,000,000</td>
<td>100.0%</td>
<td>$1,099,123</td>
<td>100.0%</td>
</tr>
<tr>
<td>4</td>
<td>Gross margin @ Std</td>
<td>380,000</td>
<td>38.0%</td>
<td>383,467</td>
<td>38.0%</td>
</tr>
<tr>
<td>5</td>
<td>Material price variance</td>
<td></td>
<td>(5,215)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Material quantity variance</td>
<td></td>
<td>(1,138)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Labor rate variance</td>
<td></td>
<td>794</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Labor efficiency variance</td>
<td></td>
<td>472</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Overhead volume variance</td>
<td></td>
<td>(5,634)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Overhead budget variance</td>
<td></td>
<td>(12,373)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Adjusted gross margin</td>
<td>380,000</td>
<td>38.0%</td>
<td>360,373</td>
<td>35.7%</td>
</tr>
<tr>
<td>12</td>
<td>Selling expenses</td>
<td>80,000</td>
<td>8.0%</td>
<td>78,750</td>
<td>7.8%</td>
</tr>
<tr>
<td>13</td>
<td>Administrative expenses</td>
<td>71,000</td>
<td>7.1%</td>
<td>72,100</td>
<td>7.1%</td>
</tr>
<tr>
<td>14</td>
<td>Accounting expenses</td>
<td>56,000</td>
<td>5.6%</td>
<td>55,100</td>
<td>5.5%</td>
</tr>
<tr>
<td>15</td>
<td>Management expenses</td>
<td>120,000</td>
<td>12.0%</td>
<td>122,000</td>
<td>12.1%</td>
</tr>
<tr>
<td>16</td>
<td>Miscellaneous</td>
<td>5,000</td>
<td>0.5%</td>
<td>5,600</td>
<td>0.6%</td>
</tr>
<tr>
<td>17</td>
<td>Total expenses</td>
<td>332,000</td>
<td>33.2%</td>
<td>333,550</td>
<td>33.1%</td>
</tr>
<tr>
<td>18</td>
<td>Operating income</td>
<td>48,000</td>
<td>4.8%</td>
<td>26,823</td>
<td>2.7%</td>
</tr>
<tr>
<td>19</td>
<td>Other income and expenses</td>
<td></td>
<td></td>
<td>17,800</td>
<td>1.8%</td>
</tr>
<tr>
<td>20</td>
<td>Net income before tax</td>
<td>68,000</td>
<td>6.8%</td>
<td>4,623</td>
<td>4.4%</td>
</tr>
<tr>
<td>21</td>
<td>Income tax (10%)</td>
<td>6,800</td>
<td>0.7%</td>
<td>4,462</td>
<td>0.4%</td>
</tr>
<tr>
<td>22</td>
<td>Net income</td>
<td>$61,200</td>
<td>6.1%</td>
<td>$40,161</td>
<td>4.0%</td>
</tr>
</tbody>
</table>

Operations at standard cost
### Figure 1-4

Operating income statement with comparative data to the previous year

<table>
<thead>
<tr>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Year to date</td>
<td>%</td>
<td>Outcome Prior Year</td>
<td>%</td>
<td>Plan/Forecast</td>
</tr>
<tr>
<td>2</td>
<td>Prior Year</td>
<td>100.0%</td>
<td>$1,161,010</td>
<td>100.0%</td>
<td>Sales at standard</td>
</tr>
<tr>
<td>4</td>
<td>1,086,000</td>
<td>100.0%</td>
<td>100.0%</td>
<td>Cost of goods sold @ Std</td>
<td>620,000</td>
</tr>
<tr>
<td>5</td>
<td>1,104,000</td>
<td>37.9%</td>
<td>4,424,560</td>
<td>38.0%</td>
<td>Gross margin @ Std</td>
</tr>
<tr>
<td>6</td>
<td>12,600</td>
<td>(50,400)</td>
<td>Material price variance</td>
<td>–</td>
<td>(5,215)</td>
</tr>
<tr>
<td>9</td>
<td>540</td>
<td>2,160</td>
<td>Material quantity variance</td>
<td>–</td>
<td>(1,138)</td>
</tr>
<tr>
<td>10</td>
<td>1,260</td>
<td>5,040</td>
<td>Labor rate variance</td>
<td>–</td>
<td>794</td>
</tr>
<tr>
<td>11</td>
<td>(231)</td>
<td>(924)</td>
<td>Labor efficiency variance</td>
<td>–</td>
<td>472</td>
</tr>
<tr>
<td>12</td>
<td>2,610</td>
<td>10,440</td>
<td>Overhead volume variance</td>
<td>–</td>
<td>(5,634)</td>
</tr>
<tr>
<td>13</td>
<td>(19,629)</td>
<td>(78,576)</td>
<td>Overhead budget variance</td>
<td>–</td>
<td>(12,373)</td>
</tr>
<tr>
<td>14</td>
<td>(28,056)</td>
<td>(112,203)</td>
<td>–</td>
<td>(23,984)</td>
<td>(58,545)</td>
</tr>
<tr>
<td>15</td>
<td>1,075,950</td>
<td>37.0%</td>
<td>4,312,360</td>
<td>37.0%</td>
<td>Adjusted gross margin</td>
</tr>
<tr>
<td>16</td>
<td>247,224</td>
<td>8.0%</td>
<td>960,896</td>
<td>8.5%</td>
<td>Selling expenses</td>
</tr>
<tr>
<td>17</td>
<td>210,600</td>
<td>7.2%</td>
<td>842,400</td>
<td>7.2%</td>
<td>Administrative expenses</td>
</tr>
<tr>
<td>18</td>
<td>153,750</td>
<td>5.3%</td>
<td>615,000</td>
<td>5.3%</td>
<td>Accounting expenses</td>
</tr>
<tr>
<td>19</td>
<td>358,400</td>
<td>12.2%</td>
<td>1,416,000</td>
<td>12.2%</td>
<td>Management expenses</td>
</tr>
<tr>
<td>20</td>
<td>32,100</td>
<td>1.1%</td>
<td>128,400</td>
<td>1.1%</td>
<td>Miscellaneous</td>
</tr>
<tr>
<td>21</td>
<td>997,874</td>
<td>34.3%</td>
<td>3,990,696</td>
<td>34.3%</td>
<td>Total expenses</td>
</tr>
<tr>
<td>22</td>
<td>78,276</td>
<td>2.7%</td>
<td>321,664</td>
<td>2.8%</td>
<td>Operating income</td>
</tr>
<tr>
<td>23</td>
<td>13,500</td>
<td>0.5%</td>
<td>54,000</td>
<td>0.5%</td>
<td>Other income and expenses</td>
</tr>
<tr>
<td>24</td>
<td>91,776</td>
<td>3.2%</td>
<td>375,664</td>
<td>3.2%</td>
<td>Net income before tax</td>
</tr>
<tr>
<td>25</td>
<td>9,178</td>
<td>0.3%</td>
<td>37,566</td>
<td>0.3%</td>
<td>Income tax</td>
</tr>
<tr>
<td>26</td>
<td>82,598</td>
<td>2.8%</td>
<td>330,086</td>
<td>2.9%</td>
<td>Net income</td>
</tr>
</tbody>
</table>

- The previous year's actual data and percentages
- The current month's plan and actual with variances
- Year-to-date figures for the prior year and current year
- The plan for the current year
- The accumulated variances from plan in the year-to-date

This provides significant information on progress towards the planned targets for the current year. More importantly, the data provides managers with a diagnostic on where problems may be occurring and, therefore, where to concentrate their support in assisting departments in keeping to the overall plan or, when necessary, in making changes to the plan.
Figure 1-4 could be extended by added additional information. It includes data on the number of employees and it could also cover other non-financial measures and targets that management believes should be monitored. This process of presenting performance measurement data is known as the balanced scorecard and is discussed in detail in Chapter 13.

Financial Analysis, Management Accounting, and Cost Accounting

Accounting information systems record every financial transaction a company makes. This transaction data, such as figures on sales and materials purchases, is processed into information helpful to managers, sales representatives, production supervisors, and others. Processing any economic transaction means collecting, categorizing, summarizing, and analyzing. For example, costs are collected by categories, often referred to as natural expense classifications because costs are recorded by the nature of the expense. Examples of cost categories include materials, labor, and overhead costs. Within each broad category, there may be several subdivisions to provide further analysis. For example, if a company requires 100 different materials and components to manufacture a product, the main cost category of materials will be divided into several further categories of materials as the managers responsible for procurement and production consider appropriate. So for all main natural expense categories, there will be further subdivisions to provide managers with an appropriately detailed cost analysis.

The transactions recorded in each cost category are then summarized to present total costs by month, quarter, or year. The results are analyzed to evaluate, for example, how costs have changed relative to revenues from one period to the next. Accounting systems provide the information found in the income statement, the balance sheet, the statement of cash flow, and in performance reports, such as the cost of serving customers or running an advertising campaign. Managers use accounting information to administer the activities, businesses, or functional areas they oversee and to coordinate those activities, businesses, or functions within the framework of the organization. Understanding this information is essential for managers to do their jobs.

Individual managers often require the information in an accounting system to be presented or reported differently. Consider, for example, sales order information. A sales manager may be interested in the total dollar amount of sales to determine the commissions to be paid. A distribution manager may be interested in the sales order quantities by geographic region and by customer-requested delivery dates to ensure timely deliveries. A manufacturing manager may be interested in the quantities of various products and their desired delivery dates, so that he or she can develop an effective production schedule. To simultaneously serve the needs of all three managers, companies create a database—sometimes called a data warehouse or infobarn—consisting of small, detailed bits of information that can be used for multiple purposes. For instance, the sales order database will contain detailed information about product, quantity ordered, selling price, and delivery details (place and date) for each sales order. The database stores information in a way that allows different managers to access the information they need. Many companies are building their own enterprise resource planning (ERP) systems, single databases that collect data and feed it into applications that support the company’s business activities, such as purchasing, production, distribution, and sales.

Financial accounting and management accounting have different goals. Financial accounting focuses on reporting to external parties such as investors, government agencies, banks, and suppliers. It measures and records business transactions and provides financial statements that are based on IFRS (international financial reporting standards) or the appropriate national accounting standards. The most important way that financial accounting information affects managers’ decisions and actions is through compensation, which is often, in part, based on numbers in financial statements.

Management accounting measures, analyzes, and reports financial and nonfinancial information that helps managers make decisions to fulfill the goals of an organization.
Managers use management accounting information to develop, communicate, and implement strategy. They also use management accounting information to coordinate product design, production, and marketing decisions and to evaluate performance. Management accounting information and reports do not have to follow set principles or rules. The key questions are always (1) how will this information help managers do their jobs better, and (2) do the benefits of producing this information exceed the costs?

Table 1-1 summarizes the major differences between management and financial accounting. Note, however, that reports such as balance sheets, income statements, and statements of cash flows are common to both management accounting and financial accounting.

Cost accounting provides information for management accounting and financial accounting. Cost accounting measures, analyzes, and reports financial and nonfinancial information relating to the costs of acquiring or using resources in an organization. It provides information for both management accounting and financial accounting.

Cost management includes decisions to enter new markets, implement new organizational processes, and change product designs. Information from accounting systems helps managers to manage costs, but the information and the accounting systems themselves are not cost management.

We frequently hear business people use the term cost management. Unfortunately, that term has no uniform definition. We use cost management to describe the approaches and activities of managers to use resources to increase value to customers and to achieve organizational goals. Cost management decisions include decisions such as whether to enter new markets, implement new organizational processes, and change product designs. Information from accounting systems helps managers to manage costs, but the information and the accounting systems themselves are not cost management.

Cost management has a broad focus and is not only about reduction in costs. Cost management includes decisions to incur additional costs, for example to improve customer satisfaction and quality and to develop new products, with the goal of enhancing revenues and profits.
Strategic Decisions and the Management Accountant

Strategy specifies how an organization plans to match its own capabilities with the opportunities in the marketplace to accomplish its objectives. In other words, strategy describes how an organization plans to compete and the opportunities its managers will seek and pursue. Businesses follow one of two broad strategies. Some companies, such as Air Arabia, follow a cost leadership strategy. These companies become profitable and grow over the years on the basis of providing quality products or services at low prices by judiciously managing their costs. Other companies such as Apple Inc., the maker of iPads and iPhones, follow a product differentiation strategy. These companies generate their profits and growth on the basis of their ability to offer differentiated or unique products or services that appeal to their customers and are often priced higher than the less-popular products or services of their competitors.

Deciding between these strategies is a critical part of what managers do. Management accountants work closely with managers in formulating strategy by providing information about the sources of competitive advantage—for example, the cost, productivity, or efficiency advantage of their company relative to competitors or the premium prices a company can charge relative to the costs of adding features that make its products or services distinctive. Strategic cost management describes cost management that specifically focuses on strategic issues.

Management accounting information helps managers formulate strategy by answering these types of questions.

- Who are our most important customers, and how can we be competitive and deliver value to them? After Amazon.com’s success in selling books online, management accountants at booksellers Barnes and Noble presented senior executives with the costs and benefits of several alternative approaches for building its information technology infrastructure and developing the capabilities to also sell books online. A similar cost-benefit analysis led Toyota to build flexible computer-integrated manufacturing (CIM) plants that enable it to use the same equipment efficiently to produce a variety of cars in response to changing customer tastes.

- What substitute products exist in the marketplace, and how do they differ from our product in terms of price and quality? Hewlett-Packard, for example, designs and prices new printers after comparing the functionality and quality of its printers to other printers available in the marketplace.

- What is our most critical capability? Is it technology, production, or marketing? How can we leverage it for new strategic initiatives? Kellogg Company, for example, uses the reputation of its brand to introduce new types of cereal.

- Will adequate cash be available to fund the strategy, or will additional funds need to be raised? Proctor & Gamble, for example, issued new debt and equity to fund its strategic acquisition of Gillette, a maker of shaving products.

The best-designed strategies and the best-developed capabilities are useless unless they are effectively executed. In the next section, we describe how management accountants help managers take actions that create value for their customers.

Value Chain and Supply Chain Analysis and Key Success Factors

Customers demand much more than just a fair price; they expect quality products (goods or services) delivered in a timely way. These multiple factors drive how a customer experiences a product and the value or usefulness a customer derives from the product. How then does a company go about creating this value?
Value Chain Analysis

Value chain is the sequence of business functions in which customer usefulness is added to products. Figure 1-5 shows six primary business functions: research and development, design, production, marketing, distribution, and customer service. We illustrate these business functions using Sony Corporation’s television division.

1. Research and development (R&D)—Generating and experimenting with ideas related to new products, services, or processes. At Sony, this function includes research on alternative television signal transmission (analog, digital, and high definition) and on the clarity of different shapes and thicknesses of television screens.

2. Design of products and processes—Detailed planning, engineering, and testing of products and processes. Design at Sony includes determining the number of component parts in a television set and the effect of alternative product designs on quality and manufacturing costs. Some representations of the value chain refer to the first two steps as technology development.  

3. Production—Procuring, transporting and storing (also called inbound logistics), coordinating, and assembling (also called operations) resources to produce a product or deliver a service. Production of a Sony television set includes the procurement and assembly of the electronic parts, the cabinet, and the packaging used for shipping.

4. Marketing (including sales)—Promoting and selling products or services to customers or prospective customers. Sony markets its televisions at trade shows, via advertisements in newspapers and magazines, on the internet, and through its sales force.

5. Distribution—Processing orders and shipping products or services to customers (also called outbound logistics). Distribution for Sony includes shipping to retail outlets, catalog vendors, direct sales via the internet, and other channels through which customers purchase televisions.

6. Customer service—Providing after-sales service to customers. Sony provides customer service on its televisions in the form of customer-help telephone lines, support on the internet, and warranty repair work.

In addition to the six primary business functions, Figure 1-5 shows an administrative function, which includes functions such as accounting and finance, human resource management, and information technology, that support the six primary business functions. When discussing the value chain we include the administrative support function within the primary functions. For example, included in the marketing function is the function of analyzing, reporting, and accounting for resources spent in different marketing channels, while the production function includes the human resource management function of training front-line workers.

Each of these business functions is essential to companies satisfying their customers and keeping them satisfied (and loyal) over time. Companies use the term customer relationship management (CRM) to describe a strategy that integrates people and technology in all business functions to deepen relationships with customers, partners, and distributors. CRM initiatives use technology to coordinate all customer-facing activities (such as

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marketing, sales calls, distribution, and post sales support) and the design and production activities necessary to get products to customers.

At different times and in different industries, one or more of these functions is more critical than others. For example, a company developing an innovative new product or operating in the pharmaceutical industry, where innovation is the key to profitability, will emphasize R&D and design of products and processes. A company in the consumer goods industry will focus on marketing, distribution, and customer service to build its brand.

Figure 1-5 depicts the usual order in which different business functional activities physically occur. Do not, however, interpret Figure 1-5 as implying that managers should proceed sequentially through the value chain when planning and managing their activities. Companies gain (in terms of cost, quality, and the speed with which new products are developed) if two or more of the individual business functions of the value chain work concurrently as a team. For example, inputs into design decisions by production, marketing, distribution, and customer service managers often lead to design choices that reduce total costs of the company.

Managers track the costs incurred in each value-chain category. Their goal is to reduce costs and to improve efficiency. Management accounting information helps managers make cost-benefit trade-offs. For example, is it cheaper to buy products from outside vendors or to do manufacturing in-house? How does investing resources in design and manufacturing reduce costs of marketing and customer service?

**Supply-Chain Analysis**

The parts of the value chain associated with producing and delivering a product or service—production and distribution—is referred to as the supply chain. *Supply chain* describes the flow of goods, services, and information from the initial sources of materials and services to the delivery of products to consumers, regardless of whether those activities occur in the same organization or in other organizations. Consider Coke and Pepsi, for example; many companies play a role in bringing these products to consumers. Figure 1-6 presents an overview of the supply chain. Cost management emphasizes integrating and coordinating activities across all companies in the supply chain, to improve performance and reduce costs. Both the Coca-Cola Company and Pepsi Bottling Group require their suppliers (such as plastic and aluminum companies and sugar refiners) to frequently deliver small quantities of materials directly to the production floor to reduce materials-handling costs. Similarly, to reduce inventory levels in the supply chain, Wal-Mart is asking its suppliers, such as Coca-Cola, to be responsible for and to manage inventory at both the Coca-Cola warehouse and Wal-Mart.

**Key Success Factors**

Customers want companies to use the value chain and supply chain to deliver ever improving levels of performance in terms of cost and efficiency, quality, time and innovation.
Cost and efficiency—Companies face continuous pressure to reduce the cost of the products they sell. To calculate and manage the cost of products, managers must first understand the tasks or activities (such as setting up machines or distributing products) that cause costs to arise. They must also monitor the marketplace to determine prices that customers are willing to pay for products or services. Management accounting information helps managers calculate a target cost for a product by subtracting the operating income per unit of product that the company desires to earn from the “target price.” To achieve the target cost, managers eliminate some activities (such as rework) and reduce the costs of performing activities in all value-chain functions—from initial R&D to customer service.

Growing global competition places ever-increasing pressure on companies to lower costs. Many multinational companies have cut costs by outsourcing some of their business functions. Nike, for example, has moved its manufacturing operations to China and Mexico. Microsoft and IBM are increasingly doing their software development in Spain, eastern Europe, and India.

Quality—Customers expect high levels of quality. Total quality management (TQM) aims to improve operations throughout the value chain and to deliver products and services that exceed customer expectations. Using TQM, companies design products or services to meet the needs and wants of customers and make these products with zero (or very few) defects and waste, and minimal inventories. Managers use management accounting information to evaluate the costs and revenue benefits of TQM initiatives.

Time—Time has many dimensions. Product development time is the time it takes for new products to be created and brought to market. The increasing pace of technological innovation has led to shorter product life cycles and more rapid introduction of new products. To make product and design decisions, managers need to understand the costs and benefits of a product over its life cycle.

Customer-response time describes the speed at which an organization responds to customer requests. To increase customer satisfaction, organizations need to reduce delivery time and reliably meet promised delivery dates. The primary cause of delays is bottlenecks that occur when the work to be performed on a machine, for example, exceeds available capacity. To deliver the product on time, managers need to increase the capacity of the machine to produce more output. Management accounting information helps managers quantify the costs and benefits of relieving bottleneck constraints.

Innovation—A constant flow of innovative products or services is the basis for ongoing company success. Managers rely on management accounting information to evaluate alternative investment and R&D decisions.

Companies are increasingly applying the key success factors of cost and efficiency, quality, time, and innovation to promote sustainability—the development and implementation of strategies to achieve long-term financial, social, and environmental performance. For example, the Japanese copier company Ricoh’s sustainability efforts aggressively focus on energy conservation, resource conservation, product recycling, and pollution prevention. By designing products that can be easily recycled, Ricoh simultaneously improves efficiency, cost, and quality. Interest in sustainability appears to be intensifying. Already, government regulations, in countries such as China and India, are impelling companies to develop and report on their sustainability initiatives.

Management accountants help managers track performance of competitors on the key success factors. Competitive information serves as a benchmark and alerts managers to market changes. Companies are always seeking continuously to improve their operations. These improvements include on-time arrival for Air Arabia, customer access to online auctions at eBay, and cost reduction on consumer products at Carrefour and other major retailers. Sometimes, more fundamental changes in operations, such as redesigning a manufacturing process to reduce costs, may be necessary. However, successful strategy implementation requires more than value-chain and supply-chain analysis and execution of key success factors. It is the decisions that managers make that help them to develop, integrate, and implement their strategies.
The Five-Step Decision-Making Process

We illustrate the five-step decision-making process using the example of *Emena*, a new magazine for students in the Middle East.

The magazine differentiates itself from its competitors based on in-depth analyses of news by its highly rated journalists, use of color to enhance attractiveness to readers and advertisers, and a website (for subscribers) that delivers up-to-the-minute news, interviews, and analyses. It has substantial capabilities to deliver on this strategy, such as an automated, computer-integrated, state-of-the-art printing facility; a web-based information technology infrastructure; and a distribution network that is one of the best in the newspaper industry.

To keep up with steadily increasing production costs, Hania Ahamada, the manager of the *Emena*, needs to increase revenues. To decide what she should do, Hania works through the five-step decision-making process.

1. **Identify the problem and uncertainties.** Hania has three main choices.
   a. Increase the number of online subscribers, as that will translate into higher revenue from advertisers who pay for advertising based on the number of customers they reach.
   b. Redesign the online presentation of *Emena* to include more advertising space, thereby increasing advertising revenue.
   c. Offer some gifts (like cups, pens, and cards) or special offers, such as tickets to nightclubs and special events. This might attract new subscribers. Existing subscribers should also provide a solid customer base for sales of special offers.

   The key uncertainties are how to expand the subscriber base and whether customers are interested in special offers. Changes of any sort are likely to lead to additional expenditure and that must be offset by the revenues that might be generated.

2. **Analyze the situation and obtain information.** Hania will want to gather as much information as she can before making a decision. She will look to gain a really good understanding of the uncertainties. Hania will expect her marketing manager to talk to some representative readers to gauge their reaction to the changes proposed and at the same time to find out if there are any other customer suggestions which might enable *Emena* to increase revenues. Meanwhile Hania asks her advertising sales manager to talk to current and potential advertisers to assess demand for advertising and in particular the opportunities that might come from special rates for promotions. For example, readers might like to receive news of promotions at nightclubs in their area. Ravi Patel, the management accountant at the *Emena*, presents information about the impact of various alternatives and collects and analyzes information on the advertising rates paid to competing magazines and other media outlets.

3. **Determine the options.** On the basis of this information, Hania considers the options available to *Emena* and discusses these options with her managers. There will probably be different views about advertising rates and special promotions and the appetite of readers for a redesign of the magazine.

   Hania recognizes that she must exercise judgment. She looks for biases in her thinking. Has she correctly judged the opinions of her managers? How sure is she that advertising can be increased if there are more subscribers? How reliable is the evidence that has come from competitors? Have circumstances changed? How confident is she that her sales representatives can convince new subscribers to sign up if these changes are made? Hania retests her assumptions and reviews her thinking.

4. **Make decisions by choosing among the options.** When making decisions, strategy is a vital guidepost; many individuals in different parts of the organization at different times make decisions. Consistency with strategy binds individuals and timelines together and provides a common purpose for disparate decisions. Aligning decisions with strategy enables an organization to implement its strategy and achieve its goals. Without this alignment, decisions will be uncoordinated, pull the organization in different directions, and produce inconsistent results.
Planning
Selecting organization goals, predicting results under various alternative ways of achieving those goals, deciding how to attain the desired goals, and communicating the goals and how to attain them to the entire organization.

Budget
Quantitative expression of a proposed plan of action by management for a specified period and an aid to coordinating what needs to be done to implement that plan.

Control
Taking actions that implement the planning decisions, deciding how to evaluate performance, and providing feedback and learning that will help future decision making.

Learning
Involves managers examining past performance and systematically exploring alternative ways to make better-informed decisions and plans in the future.

Hania decides to follow the idea of special promotions with a minor redesign of Emena so that she can add advertising space and at the same time attract readers with something extra, such as special offers for nightclubs and other social activities, and provide them with a calendar of what is going on. The strategic aim is more customers. She is confident that Emena’s new distinctive style and web presence will increase readership, creating value for advertisers.

Steps 1 through 4 are collectively referred to as planning. Planning comprises selecting organization goals and strategies, projecting results under various alternative ways of achieving those goals, deciding how to attain the desired goals, and communicating the goals and how to achieve them to the entire organization. Management accountants serve as business partners in these planning activities because of their understanding of what creates value and the key success factors.

The most important planning tool when implementing strategy is a budget. A budget is the quantitative expression of a proposed plan of action by management and is an aid to coordinating what needs to be done to execute that plan. So Hania and her team produce a budget to execute the plan and, most importantly, set up regular monthly reports to review outcomes against the plan so that they can see if the strategy is working. As the process of preparing a budget crosses business functions, the budget actually promotes coordination and communication throughout the Emena organization.

5. Implement the decision, evaluate performance, and learn. Managers at the Emena take actions to implement the new budget. Management accountants collect information to follow through on how actual performance compares to planned or budgeted performance (this is sometimes referred to as scorekeeping). Managers will receive an income statement (perhaps similar to Figure 1-2, see page 4) and a performance report (see Figure 1-7), so that they can see how actual results differ from the plan.

The comparison of actual performance to budgeted performance is the control or post-decision role of information. Control comprises monitoring performance and then taking actions that implement the planning decisions.

Control and financial analysis spur investigation and learning. Learning is examining past performance (the control function) and systematically exploring alternative ways to make better-informed decisions and plans in the future. Learning can lead to changes in goals, changes in strategies, changes in the ways decision alternatives are identified, changes in the range of information collected when making projections, and sometimes changes in managers.

The follow-up process will try and determine whether the new strategy for Emena is actually attracting new readers. In implementing the changes, did the marketing and sales department make sufficient efforts to convince advertisers that Emena continues to offer them good value? Answers to these and other questions which arise from the changes made will inevitably prompt further actions, such as, perhaps, adding more sales personnel and making changes in editorial policy. Good implementation requires the marketing, editorial, and production departments to work together and coordinate their actions.

The Emena controller could go further by identifying the specific advertisers that increased or cut back advertising after the changes went into effect. Managers could then decide when and how sales representatives should follow up with these advertisers. Figure 1-8 provides a complete overview of the decision-making process on this project and highlights how the management accounting system aids in this process.
Key Management Accounting Guidelines

Three guidelines help management accountants provide the most value to their companies in strategic and operational decision making. These are employ a cost-benefit approach, give full recognition to behavioral and technical considerations, and use different costs for different purposes.

Cost-Benefit Approach

Managers continually face resource-allocation decisions, such as whether to purchase a new software package or hire a new employee. They use a cost-benefit approach when making these decisions: resources should be spent if the expected benefits to the company exceed the expected costs. Managers rely on management accounting information to quantify expected benefits and expected costs although all benefits and costs are not easy to quantify. Nevertheless, the cost-benefit approach is a useful guide for making resource-allocation decisions.

Consider the installation of a company’s first budgeting system. Previously, the company used historical recordkeeping and little formal planning. A major benefit of installing a budgeting system is that it compels managers to plan ahead, compare actual to budgeted information, learn, and take corrective action. These actions lead to different decisions that improve performance relative to decisions that would have been made using the historical system, but the benefits are not easy to measure. On the cost side, some costs, such as investments in software and training are easier to quantify. Others, such as the time spent by managers on the budgeting process, are harder to quantify. Regardless, senior managers compare expected benefits and expected costs, exercise judgment, and reach a decision, in this case to install the budgeting system.

Behavioral and Technical Considerations

The cost-benefit approach is the criterion that assists managers in deciding whether, say, to install a proposed budgeting system instead of continuing to use an existing historical
system. In making this decision senior managers consider two simultaneous missions: one technical and one behavioral. The technical considerations help managers make wise economic decisions by providing them with the desired information (for example, costs in various value-chain categories) in an appropriate format (such as actual results versus budgeted amounts) and at the preferred frequency. Now consider the human (the behavioral) side of why budgeting is used. Budgets induce a different set of decisions within an organization because of better collaboration, planning, and motivation. The behavioral considerations encourage managers and other employees to strive for achieving the goals of the organization.

Both managers and management accountants should always remember that management is not confined exclusively to technical matters. Management is primarily a human activity that should focus on how to help individuals do their jobs better—for example, by helping them to understand which of their activities adds value and which does not. Moreover, when workers underperform, behavioral considerations suggest that management systems and processes should cause managers to personally discuss with workers ways to improve performance rather than just sending them a report highlighting their underperformance.

Different Costs for Different Purposes

Managers use alternative ways to compute costs in different decision-making situations, because there are different costs for different purposes. A cost concept used for the external-reporting purpose of accounting may not be an appropriate concept for internal, routine reporting to managers.

Consider the advertising costs associated with Microsoft Corporation’s launch of a major product with a useful life of several years. For external reporting to shareholders, television advertising costs for this product are fully expensed in the income statement in the year they are incurred. In the United States, GAAP (generally accepted accounting principles) requires this immediate expensing for external reporting. For internal purposes of evaluating management performance, however, the television advertising costs could be capitalized and then amortized or written off as expenses over several years. Microsoft could capitalize these advertising costs if it believes doing so results in a more accurate and fairer measure of the performance of the managers that launched the new product.

We now discuss the relationships and reporting responsibilities among managers and management accountants within a company’s organization structure.

Organization Structure and the Management Accountant

We focus first on broad management functions and then look at how the management accounting and finance functions support managers.

Line and Staff Relationships

Organizations distinguish between line management and staff management. Line management, such as production, marketing, and distribution management, is directly responsible for attaining the goals of the organization. For example, managers of manufacturing divisions may target particular levels of budgeted operating income, certain levels of product quality and safety, and compliance with environmental laws. Similarly, the pediatrics department in a private hospital is responsible for quality of service, costs, and patient billing. Staff management, such as management accountants and information technology and human-resources management, provides advice, support, and assistance to line management. A plant manager (a line function) may be responsible for investing in new equipment. A management accountant (a staff function) works as a business partner of the plant manager by preparing detailed operating-cost comparisons of alternative pieces of equipment.

Increasingly, organizations such as Honda and Dell are using teams to achieve their objectives. These teams include both line and staff management so that all inputs into a decision are available simultaneously.
The Chief Financial Officer and the Controller

The chief financial officer (CFO)—also called the vice-president finance or finance director in many countries—is the executive responsible for overseeing the financial operations of an organization. The responsibilities of the CFO vary among organizations, but they usually include the following areas:

- **Controllership**—includes providing financial information for reports to managers and shareholders, and overseeing the overall operations of the accounting system
- **Treasury**—includes banking and short- and long-term financing, investments, and cash management
- **Risk management**—includes managing the financial risk of interest-rate and exchange-rate changes and derivatives management
- **Taxation**—includes income taxes, sales taxes, and international tax planning
- **Investor relations**—includes communicating with, responding to, and interacting with shareholders
- **Internal audit**—includes reviewing and analyzing financial and other records to attest to the integrity of the organization’s financial reports and to adherence to its policies and procedures

The controller (also called the chief accounting officer) is the financial executive primarily responsible for management accounting and financial accounting. Modern controllers do not do any controlling in terms of line authority except over their own departments. Yet the modern concept of controllership maintains that the controller exercises control in a special sense. By reporting and interpreting relevant data, the controller influences the behavior of all employees and exerts a force that impels line managers toward making better-informed decisions as they implement their strategies.

Figure 1-9 is an organization chart of the CFO and the corporate controller at Nike, the leading footwear and apparel company. The CFO is a staff manager who reports to and supports the chief executive officer (CEO). As in most organizations, the corporate controller at Nike reports to the CFO. Nike also has regional controllers who support regional managers in the major geographic regions in which the company operates, such as the United States, Asia Pacific, Latin America, and Europe. Individual countries sometimes have a country controller. Organization charts such as the one in Figure 1-9 show formal reporting relationships. In most organizations, there also are informal relationships that must be understood when managers attempt to implement their decisions. Examples of informal relationships are friendships among managers (friendships of a professional
CHAPTER 1  THE MANAGER AND MANAGEMENT ACCOUNTING

or personal kind) and the personal preferences of top management about the managers they rely on in decision making.

Ponder what managers do to design and implement strategies and the organization structures within which they operate. Then think about the management accountants’ and controllers’ roles. It should be clear that the successful management accountant must have technical and analytical competence as well as behavioral and interpersonal skills. The Concepts in Action box below describes some desirable values and behaviors and why they are so critical to the partnership between management accountants and managers.

Management Accounting Beyond the Numbers

When you hear the job title “accountant,” what comes to mind? The person who does your audit each year? Individuals who prepare budgets at Dell or Samsung? To people outside the profession, it may seem like accountants are just “numbers people.” It is true that most accountants are adept financial managers, yet their skills do not stop there. To be successful, management accountants must possess certain values and behaviors that reach well beyond basic analytical abilities.

Working in cross-functional teams and as a business partner of managers. It is not enough that management accountants simply be technically competent in their area of study. They also need to be able to work in teams, to learn about business issues, to understand the motivations of different individuals, to respect the views of their colleagues, and to show empathy and trust.

Promoting fact-based analysis and making tough-minded, critical judgments without being adversarial. Management accountants must raise tough questions for managers to consider, especially when preparing budgets. They must do so thoughtfully and with the intent of improving plans and decisions. In the case of Jordan French Insurance (JOFR), management accountants should have raised questions about whether the company’s risky credit insurance would be profitable.

Leading and motivating people to change and be innovative. Implementing new ideas, however good they may be, is seldom easy. When the United States Department of Defense sought to consolidate more than 320 finance and accounting systems into a centralized platform, the accounting services director and his team of management accountants made sure that the vision for change was well understood throughout the agency. Ultimately, each individual’s performance was aligned with the transformative change and incentive pay was introduced to promote adoption and drive innovation within this new framework.

Communicating clearly, openly, and candidly. Communicating information is a large part of a management accountant’s job. A few years ago, Pitney Bowes Inc. (PBI), a US$4 billion global provider of integrated mail and document management solutions, implemented a reporting initiative to give managers feedback in key areas. The initiative succeeded because it was clearly designed and openly communicated by PBI’s team of management accountants.

Having a strong sense of integrity. Management accountants must never succumb to pressure from managers to manipulate financial information. They must always remember that their primary commitment is to the organization and its shareholders. At WorldCom, the U.S. telecommunications company, members of the accounting staff concealed billions of dollars in expenses because they were placed under pressure to do so by senior managers. Because the accounting staff lacked the integrity and courage to stand up to and report corrupt senior managers, WorldCom landed in bankruptcy. Some members of the accounting staff and the senior executive team served prison terms for their actions.

Professional Ethics

At no time has the focus on ethical conduct been sharper than it is today. Corporate scandals at Satyam (India), Parmalat (Italy), and Enron (United States) have seriously eroded the public’s confidence in corporate governance. There is a worldwide expectation of higher standards for all employees in a company, whether in line management or staff management, when it comes to ethical behavior.

Institutional Support

Accountants have special obligations regarding ethics, given that they are responsible for the integrity of the financial information provided to internal and external parties. The IFRS (International Financial Reporting Standards) focus on standardizing the content and reporting of financial matters for all companies. In the process the goal is to improve internal control, upgrade corporate governance, monitor the actions of managers, and provide for increasing transparency for both public and private corporations. Tough ethical standards on managers and accountants provide a process for employees to report procedural violations and apparent illegal and unethical acts.

Professional accounting organizations, which represent management accountants in many countries, promote high ethical standards. Each of these organizations provides certification programs indicating that the holder has demonstrated the competency of technical knowledge required by that organization in management accounting and financial management, respectively.

The International Federation of Accountants (IFAC) established the International Ethics Standards Board of Accountants (IESBA) as an independent standard-setting body to develop internationally appropriate code of ethics for professional accountants. The IESBA has issued ethical guidelines on issues relating to integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. These require a professional accountant to comply with five fundamental principles. These are set out in Figure 1-10.

Adherence to the IESBA standards, both domestically and internationally, is integral to achieving the objectives of management accounting. Practitioners should not commit acts contrary to these standards nor should they condone the commission of such acts by others within their organizations. Failure to comply with the standards may result in disciplinary action.

Typical Ethical Challenges

Ethical issues can confront management accountants in many ways. Here are two examples.

■ Case A: A division manager has concerns about the commercial potential of a software product for which development costs are currently being capitalized as an asset rather than being shown as an expense for internal reporting purposes. The manager’s bonus is based, in part, on division profits. The manager argues that showing development costs as an asset is justified because the new product will generate profits but presents little evidence to support his argument. The last two products from this division have been unsuccessful. The management accountant disagrees but wants to avoid a difficult personal confrontation with the boss, the division manager.

■ Case B: A packaging supplier, bidding for a new contract, offers the management accountant of the purchasing company an all-expenses-paid weekend break to New York. The supplier does not mention the new contract when extending the invitation. The accountant is not a personal friend of the supplier. The accountant knows cost issues are critical in approving the new contract and is concerned that the supplier will ask for details about bids by competing packaging companies.

In each case the management accountant is faced with an ethical dilemma. Case A involves competence, credibility, and integrity. The management accountant should request that the division manager provide credible evidence that the new product is commercially...
viable. If the manager does not provide such evidence, expensing development costs in the current period is appropriate. Case B involves confidentiality and integrity.

Ethical issues are not always clear-cut. The supplier in Case B may have no intention of raising issues associated with the bid. However, the appearance of a conflict of interest in Case B is sufficient for many companies to prohibit employees from accepting “favors” from suppliers. Figure 1-11 presents the IESBA’s guidance on resolution of ethical conflict. The accountant in Case B should discuss the invitation with his or her immediate supervisor. If the visit is approved, the accountant should inform the supplier that the invitation has been officially approved subject to following corporate policy (which includes maintaining information confidentiality).

Most professional accounting organizations around the globe issue statements about professional ethics. These statements include many of the same fundamental principles and issues outlined in Figures 1-10 and 1-11. For example, the Chartered Institute of Management Accountants (CIMA) in the United Kingdom identifies four fundamental principles: competency, confidentiality, integrity, and credibility.

What are the ethical responsibilities of management accountants?

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**Integrity**
The principle of integrity imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

(a) Contains a materially false or misleading statement;
(b) Contains statements or information furnished recklessly; or
(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

**Objectivity**
The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. A professional accountant may be exposed to situations that may impair objectivity.

**Professional competence and due care**
This principle requires a professional accountant to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

**Confidentiality**
The principle of confidentiality requires a professional accountant to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant.

**Professional behavior**
The principle of professional behavior imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good reputation of the profession.

A professional accountant may be required to resolve a conflict in complying with the fundamental principles. When initiating either a formal or informal conflict resolution process, the following factors, either individually or together with other factors, may be relevant to the resolution process:

(a) Relevant facts;
(b) Ethical issues involved;
(c) Fundamental principles related to the matter in question;
(d) Established internal procedures; and
(e) Alternative courses of action.

Having considered the relevant factors, a professional accountant shall determine the appropriate course of action, weighing the consequences of each possible course of action. If the matter remains unresolved, the professional accountant may wish to consult with other appropriate persons within the firm or employing organization for help in obtaining resolution.

Where a matter involves a conflict with, or within, an organization, a professional accountant shall determine whether to consult with those charged with governance of the organization, such as the board of directors or the audit committee.

It may be in the best interests of the professional accountant to document the substance of the issue, the details of any discussions held, and the decisions made concerning that issue.

If a significant conflict cannot be resolved, a professional accountant may consider obtaining professional advice from the relevant professional body or from legal advisors. The professional accountant generally can obtain guidance on ethical issues without breaching the fundamental principle of confidentiality if the matter is discussed with the relevant professional body on an anonymous basis or with a legal advisor under the protection of legal privilege. Instances in which the professional accountant may consider obtaining legal advice vary. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant’s responsibility to respect confidentiality. The professional accountant may consider obtaining legal advice in that instance to determine whether there is a requirement to report.

If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant shall, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant shall determine whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.


Problem for Self-Study

Campbell Soup Company incurs the following costs:

a. Purchase of tomatoes by a canning plant for Campbell’s tomato soup products
b. Materials purchased for redesigning Pepperidge Farm biscuit containers to make biscuits stay fresh longer
c. Payment to Backer, Spielvogel, & Bates, the advertising agency, for advertising work on Healthy Request line of soup products
d. Salaries of food technologists researching feasibility of a Prego pizza sauce that has minimal calories
e. Payment to Safeway for redeeming coupons on Campbell’s food products
f. Cost of a toll-free telephone line used for customer inquiries about using Campbell’s soup products
g. Cost of gloves used by line operators on the Swanson Fiesta breakfast-food production line
h. Cost of handheld computers used by Pepperidge Farm delivery staff serving major supermarket accounts

Classify each cost item (a–h) as one of the business functions in the value chain in Figure 1-5 (p. 10).
The following question-and-answer format summarizes the chapter's learning objectives. Each decision presents a key question related to a learning objective. The guidelines are the answer to that question.

### Decision Points

<table>
<thead>
<tr>
<th>Decision</th>
<th>Guidelines</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. What is the role of the controller?</td>
<td>The controller (a management accountant) is employed to generate accurate cost accounting information so that decisions related to corporate strategy are made on the basis of accurate information.</td>
</tr>
<tr>
<td>2. How is management accounting different from financial accounting?</td>
<td>Management accounting provides future-oriented information in formats that help managers (internal users) make decisions and achieve organizational goals. Financial accounting reports to external users on past financial performance using GAAP.</td>
</tr>
<tr>
<td>3. How do management accountants support strategic decisions?</td>
<td>Management accountants contribute to strategic decisions by providing information about the sources of competitive advantage.</td>
</tr>
<tr>
<td>4. How do companies add value, and what are the dimensions of performance that customers are expecting of companies?</td>
<td>Companies add value through R&amp;D, design of products and processes, production, marketing, distribution, and customer service. Customers want companies to deliver performance through cost and efficiency, quality, timeliness, and innovation.</td>
</tr>
<tr>
<td>5. How do managers make decisions to implement strategy?</td>
<td>Managers use a five-step decision-making process to implement strategy: (1) identify the problem and uncertainties; (2) analyze the situation; (3) determine the options available; (4) make decisions by choosing among the available options; and (5) implement the decision, evaluate performance, and learn. The first four steps are the planning decisions, which include deciding on organization goals, predicting results under various alternative ways of achieving those goals, and deciding how to attain the desired goals. Step 5 is the control decision, which includes taking actions to implement the planning decisions and deciding on performance evaluation and feedback that will help future decision making.</td>
</tr>
<tr>
<td>6. What guidelines do management accountants use?</td>
<td>Three guidelines that help management accountants increase their value to managers are (a) employ a cost-benefit approach, (b) recognize behavioral as well as technical considerations, and (c) identify different costs for different purposes.</td>
</tr>
</tbody>
</table>
Decision

7. Where does the management accounting function fit into an organization’s structure?

Guidelines

Management accounting is an integral part of the controller’s function in an organization. In most organizations, the controller reports to the chief financial officer, who is a key member of the top management team.

8. What are the ethical responsibilities of management accountants?

Management accountants have ethical responsibilities that relate to competence, confidentiality, integrity, and credibility.

Terms to Learn

The meaning of each of the following terms is given in this chapter and in the glossary at the end of this book.

- budget (p. 14)
- chief accounting officer (p. 17)
- chief financial officer (CFO) (p. 17)
- control (p. 14)
- controller (p. 17)
- cost accounting (p. 8)
- cost-benefit approach (p. 15)
- cost management (p. 8)
- customer service (p. 10)
- design of products and processes (p. 10)
- distribution (p. 10)
- finance director (p. 17)
- financial accounting (p. 7)
- learning (p. 14)
- line management (p. 16)
- management accounting (p. 7)
- marketing (p. 10)
- planning (p. 14)
- production (p. 10)
- research and development (R&D) (p. 10)
- staff management (p. 16)
- strategic cost management (p. 9)
- strategy (p. 9)
- supply chain (p. 11)
- value chain (p. 10)
- vice president finance (p. 17)

Assignment Material

Questions

1-1 What is the role of the controller and how does management accounting differ from financial accounting?

1-2 “Management accounting should not fit the straitjacket of financial accounting.” Explain and give an example.

1-3 How can a management accountant help formulate strategy?

1-4 Describe the business functions in the value chain.

1-5 Explain the term “supply chain” and its importance to cost management.

1-6 “Management accounting deals only with costs.” Do you agree? Explain.

1-7 How can management accountants help improve quality and achieve timely product deliveries?

1-8 Describe the five-step decision-making process.

1-9 Distinguish planning decisions from control decisions.

1-10 What three guidelines help management accountants provide the most value to managers?

1-11 “Knowledge of technical issues such as computer technology is a necessary but not sufficient condition to becoming a successful management accountant.” Do you agree? Why?

1-12 As a new controller, reply to this comment by a plant manager: “As I see it, our accountants may be needed to keep records for shareholders and Uncle Sam, but I don’t want them sticking their noses in my day-to-day operations. I do the best I know how. No bean counter knows enough about my responsibilities to be of any use to me.”

1-13 Where does the management accounting function fit into an organization’s structure?

1-14 Name the five principles that provide a framework for the standards of ethical conduct for management accountants. What organization sets these standards?

1-15 What steps should a management accountant take if established written policies provide insufficient guidance on how to handle an ethical conflict?
Exercises

1-16 **Value chain and classification of costs, computer company.** Compaq Computer incurs the following costs:

a. Electricity costs for the plant assembling the Presario computer line of products
b. Transportation costs for shipping the Presario line of products to a retail chain
c. Payment to a design company for the design of the Armada Notebook
d. Salary of computer scientist working on the next generation of minicomputers
e. Cost of Compaq employees’ visit to a major customer to demonstrate Compaq’s ability to interconnect with other computers
f. Purchase of competitors’ products for testing against potential Compaq products
g. Payment to television network for running Compaq advertisements
h. Cost of cables purchased from outside supplier to be used with Compaq printers

Classify each of the cost items (a–h) into one of the business functions of the value chain shown in Figure 1-5 (p. 10).

1-17 **Value chain and classification of costs, pharmaceutical company.** Merck, an international pharmaceutical company, incurs the following costs:

a. Cost of redesigning blister packs to make drug containers more tamperproof
b. Cost of videos sent to doctors to promote sales of a new drug
c. Cost of a toll-free telephone line used for customer inquiries about drug usage, side effects of drugs, and so on
d. Equipment purchased to conduct experiments on drugs yet to be approved by the government
e. Payment to actors for a television commercial promoting a new hair-growth product for balding men
f. Labor costs of workers in the packaging area of a production facility
g. Bonus paid to a salesperson for exceeding a monthly sales quota
h. Cost of courier service to deliver drugs to hospitals

Classify each of the cost items (a–h) as one of the business functions of the value chain shown in Figure 1-5 (p. 10).

1-18 **Value chain and classification of costs, fast food restaurant.** Burger King, a global fast food restaurant, incurs the following costs:

a. Cost of oil for the deep fryer
b. Wages of the counter help who give customers the food they order
c. Cost of costume materials for television commercials
d. Cost of children’s toys given away free with kids’ meals
e. Cost of special promotion posters
f. Costs of frozen onion rings and French fries
g. Salaries of the food specialists who create new menu items for the restaurant chain
h. Cost of “to-go” bags requested by customers who could not finish their meals in the restaurant

Classify each of the cost items (a–h) as one of the business functions of the value chain shown in Figure 1-5 (p. 10).

1-19 **Key success factors.** Ghanem Brothers Consulting has issued a report recommending changes for its newest manufacturing client, Energy Motors. Energy Motors currently manufactures a single product, which is sold and distributed nationally. The report contains the following suggestions for enhancing business performance:

a. Add a new product line to increase total revenue and to reduce the company’s overall risk.
b. Increase training hours of assembly line personnel to decrease the currently high volumes of scrap and waste.
c. Reduce lead times (time from customer order of product to customer receipt of product) by 20% in order to increase customer retention.
d. Reduce the time required to set up machines for each new order.
e. Benchmark the company’s gross margin percentages against its major competitors.

Link each of these changes to the key success factors that are important to managers.

1-20 **Planning and control decisions.** Al Khor Company makes and sells brooms and mops. It takes the following actions, not necessarily in the order given. For each action (a–e) state whether it is a planning decision or a control decision.
a. Al Khor asks its marketing team to consider ways to get back market share from its newest competitor, a company that makes a product called the Swiffer.

b. Al Khor calculates market share after introducing its newest product.

c. Al Khor compares costs it actually incurred with costs it expected to incur for the production of the new product.

d. Al Khor’s design team proposes a new product to compete directly with the Swiffer.

e. Al Khor estimates the costs it will incur to sell 30,000 units of the new product in the first quarter of next fiscal year.

1-21 Five-step decision-making process, manufacturing. El Gharabelli Foods makes frozen dinners that it sells through grocery stores. The managers at El Gharabelli have recently introduced a line of frozen chicken pies. They take the following actions with regard to this decision.

a. El Gharabelli’s chief executive performs a taste test at the local shopping mall to see if consumers like the taste of its proposed new chicken pie product.

b. El Gharabelli sales managers estimate they will sell more meat pies in their northern sales territory than in their southern sales territory.

c. El Gharabelli managers discuss the possibility of introducing a new chicken pie.

d. El Gharabelli managers compare actual costs of making chicken pies with their budgeted costs.

e. Costs for making chicken pies are budgeted.

f. El Gharabelli decides to introduce a new chicken pie.

g. To help decide whether to introduce a new chicken pie, the purchasing manager calls a supplier to check the prices of chicken.

Classify each of the actions (a–g) as a step in the five-step decision-making process (identify the problem and uncertainties, analyze the situation and obtain information, determine the options available, choose among alternatives, implement the decision, evaluate performance, and learn). The actions are not listed in the order they are performed.

1-22 Five-step decision-making process, service firm. Bin Sharakha Exteriors is a firm that provides house painting services. Abdullah Bin Sharakha, the owner, is trying to find new ways to increase revenues. Abdullah Bin Sharakha performs the following actions, not in the order listed.

a. Abdullah Bin Sharakha calls Home Depot to ask the price of paint sprayers.

b. Abdullah Bin Sharakha discusses with his employees the possibility of using paint sprayers instead of hand painting to increase productivity and thus revenues.

c. The workers who are not familiar with paint sprayers take more time to finish a job than they did when painting by hand.

d. Abdullah compares the expected cost of buying sprayers to the expected cost of hiring more workers who paint by hand, and estimates profits from both alternatives.

e. The project scheduling manager confirms that demand for house painting services has increased.

f. Abdullah decides to buy the paint sprayers rather than hire additional painters.

Classify each of the actions (a–f) according to its step in the five-step decision-making process (identify the problem and uncertainties, analyze the situation and obtain information, determine the options available, choose among alternatives, implement the decision, evaluate performance, and learn).

1-23 Professional ethics and reporting division performance. Ayasha Al Saleh is division controller and Ababneh Hanan is division manager of the Ramses Shoe Company. Ayasha has line responsibility to Ababneh, but she also has staff responsibility to the company controller.

Ababneh is under severe pressure to achieve the budgeted division income for the year. He has asked Ayasha to book US$200,000 of revenues on December 31. The customers’ orders are firm, but the shoes are still in the production process. They will be shipped on or around January 4. Ababneh says to Ayasha, “The key event is getting the sales order, not shipping the shoes. You should support me, not obstruct my reaching division goals.”

1. Describe Ayasha’s ethical responsibilities.

2. What should Ayasha do if Ababneh gives her a direct order to book the sales?

Problems

1-24 Planning and control decisions, internet company. WebNews.com offers its subscribers several services, such as an annotated television guide and local area information on weather, restaurants, and movie theaters. Its main revenue sources are fees for banner advertisements and fees from subscribers. Recent data are as follows:
CHAPTER 1  THE MANAGER AND MANAGEMENT ACCOUNTING

<table>
<thead>
<tr>
<th>Month/Year</th>
<th>Advertising Revenues</th>
<th>Actual Number of Subscribers</th>
<th>Monthly Fee Per Subscriber</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 2009</td>
<td>$415,972</td>
<td>29,745</td>
<td>$15.50</td>
</tr>
<tr>
<td>December 2009</td>
<td>867,246</td>
<td>55,223</td>
<td>20.50</td>
</tr>
<tr>
<td>June 2010</td>
<td>892,134</td>
<td>59,641</td>
<td>20.50</td>
</tr>
<tr>
<td>December 2010</td>
<td>1,517,950</td>
<td>87,674</td>
<td>20.50</td>
</tr>
<tr>
<td>June 2011</td>
<td>2,976,538</td>
<td>147,921</td>
<td>20.50</td>
</tr>
</tbody>
</table>

The following decisions were made from June through October 2011:

a. June 2011: Raised subscription fee to US$25.50 per month from July 2011 onward. The budgeted number of subscribers for this monthly fee is shown in the following table.

b. June 2011: Informed existing subscribers that from July onward, monthly fee would be US$25.50.

c. July 2011: Offered e-mail service to subscribers and upgraded other online services.

d. October 2011: Dismissed the vice president of marketing after significant slowdown in subscribers and subscription revenues, based on July through September 2011 data in the following table.

e. October 2011: Reduced subscription fee to US$22.50 per month from November 2011 onward.

Results for July–September 2011 are as follows:

<table>
<thead>
<tr>
<th>Month/Year</th>
<th>Budgeted Number of Subscribers</th>
<th>Actual Number of Subscribers</th>
<th>Monthly Fee Per Subscriber</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 2011</td>
<td>145,000</td>
<td>129,250</td>
<td>$25.50</td>
</tr>
<tr>
<td>August 2011</td>
<td>155,000</td>
<td>142,726</td>
<td>25.50</td>
</tr>
<tr>
<td>September 2011</td>
<td>165,000</td>
<td>145,643</td>
<td>25.50</td>
</tr>
</tbody>
</table>

1. Classify each of the decisions (a–e) as a planning or a control decision.
2. Give two examples of other planning decisions and two examples of other control decisions that may be made at WebNews.com.

1-25  **Strategic decisions and management accounting.** A series of independent situations in which a firm is about to make a strategic decision follow.

a. Temiz Phones is about to decide whether to launch production and sale of a cell phone with standard features.

b. Computer Magic is trying to decide whether to produce and sell a new home computer software package that includes the ability to interface with a sewing machine and a vacuum cleaner. There is no such software currently on the market.

c. Mansoura Cosmetics has been asked to provide a “store brand” lip gloss that will be sold at discount retail stores.

d. Naser Fruits is entertaining the idea of developing a special line of gourmet mix made with sun dried apples, pine nuts, and oranges.

1. For each decision, state whether the company is following a low price or a differentiated product strategy.
2. For each decision, discuss what information the management accountant can provide about the source of competitive advantage for these firms.

1-26  **Management accounting guidelines.** For each of the following items, identify which of the management accounting guidelines applies: cost-benefit approach, behavioral and technical considerations, or different costs for different purposes.

1. Analyzing whether to keep the customer invoicing function within an organization or outsource it
2. Deciding to give bonuses for superior performance to the employees in a Qatari subsidiary and extra vacation time to the employees in an Iraqi subsidiary
3. Including costs of all the value-chain functions before deciding to launch a new product, but including only its manufacturing costs in determining its inventory valuation
4. Considering the desirability of hiring one more salesperson
5. Giving each salesperson the compensation option of choosing either a low salary and a high-percentage sales commission or a high salary and a low-percentage sales commission
6. Selecting the costlier computer system after considering two systems
7. Installing a participatory budgeting system in which managers set their own performance targets, instead of top management imposing performance targets on managers
8. Recording research costs as an expense for financial reporting purposes (as required by U.S. GAAP) but capitalizing and expensing them over a longer period for management performance-evaluation purposes
9. Introducing a profit-sharing plan for employees
1-27 Role of controller, role of chief financial officer. Omar Mourad is the controller at Allied Electronics, a manufacturer of devices for the computer industry. He is being considered for a promotion to chief financial officer.

1. In this table, indicate which executive is primarily responsible for each activity.

<table>
<thead>
<tr>
<th>Activity</th>
<th>Controller</th>
<th>CFO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managing accounts payable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Communicating with investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Strategic review of different lines of businesses</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Budgeting funds for a plant upgrade</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Managing the company’s short-term investments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Negotiating fees with auditors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assessing profitability of various products</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Evaluating the costs and benefits of a new product design</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

2. Based on this table and your understanding of the two roles, what types of training or experiences will Omar find most useful for the CFO position?

1-28 Pharmaceutical company, budgeting, ethics. Salih Al Khatib was recently promoted to controller of research and development (R&D) for PharmaCor, a leading pharmaceutical company that manufactures prescription drugs and nutritional supplements. The company’s total R&D cost for 2012 was expected (budgeted) to be US$5 billion. During the company’s mid-year budget review, Salih realized that current R&D expenditures were already at US$3.5 billion, nearly 40% above the mid-year target. At this current rate of expenditure, the R&D division was on track to exceed its total year-end budget by US$2 billion.

In a meeting with CFO, Sharif Mohammed, later that day, Salih delivered the bad news. Sharif was both shocked and outraged that the R&D spending had become out of control. Sharif wasn’t any more understanding when Salih revealed that the excess cost was entirely related to research and development of a new drug, Lyricon, which was expected to go to market next year. The new drug would result in large profits for PharmaCor, if the product could be approved by year-end.

Sharif had already announced his expectations of third quarter earnings to financial analysts. If the R&D expenditures weren’t reduced by the end of the third quarter, Sharif was certain that the targets he had announced publicly would be missed and the company’s stock price would tumble. Sharif instructed Salih to make up the budget short-fall by the end of the third quarter using “whatever means necessary.”

Salih was new to the controller’s position and wanted to make sure that Sharif’s orders were followed. Salih came up with the following ideas for making the third quarter budgeted targets.

a. Stop all research and development efforts on the drug Lyricon until after year-end. This change would delay the drug going to market by at least six months. It is also possible that in the meantime a PharmaCor competitor could make it to market with a similar drug.

b. Sell off rights to the drug, Markapro. The company had not planned on doing this because, under current market conditions, it would get less than fair value. It would, however, result in a onetime gain that could offset the budget short-fall. Of course, all future profits from Markapro would be lost.

c. Capitalize some of the company’s R&D expenditures reducing R&D expense on the income statement. This transaction would not be in accordance with IFRS, but Salih thought it was justifiable, since the Lyricon drug was going to market early next year. Salih would argue that capitalizing R & D costs this year and expensing them next year would better match revenues and expenses.

1. Referring to the fundamental principles of ethical behavior for professional accountants (see Figure 1-10 on page 20), which of the preceding items (a–c) are acceptable to use? Which are unacceptable?

2. What would you recommend that Salih does?

1-29 Professional ethics and end-of-year actions. Ameena Khaleel is the new division controller of the snack foods division of Gourmet Foods. Gourmet Foods has reported a minimum 15% growth in annual earnings for each of the past five years. The snack foods division has reported annual earnings growth of more than 20% each year in this same period. During the current year, the economy went into a recession. The corporate controller estimates a 10% annual earnings growth rate for Gourmet Foods this year. One month before the December 31 fiscal year-end of the current year, Khaleel estimates the snack-foods division will report an annual earnings growth of only 8%. Hasan Asaad, the snack foods division president, is not happy, but he notes that the end-of-year actions still need to be taken.

Khaleel makes some inquiries and is able to compile the following list of end-of-year actions that were more or less accepted by the previous division controller:

a. Deferring December’s routine monthly maintenance on packaging equipment by an independent contractor until January of next year
CHAPTER 1 THE MANAGER AND MANAGEMENT ACCOUNTING

b. Extending the close of the current fiscal year beyond December 31 so that some sales of next year are included in the current year

c. Altering dates of shipping documents of next January’s sales to record them as sales in December of the current year

d. Giving salespeople a double bonus to exceed December sales targets

e. Deferring the current period’s advertising by reducing the number of television spots run in December and running more than planned in January of next year

f. Deferring the current period’s reported advertising costs by having Gourmet Foods’ outside advertising agency delay invoicing December advertisements until January of next year or by having the agency alter invoices to conceal the December date

g. Persuading carriers to accept merchandise for shipment in December of the current year although they normally would not have done so

1. Why might the snack foods division president want to take these end-of-year actions?

2. Khaleel is deeply troubled and reads the fundamental principles of ethical behavior for professional accountants (see Figure 1-10 on page 20). Classify each of the end-of-year actions (a–g) as acceptable or unacceptable according to these principles.

3. What should Khaleel do if Asaad suggests that these end-of-year actions are taken in every division of Gourmet Foods and that she will greatly harm the snack foods division if she does not cooperate and paint the rosiest picture possible of the division’s results?

1-30 Professional ethics and end-of-year actions. Sulaiman Publishing House produces consumer magazines. The house and home division, which sells home-improvement and home-decorating magazines, has seen a 20% reduction in operating income over the past nine months, primarily due to the recent economic recession and the depressed consumer housing market. The division’s controller, Ismail Yousif, has felt pressure from the CFO to improve his division’s operating results by the end of the year. Yousif is considering the following options for improving the division’s performance by year-end:

a. Cancelling two of the division’s least profitable magazines, resulting in the layoff of 25 employees.

b. Selling the new printing equipment that was purchased in January and replacing it with discarded equipment from one of the company’s other divisions. The previously discarded equipment no longer meets current safety standards.

c. Recognizing unearned subscription revenue (cash received in advance for magazines that will be delivered in the future) as revenue when cash is received in the current month (just before fiscal year end) instead of showing it as a liability.

d. Reducing the division’s allowance for bad debt expense. This transaction alone would increase operating income by 5%.

e. Recognizing advertising revenues that relate to January in December.

f. Switching from declining balance to straight line depreciation to reduce depreciation expense in the current year.

1. What are the motivations for Yousif to improve the division’s year-end operating earnings?

2. From the point of view of the fundamental principles of ethical behavior for professional accountants (see Figure 1-10 on page 20), which of the preceding items (a–f) are acceptable? Which are unacceptable?

3. What should Yousif do about the pressure to improve performance?

Collaborative Learning Problem

1-31 Global company, ethical challenges. Rashid Logistics, an Egyptian shipping company, has just begun distributing goods across the Red Sea and the Indian Ocean to India. The company began operations in 2010, transporting goods to Yemen. The company’s earnings are currently trailing behind its competitors and Rashid’s investors are becoming anxious. Some of the company’s largest investors are even talking of selling their interest in the shipping newcomer. Rashid’s CEO, Isa Mahmad, calls an emergency meeting with his executive team. Mahmad needs a plan before his upcoming conference call with uneasy investors. Rashid’s executive staff make the following suggestions for salvaging the company’s short-term operating results:

a. Stop all shipping efforts to India. The start-up costs for the new operations are hurting current profit margins.

b. Make deep cuts in pricing through the end of the year to generate additional revenue.

c. Pressure current customers to take early delivery of goods before the end of the year so that more revenue can be reported in this year’s financial statements.

d. Sell-off distribution equipment prior to year-end. The sale would result in one-time gains that could offset the company’s lagging profits. The owned equipment could be replaced with leased equipment at a lower cost in the current year.

Required
e. Record executive year-end bonus compensation for the current year in the next year when it is paid after the December fiscal year-end.
f. Recognize sales revenues on orders received, but not shipped as of the end of the year.
g. Relocate the corporate headquarters to another country before the end of the year, lowering the company’s corporate tax rate to 12.5%.

1. As the management accountant for Rashid, evaluate each of the preceding items (a–g) in the context of the fundamental principles of ethical behavior for professional accountants (see Figure 1-10 on page 20). Which of the items are in violation of these ethics standards and which are acceptable?
2. What should the management accountant do with respect to those items that are in violation of the ethical standards for management accountants?