ACCOUNTING 2

RELEVANT INFORMATION AND DECISION MAKING

A. Criteria for relevant information
   1. Predicted future cost: Differ among alternatives
   2. Past data: Irrelevant
   3. Cost or revenue that remains the same regardless of the
      alternative: Irrelevant

B. Special Sales order
   1. Should accept when additional revenues > additional costs
   2. Fixed costs normally unaffected

C. Deletion or addition of products or departments
   1. Avoidable costs: Will not continue
   2. Unavoidable costs: Continue

D. Optimal use of limited resources
   1. Emphasize product with largest total profit
   2. Used in differential analysis

E. Role of costs in pricing decisions
   1. Marginal cost: Additional cost for one more unit produced
   2. Marginal revenue: Additional revenue from one more unit sold
   3. Price elasticity: Effect of price changes on sales volume

F. Influences on pricing in practice
   1. Legal requirements:
      a. Predatory pricing
      b. Discriminatory pricing
   2. Competition
   3. Costs
   4. Customer demand
   5. Target costing: Design a product that can be produced at
      a low enough cost to provide an adequate profit margin

G. Opportunity cost
   1. Max profit forgone by choosing an alternative
   2. Economic in nature

H. Outlay cost
   1. Requires cash outlay
   2. Accounting in nature
   3. Requires cash outlay

J. Make-or-buy decisions
   1. Identification and qualitative factors
   2. Focus on relevant costs

K. Joint product costs: Occur when two or more
   products have relatively significant sales values
   1. Not separately identifiable until split-off point
   2. Identify separable costs beyond split-off point
   3. Identify joint costs prior to split-off point
   4. Decide whether to sell or process further

L. Relevant range: Limit of cost-driver activity where
   FC/VC assumption is valid

INTRODUCTION TO COST SYSTEMS

A. Classification of costs
   1. Cost accumulation and cost objectives
      a. A cost is a sacrifice or giving up of resources for a purpose.
      b. A cost objective is something that managers want to
         know the cost of.
   2. Direct and indirect costs
      a. Direct costs can be identified specifically and
         exclusively with a given cost objective.
      b. Indirect costs cannot be identified with a given
         cost objective.
   3. Manufacturing costs
      a. Direct-material costs (DM): Costs of all materials
         that are physically identified as a part of the
         manufactured goods
      b. Direct-labor costs (DL): The wages of all the labor
         that can be traced to manufactured goods

B. Types of accounting systems
   1. Activity-based cost accounting
      a. Accumulate overhead costs for each activity
      b. Assign the costs to cost objects
   2. Cost management system
      a. Measure the resources used
      b. Assess the effects of costs of changes
      c. Purchase and produce when needed in the production
   3. Cost accounting for I/S and B/S
      a. Product cost: Identified with goods purchased or
         produced for resale and become expenses (CGS) when
         inventory is sold
      b. Period cost: Expensed during the current period
      c. Fixed costs normally unaffected

C. BUDGETING

A. Budgeting over time
   1. Strategic plan: Overall goals and objectives
   2. Long-range planning: For 5-10 yrs
   3. Capital budget: Planned expenditures for facilities,
      equipment, etc.

B. Advantages of budgets
   1. A planning tool
   2. Maintaining control by evaluating actual to budget
   3. Enhanced communication and coordination

C. Preparation of master budget
   1. Operating budget
      a. Prepare sales budget
      b. Estimate cash collections
   2. Financial budget
      a. Prepare cash budget
      b. Prepare purchases budget
      c. Estimate disbursements for purchases
   3. Master budget: Summarize all subunits
      a. Operating budget: Focus on I/S and its schedules
      b. Financial budget: Effects of operating and capital
         budgets on cash

D. Flexibilities - All budgets rely on sales budget
   1. Past patterns used
   2. Estimation
   3. Volatile economic environment

FLEXIBLE BUDGETS AND STANDARDS FOR CONTROL

A. Static budget = standard budget
   1. Performance report: Actual results vs. original plan
   2. Master budget variances
      a. Favorable or unfavorable
      b. Not useful for management by exception

B. Flexible budget = variable budget
   1. Adjust for changes in cost-drivers
   2. Prepared for a range of activity
   3. Reflect FC and VC behavior

C. Flexible budget variances
   1. Favorable or unfavorable
   2. Not useful for management by exception

D. Flexible budget variances: Flexible budget vs. actual results
   1. Activity level variances: Flexible budget vs. master budget

ACCOUNTING FUNCTIONS

A. Helps an organization to achieve its goals and
   objectives by gathering, organizing, and
   communicating information about its activities
B. Main uses
   1. Internal managers: Short-term planning, long range
      planning, controlling routine operations, and non-
      routine decisions
   2. External parties: Making decisions about the company
      based on information presented in financial statements
      governed by GAAP
C. An accounting system uses 3 types of activities
   1. Score-keeping to accumulate and classify data
   2. Attention-directing to focus on problems and opportunities
   3. Problem-solving to recommend the best course of action
D. Themes that guide the design of all accounting systems
   1. Cost/benefit criteria
   2. Behavioral implications; effects on the manager’s
      decision making
E. Accounting’s position in the organization
   1. Line authority: Downward over subordinates
   2. Staff authority: Downward, laterally, or upward
   3. The controller: Top accounting officer in an organization,
      measures and reports on operating performance
F. Accountants are expected to adhere to standards of
   ethical conduct

COST BEHAVIOR

A. Cost drivers: Activities that cause costs to
   be incurred
   1. Fixed: Cost per unit is constant; total cost
      varies with activity level
   2. Variable: Cost per unit varies; total cost
      varies with activity level

B. Relevant range: Limit of cost-driver activity where
   FC/VC assumption is valid

VARIATIONS OF COST BEHAVIOR

A. Cost drivers and cost behavior
   1. Cost behavior is assumed linear over some relevant
      range of activities or cost drivers.
   2. Cost behaviors that combine characteristics of both
      fixed and variable cost behavior
      a. Step costs: Either fixed or variable, changed abruptly
         at interval of activity because the resources and their
         costs come in divisible chunks
      b. Mixed costs: Contain elements of FC & VC

B. Management’s influence on cost functions
   Through decisions about product or service attributes,
   capacity, technology, and policies to create incentives
   to control costs

C. Measure cost behavior as a function of appropriate
   cost drivers
   1. Total cost = FC + VC
   2. Variable cost = (Variable cost x # of Units)
   2. Engineering analysis: what costs should be
   3. Accounting analysis:
      a. Volume related cost driver versus what cost could
         have been
      b. Classify each account as a VC or FC
   4. High-low, visual-fit, and least-squares methods:
      separate F & VC past data to predict costs

COST-VOLUME RELATIONSHIPS

A. Cost drivers: Activities that cause costs to
   be incurred
   1. VC: Change in direct proportion to the cost driver
   2. FC: Do not change immediately with the cost driver

B. Variable costs vs. fixed costs
   1. VC: Changes in opposite proportion to the cost driver
   2. FC: Normally unaffected

C. Cost-volume-profit analysis
   1. Break-even point: Level of sales at which revenues = expenses
   2. Contribution (CM) = sales price/unit - VC/unit
   3. Contribution margin = CM/Unit
   4. Break even in units = FC/CM per unit
   5. Break even in $ = FC/CM ratio

D. Relevant range: Limit of cost-driver activity where
   FC/VC assumption is valid

FLEXIBLE BUDGETS AND STANDARDS FOR CONTROL

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B. Flexible budget = variable budget
   1. Adjust for changes in cost-drivers
   2. Prepared for a range of activity
   3. Reflect FC and VC behavior

C. Flexible budget variances
   1. Flexible budget vs. actual results
   2. Activity level variances: Flexible budget vs. master budget
C. Isolation of variances and their causes
1. Effectiveness: Degree to which a goal or target is met, measured by sales-activity variance
2. Efficiency: Inputs used in relation to outputs, measured by flexible budget variance
3. Expected cost: Most likely to be attained
4. Standard cost: Should be attained; Budget for one unit

D. Flexible budget variances
1. Variances from material and labor standards
   a. Price (rate) variance: Difference between actual input price and standard price
   b. Usage (quantity or efficiency) variance: Difference between quantity of input used and quantity allowed for actual output
2. Overhead variances
3. Overhead (OH) variances
   a. Variable OH efficiency variance
   b. Variable OH spending variance

**MANAGEMENT CONTROL SYSTEMS**

A. MCS: an integration of management accounting tools
1. Organizational goals: #1 in designing MCS (broad)
2. Organizational sub-goals: Means of achieving organization’s overall goals (mid-range)
3. Organizational objectives: Day-to-day guidance (specific)
4. Balance of goals, sub-goals, and objectives: Overemphasis on short term to the detriment of long range threatens achievement of organization’s basic goals

B. Designing a MCS
1. Working within constraints; MCS must fit organization’s structure (i.e.: whether it is by function or division)
2. Identification of responsibility centers
   a. Cost center: Where costs are accumulated
   b. Profit center: Measures revenue less costs
   c. Investment center: Measures net income to invested capital
3. Weighing costs and benefits: Maximum benefits at minimum cost
4. Motivation of employees
   a. Goal congruence: Individuals and groups aim at same goals
   b. Managerial effort: Exertion toward goal or objective
5. Design of internal controls: Prevent, detect errors & irregularities and promote operational efficiency
   a. Accounting controls: Separation of duties, etc.
   b. Administrative controls: Budgets for planning, controlling, and evaluating
6. Development of measures of performance: For both financial & non-financial performance measures

C. Control and measurement of financial performance
1. Uncontrollable costs: Cannot be affected by management within a given time span
2. Controllable costs: Influenced by management’s decisions
3. Contribution margin
4. Contribution by segment-controllable by responsibility center managers
5. Unallocated costs

D. Control and measurement of non-financial performance
1. Quality control
   a. Prevention: Costs to prevent defects/substandard service
   b. Appraisal: Costs to identify defects/substandard service
   c. Internal failure: Costs to scrap or rework
   d. External failure: Customer dissatisfaction
2. Control of time cycle
3. Control of productivity

**CAPITAL BUDGETING**

A. Discounted cash flow models
1. Net present value (NPV) method
   a. Total project approach: Choose largest NPV
   b. Differential approach: Choose if NPV is positive
2. Internal rate of return (IRR) method: choose if IRR > desired rate of return
3. Risk assessment and sensitivity analysis
4. Complications: Income taxes, inflation, mutually exclusive projects, and unequal lives

B. Pay-back method: P = I/O
1. Pay-back time = Initial investment / Annual cash flow
2. Does not measure profitability
3. Ignores time value of money

C. Accounting rate-of-return (ARR) method: ARR = (O - D)/I
1. Increase in operating income - dept.) / initial investment
2. Ignores time value of money

D. Performance evaluation
1. Conflict: Evaluations based on accounting measures can deter from making major long-term decisions with large initial investments
2. Reconciliations of conflict
   a. Post audit: Monitor and evaluate projects
   b. Base management evaluations on different priorities

**TAXES AND INFLATION**

A. Marginal income tax rate
   Tax rate paid on additional amounts of pretax income
B. Recovery period
   Number of periods assets are depreciated for tax purposes
C. Tax shields; deductions protect that amount of income from taxation
D. Accelerated depreciation
   1. Writes off assets quicker than straight-line method
   2. Tax avoidance (minimizing and delaying taxes)
   3. Double declining balance depreciation: (100%/# of years asset is to be depreciated) x 2

E. Depreciation and equipment replacement
1. Initial investment
   a. Cost of old equipment: Effect on tax cash flows
   b. Cost of new equipment is relevant
2. Do not double count: Equipment investment is a one-time outlay not to be double-counted as an outlay in the form of depreciation
3. Relation to income tax cash flow: Income tax cash effect relevant (Not the book value or depreciation)

F. Gains or losses on disposal
1. Losses produce tax savings and gains produce tax expenditures
2. Gains are still more desirable than losses

G. Capital budgeting and inflation
1. Nominal rate: Quoted market interest rate
   a. Includes an element of inflation
   b. Use for minimum desired rate of return
2. Depreciation: Deductions; No allowance for inflationary effects

H. After-tax impact of operating cash inflows
   Inflow x (1-tax rate)

**ACTIVITY BASED COSTING**

A. Variable vs. absorption costing
1. Accounting for fixed manufacturing overhead
   a. Variable costing method: FFO is excluded
   b. Absorption costing method: FFO is included
2. Variable method
   a. Apply all variable manufacturing costs to goods produced
   b. Fixed FO is expensed as incurred
   c. L/S separates costs into categories of fixed and variable
3. Absorption method
   a. Apply all variable manufacturing costs plus part of fixed FO to each product
   b. L/S separates costs into categories of manufacturing and non-manufacturing
   c. Fixed overhead rate = budgeted fixed overhead/expected cost driver activity
   d. Production-volume variance: Actual production deviates from the expected volume used

B. Fixed overhead and absorption costing of product
1. Variable and fixed unit costs
2. Production-volume variance = applied fixed overhead-budgeted fixed overhead
   a. Actual production volume does not coincide with expected volume
3. Fixed overhead rate depends on expected activity level chosen
4. Actual costing: Actual materials, actual labor, and actual variable and fixed overhead
5. Normal costing: Actual materials, actual labor, and budgeted rates for FO
6. Standard costing: Budgeted rates

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