

ACCOUNTING AS A TOOL FOR MANAGEMENT



UNITS

LEARNING OBJECTIVES

UNIT 1.1 What Is Managerial Accounting?

- LO 1:** Define managerial accounting.
- LO 2:** Describe the differences between managerial and financial accounting.
- LO 3:** List and describe the four functions of managers.

UNIT 1.2 Different Strategies, Different Information

- LO 4:** Explain how the selection of a particular business strategy determines the information that managers need to run an organization effectively.

UNIT 1.3 Ethical Considera- tions in Managerial Accounting

- LO 5:** Discuss the importance of ethical behavior in managerial accounting.



What Is Managerial Accounting?

GUIDED UNIT PREPARATION

Answering the following questions while you read this unit will guide your understanding of the key concepts found in the unit. The questions are linked to the learning objectives at the beginning of the chapter.

- | | |
|-------------|---|
| LO 1 | 1. Define managerial accounting in your own words. |
| LO 2 | 2. Who are the primary users of financial accounting information?
3. Who are the primary users of managerial accounting information?
4. Compare and contrast managerial and financial accounting information. |
| LO 3 | 5. What are the four functions of management? How does management carry out each function? |

What do a marketing manager, a human resources manager, and a production manager have in common? A large part of their job is decision making. To make the best decisions possible, these managers need a wealth of good information. Much of that information will be the product of a managerial accounting system.

Watch the **What is Managerial Accounting?** and the [Pizza Hut Managerial Accounting Today](#) videos in WileyPLUS for an introduction to managerial accounting.

Definition of Managerial Accounting

You may be wondering, “What is managerial accounting? Is it accounting done by managers? Is it managers’ accountability for their actions?” The Institute of Management Accountants (IMA[®]), the leading worldwide professional organization for management accountants and finance professionals, first defined managerial accounting in 1981 as “the process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of financial information used by management to plan, evaluate, and control within an organization and to assure appropriate use of and accountability for its resources.”¹ However, in recognition of the increasingly strategic role that managerial accounting plays in today’s organizations, the IMA issued the following revised definition in December 2008.

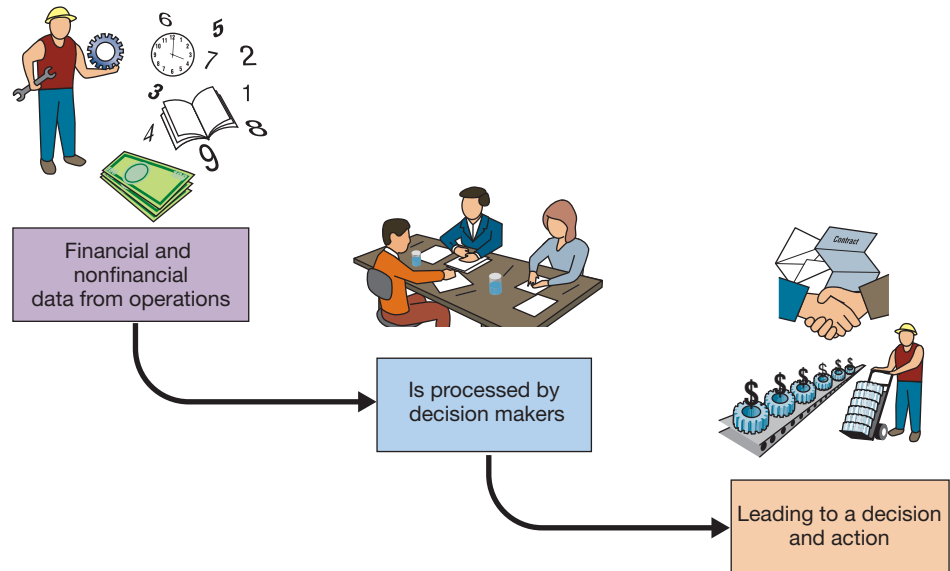
Management accounting is a profession that involves partnering in management decision making, devising planning and performance management systems, and providing expertise in financial reporting and control to assist management in the formulation and implementation of an organization’s strategy.²

What does this formal definition really mean? Simply put, **managerial accounting** is the generation and analysis of relevant information to support managers’

strategic decision-making activities. In this context, relevant information is information that will make a difference in the decision (see Exhibit 1-1). Managerial accounting adds value to the organization by helping managers do their jobs more efficiently and effectively. In a recent article, Peter Brewer discusses how management accounting adds value to the organization “by providing leadership, by supporting a company’s strategic management efforts, by creating operational alignment throughout an organization, and by facilitating continuous learning and improvement.”³

EXHIBIT 1-1

Managerial accounting.



Comparison of Managerial and Financial Accounting

If you have completed a financial accounting course, you are familiar with many of its concepts. If you have not already taken a financial accounting course, you may have read about financial accounting issues in publications such as *The Wall Street Journal* or *Bloomberg Businessweek*. If you have a little knowledge of financial accounting, it will be useful to compare and contrast what you know about financial accounting to managerial accounting. Exhibit 1-2 summarizes the differences between managerial accounting and financial accounting.

EXHIBIT 1-2

Comparison of managerial and financial accounting.

	Managerial Accounting	Financial Accounting
Primary users	Internal—managers and decision makers	External—investors and creditors
Mandated rules	None	Generally accepted accounting principles (GAAP)
Reporting unit	Organizational segments such as divisions, locations, and product lines	Organization as a whole
Time horizon	Past results and projected future results	Past results
Timing of information	As needed, even if information is not exact	After the end of an accounting period

Internal versus External Users

When most people think about accounting, they think about financial statements such as those contained in corporate annual reports. The purpose of such statements is to communicate information about the financial health of a company to external users—people outside the company such as creditors and current or potential investors. The information contained in financial statements benefits those external users who otherwise would have no access to financial or operating information about a company.

Managerial accounting, on the other hand, benefits internal users. It includes reports and information prepared for a range of decision makers within the organization. These reports come in a variety of formats, each designed to provide the ultimate decision maker with the appropriate information.

The information provided by managerial accountants is *not* disseminated to the general public. To do so would be to provide competitors with vital information about corporate strategies and capabilities. Imagine what could happen if Samsung were to report publicly what it cost the company to produce a 55-inch 4K ultra-high-definition television. If Samsung's cost was higher than Sony's, Sony's sales manager could start and win a price war simply by setting Sony's price lower than Samsung's cost. Sony would still make money on the televisions it sold, but at the lower price, Samsung would lose money.

Lack of Mandated Rules

All public companies that are traded on a United States stock exchange and governed by the Securities and Exchange Commission (SEC) must prepare financial statements following **generally accepted accounting principles (GAAP)**. Many other nonpublic companies prepare GAAP-based financial statements at the request of creditors. GAAP “rules” govern how transactions are valued and recorded and how information about them is presented. Since external users of financial statements have no way to verify the reported information, GAAP provides a level of protection or assurance that the reports will follow certain standards. Managerial accounting, on the other hand, has no comparable set of rules governing what information must be provided to decision makers or how that information is presented. Since internal users have access to all of the underlying data, they can create reports that suit their particular decision-making needs. In fact, managerial accounting is completely optional—a company does not have to prepare managerial accounting reports. However, a company is unlikely to be successful in the long run without adequate managerial accounting information to support decision makers.

Consider the case of a family-run lumber mill that borrowed \$2 million from the bank to modernize its operations, but then had trouble generating enough cash to repay the loan. The bank brought in consultants to improve the mill's profitability. In talking with the lumber mill's president and accountant, the consultants realized that the company had not prepared basic managerial accounting information such as the cost of producing a particular size of lumber. The product that managers thought was most profitable (because the company could sell all it could produce) was actually being sold at a loss. Unfortunately, the mill was not able to return to profitability and was eventually sold to satisfy the bank's loan.

Focus on Operating Segments

GAAP-based financial statements present a picture of the financial health of the company as a whole. Think about how inventory is reported on the balance

sheet. If the company is a merchandising firm, inventory is just one number. But does [Macy's](#) department store have only one kind of inventory? Of course not. The store sells men's clothes, women's clothes, shoes, and many other items. In each of those categories Macy's carries different styles, colors, and sizes. How could a manager know how well a certain item sells by looking at one number on a balance sheet? It would be impossible.

Macy's inventory decision is just one example of the decisions managers face. Because most managerial decisions are made at an operating-segment level, managerial accounting information must focus on smaller units of the company. Decision makers need to know about product lines, manufacturing plants, business segments, and operating divisions.

Focus on the Future

Financial accounting exists to report the results of operations. The basic financial statements always report on transactions and events that have already occurred. Thus, the information contained in these financial statements is historical in nature. Managerial accounting, too, reports historical information, often with the purpose of comparing actual results to budgeted results. But managerial accounting helps managers to make decisions that will affect the company's future by projecting the results of certain decisions. That does not mean that managerial accountants don't use historical amounts in developing future projections, but it does mean that they can and will estimate the future results of certain decisions. That is the only way to evaluate whether a decision will have a positive or negative effect on the company.

Suppose [Panera Bread](#) is trying to decide whether to open a new restaurant in Greenville, South Carolina. Before making a decision, managers will project the new restaurant's sales and profits. While they might look at the historical performance of their other restaurants in the Greenville area, ultimately it is their future projections rather than past performance that will determine whether they open a new store.

Emphasis on Timeliness

Suppose you have been thinking about opening a business. One day, you just happen to drive by what looks like the perfect location. You call the real estate broker who listed the property to get details and are offered what appears to be an attractive price if you purchase the property within 48 hours. You might like to do a lot of detailed research and analysis first, but time will not allow you that luxury. You have only two days to get all your information together. So you do the best you can and then decide whether to purchase the building.

Because of the nature of many business decisions, managerial accountants place more emphasis on the timely delivery of information than on the delivery of information that is precise to the penny. Financial accountants, in contrast, record transaction amounts to the penny, and it often takes weeks or even months after the end of the period to gather all of the necessary information to prepare accurate reports for external users.

Time-limited windows of opportunity often arise in business. Decision makers might have a long list of information they would find helpful, and they might want that information to be very accurate. But sometimes they might need to sacrifice precision for timeliness and make a decision without all the information they want. After all, receiving highly accurate information after the deadline has passed would be of no help. J. David Flanery, [Papa John's International, Inc.](#)'s then senior vice president, CFO, and treasurer, told students at the 8th Annual

IMA Student Leadership Conference that “Most decisions are made without 100% certainty, so you’ve just got to trust your gut. . . . There is a range of possible answers. . . . So you’ve got to go with a decision and move ahead—and have confidence in your own judgment to do that.”⁴

The Manager’s Role

Have you ever been in a group of people who are trying to decide which restaurant to go to? Often in this type of situation, everyone is waiting for someone else to make the decision. As a result, nothing gets done. The same is true in business. Someone with authority must take responsibility for making decisions and directing operations. That person is a manager. Managers are found throughout the organization, from the lower operational levels up to the chief executive officer’s suite.

Managerial accounting is designed to assist managers with four general activities: planning, controlling, evaluating, and decision making (see Exhibit 1-3). While this list may appear to imply a linear relationship between the four activities, in practice that is not the case. Frequent feedback from all four activities creates more of a circular decision-making process.

	Planning	Controlling	Evaluating	Decision Making
<i>What is it?</i>	Strategic: deciding on long-term direction of corporation Operational: deciding how to implement long-term strategy	Monitoring day-to-day operations to ensure that processes operate as required	Comparing actual results to planned results for the period	Choosing a course of action
<i>Who does it?</i>	Strategic: upper management Operational: upper and middle management	Managers and workers	Managers	Managers and workers
<i>When is it done?</i>	Strategic: annually, focusing on a 5- to 10-year period Operational: monthly, quarterly, or annually, focusing on no more than the next 12 months	In real time, hourly, daily—the sooner the better	Weekly, monthly, quarterly, annually	As needed
<i>Examples</i>	Preparing the annual operating budget that allocates resources	Checking a sample of products to determine whether they are in compliance with customer specifications	Reviewing the regional sales history for the year during the regional sales manager’s annual performance appraisal	Dropping a slow-selling product from the catalog

EXHIBIT 1-3 The role of managers.

Planning

Managers participate in both short-term and long-term planning activities. **Long-term planning**, often referred to as strategic planning, establishes the direction in which an organization wishes to go. Managers must decide where the company

is currently and where they want it to be in the future. Typical questions asked during the strategic planning process include: “Who are we?”; “What do we do?”; “What value do we deliver to our customers?” “Why do we do what we do?” and “Where do we want to go?” Many organizations prepare a formal strategic plan that documents the answers to these questions and provides direction for a five- to ten-year period.

Once a strategy has been established for the organization as a whole, managers begin to develop plans for achieving that strategy. **Short-term planning** or **operational planning** translates the long-term strategy into a short-term plan to be completed within the next year. One of the primary products of this planning stage will likely be a budget that specifies how resources will be spent to achieve the organization’s goals. Managerial accountants provide much of the information that is used to prepare the budget.

Consider the case of San Francisco-based [Design Within Reach, Inc.](http://www.dwr.com/), a retailer of modern design furniture and accessories (<http://www.dwr.com/>). When founder Rob Forbes experienced difficulty acquiring modern design furniture for his home, he decided that there had to be a better way to buy furniture. His company has adopted a strategy of accessibility, selling its products through multiple channels including a catalog, a sales force, a website, and retail showrooms. Design Within Reach delivers value to customers by maintaining its inventory in a single warehouse and shipping the majority of orders within 24 to 48 hours. Compared to what can be a three- to six-month wait for delivery at many other dealers, its service is exceptional.

Strategically, Design Within Reach aimed to become the country’s leading provider of modern design furniture and accessories. To accomplish this goal, the company opened 66 studios, two DWR: Tools for Living stores, two outlets, and one fulfillment center between 2000 and 2008. Unfortunately, a fast expansion coupled with a weakened economy created financial difficulties for the company, and the company voluntarily delisted itself on the Nasdaq stock exchange in July 2009. By early 2010, company managers decided to close the Tools for Living stores, though the product line was still available through other outlets. Herman Miller purchased the company in 2014, and today Design Within Reach operates 32 studios, one outlet, and one warehouse. Though the fundamental strategy has not changed, managers continue to look for more focused ways to implement the strategy.⁵

Controlling and Evaluating

After plans have been put in place and the organization has begun to move toward its goals, managers become involved in **controlling** activities. One purpose of controlling activities is to monitor day-to-day operations to ensure that processes are operating as expected. If something appears out of line, corrective action should be taken before the problem becomes worse. For instance, [Kellogg’s](#) monitors how much Raisin Bran[®] goes into each cereal box. If the box is supposed to have 20 ounces of cereal, the company doesn’t want to overfill it with 23 ounces or underfill it with only 19 ounces. Without controlling activities, an organization will not be able to track its performance in implementing the strategic plan.

Managers can perform controlling activities in real time as operations are occurring, or they may choose to perform them once an hour or once a day. The frequency will be based on the potential consequences of the process being out of control. All other things held equal, the more frequent the controlling activity, the faster an out-of-control process can be corrected. And generally, the faster the process is corrected, the better the results.

Besides production processes, managers also monitor individual employees' actions, though less frequently than they do process control. Managers want to motivate employees to help the organization achieve its strategic plan and must assess how well they have performed relative to expectations. This task is an **evaluating** activity. Once operations have been completed (say, at the end of a job or a period), managers review the information and compare actual results to planned results. The results of this evaluation may lead to changes in business processes, or even in strategy. To help managers with their evaluations, managerial accountants often perform variance analysis and prepare performance reports. The information they prepare is used by managers as the basis for evaluating employees and awarding bonuses.

THINK ABOUT IT 1.1

Companies that buy online advertising often pay search engine sites based on the number of times that web surfers "click" on the company's hyperlink. This practice has given rise to "click fraud" in which the company's competitors erode the advertising budget or websites increase their advertising revenues through false clicking on such links. As a manager, how could you use controlling activities to determine whether your company is a victim of "click fraud"?⁶

Decision Making

Decision making is at the forefront of managerial activity. A human resource manager must select the best health care plan for the company's employees. A sales manager must decide whether to pay the sales staff a salary or a commission. An advertising manager must choose the campaign that will deliver the best message to potential customers. An operations manager must select the best piece of equipment. Managers face such choices on a daily basis. Before making a decision, they need information about the available alternatives. Managerial accountants provide much of that information.

Management in Action

Let's look at a real-world example of the four managerial functions in action. **GLK Foods, LLC** (<http://www.glkfoods.com>) traces its roots in Bear Creek, Wisconsin, back to 1900. Annual sauerkraut production at its plants is now more than 125,000 tons, making the company the world's largest sauerkraut producer, with over 85% of the market in the northern hemisphere. How do managers at GLK Foods plan, control, evaluate, and make decisions?

One of the planning activities that occupies managers is inventory planning. To produce 125,000 tons of sauerkraut, the company must obtain 170,000 tons of raw cabbage. That means planning cabbage purchases, production schedules, and inventory levels. Inputs to the planning process include projected sales forecasts, projected cabbage supply and prices, and anticipated manufacturing capacity. The outcome of this planning process includes a production schedule

The managers at GLK Foods must use their sales forecast to determine how much cabbage to buy to meet anticipated demand. Then they use actual orders from customers to schedule production.

Courtesy of GLK Foods



and an operating budget. One thing that makes the planning process a challenge is that all the cabbage used in production for the entire year is harvested between September and November. After the harvest is over, no more cabbage can be purchased to cover unexpected increases in demand.

Once the plan is in place and sauerkraut production has begun, managers control and evaluate production. They monitor actual production rates and output, checking them against the plan to ensure that the desired inventory levels will be there when needed. If a machine breaks down, causing production to slip behind schedule, managers might ask employees to work overtime or shift to another production line for a time. At the end of the month, they compare actual production to the plan, evaluate the results, and make any necessary changes to the plan for the next month.

Throughout this process, decision making takes place almost automatically, as managers decide what to do based on their controlling and evaluating activities. Sometimes managers face unexpected events and must evaluate their alternatives for responding. One such event occurred when studies suggesting that sauerkraut might serve as a preventative for avian or bird flu surfaced in the media in 2005. According to Ryan Downs, co-owner of GLK Foods, same-store sales rose 15% after the studies were made public. Since the stories broke just before the end of the cabbage harvest, GLK was able to adjust its plan, purchasing all the cabbage its farmers could deliver to cover the anticipated increase in demand for the coming year. The company purchased about 20% more cabbage than originally planned. To meet the increased demand, managers ramped up production schedules from 40 to 50 hours a week.

The Managerial Accountant's Role

Just as managers in different areas of the organization use managerial accounting information to make decisions, a variety of accounting personnel provide this information. Managerial accounting information can be provided by a controller,

a plant accountant, a cost accountant, a financial analyst, a budget or cost analyst, a general accountant, or even a chief financial officer. And these accountants aren't necessarily located in the accounting department. Some organizations prefer to locate accounting personnel within the operating units, where they can learn about the business processes they are supporting.

To understand what functions preparers of managerial accounting information perform, the IMA conducted two studies, *The Practice Analysis of Management Accounting* (1995) and *Counting More, Counting Less: Transformations in the Management Accounting Profession* (1999). The authors of these studies found that preparers of managerial accounting information are no longer solely number crunchers but active participants in the decision-making process. Across the organization, their skill at analyzing and interpreting financial and operating data is becoming more valuable. These accounting personnel reported that the time they spend analyzing information and making decisions has increased, and they expect it to continue to increase. They are also spending more time doing strategic planning and internal consulting and less time preparing standard financial reports than in the past. Exhibit 1-4 shows the reported changes in their work.⁷

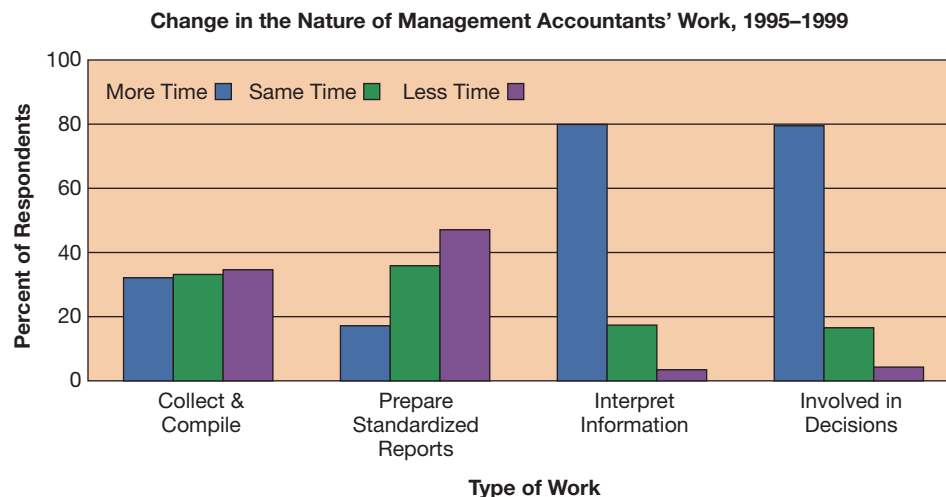
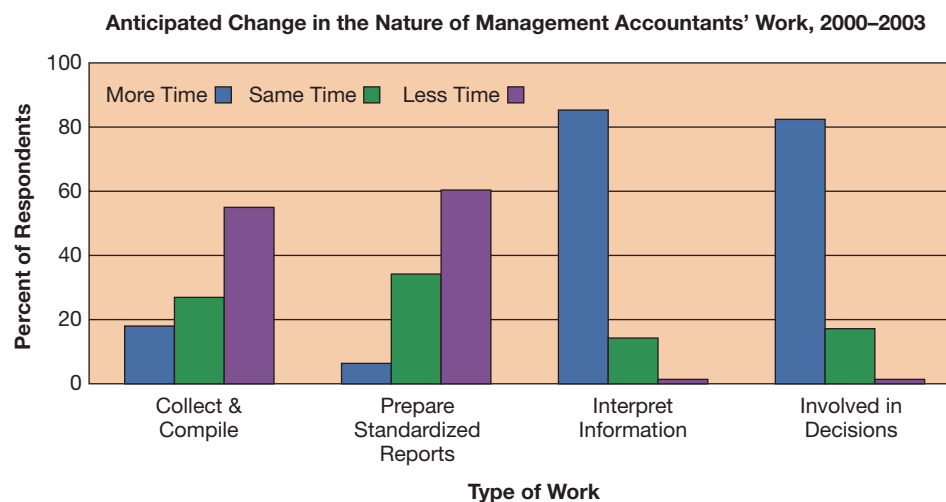


EXHIBIT 1-4

The changing nature of management accountants' work.



Source: Gary Siegel and James E. Sorensen, *Counting More, Counting Less: Transformations in the Management Accounting Profession* (Institute of Management Accountants, 1999); Montvale, NJ.

REALITY CHECK—*Taking a sales route detour can be a good thing*

© Igor Dutina/iStockphoto



With these routes accounting for 71% of net sales revenue in 2014, early indications are promising.

What would you do if a customer backed out of an order for 500 pounds of raw peanuts? In Phillip L. Lance's case, he roasted them and peddled them on the streets of Charlotte, NC. And that's how [Lance, Inc.](#) started in 1913. From those humble beginnings, Lance, Inc. developed a vast direct-store delivery route system and grew into a leader in the snack food industry.

Almost 100 years later, after a two-year drop in sales and net income, managers developed plans to revamp the company's sales route system with the goal of removing unprofitable, low-volume customers so that salespeople could spend more time servicing profitable customers. By the end of 2009, the company had reduced the number of direct-store delivery routes by 33% while increasing the average sales per stop and average sales per route. Without a program of strategic planning, control, and evaluation, managers would not have recognized the need to realign the sales routes, nor would they have been able to measure the results of their decisions.

In 2010, Lance and [Snyder's of Hanover](#) agreed to a "merger of equals," creating an even stronger national snack foods company. [Snyder's-Lance](#) continued the Lance model of direct-store delivery routes and now supports approximately 3,100 routes. While many of these routes once had been company-owned, most of the routes now are serviced by independent business operators. The company re-engineers the routes when sales volume increases.

Time will tell if the company's decision to divest its routes was a good move. But with these routes accounting for 71% of net sales revenue in 2014, early indications are promising.

Sources: Gillian Wee, "Lance Reshuffles Its Snack Strategy," *The Charlotte Observer*, March 20, 2005, 1D; Lance, Inc., 2003 Annual Report; Lance, Inc., 2003 Form 10-K; Lance, Inc., 2009 Form 10-K; Snyder's-Lance, Inc., 2011 Form 10-K; Snyder's-Lance, Inc., 2014 Form 10-K; <http://northcarolinahistory.org/encyclopedia/lance-incorporated/> (accessed June 28, 2016) Snyder's-Lance 2011 Annual Report.

UNIT 1.1 REVIEW

KEY TERMS

Controlling p. 8
Decision making p. 9
Evaluating p. 9

Generally accepted accounting principles (GAAP) p. 5
Long-term planning p. 7

Managerial accounting p. 3
Short-term (operational) planning p. 8

PRACTICE QUESTIONS

- LO 1** The goal of management accounting is to provide accurate financial records for external reporting. True or False?
- LO 2** Which of the following is *not* characteristic of managerial accounting?
 - Providing information to internal users
 - Focusing on historical cost information
 - Focusing on operating segments
 - Emphasizing the timeliness of information
- LO 2** Managerial accounting information need *not* comply with generally accepted accounting principles. True or False?
- LO 3** Operational planning converts a strategic plan into short-term action steps. True or False?
- LO 3** Controlling activities compare actual annual results to planned annual results for the purpose of awarding managers' bonuses. True or False?

UNIT 1.1 PRACTICE EXERCISE

Marcie Scott owns several laundromats in Morrisville. Identify each of the following actions she performs as a planning, controlling, evaluating, or decision-making activity.

	PLANNING	CONTROLLING	EVALUATING	DECISION MAKING
1. Marcie prepares a budget for the next year.				
2. Marcie chooses to replace the 10-year-old washing machines with the latest model.				
3. Marcie looks at her income statement for the last month to see how well the business performed.				
4. Marcie checks the change machine to make sure that it dispenses four, and only four, quarters for each dollar bill inserted.				

SELECTED UNIT 1.1 ANSWERS

Think About It 1.1

You could compare the actual click-through volume to historical or planned click-through volume. If the additional click-throughs are legitimate, the company should see a corresponding increase in sales volume. If actual

click-through volume is higher than historical or planned volume—particularly if there is not a corresponding increase in sales volume—your company may be a victim of “click fraud.”

Practice Questions

1. False
2. B
3. True
4. True
5. False

Unit 1.1 Practice Exercise

1. Planning: Marcie is determining the resources required to operate next year.
2. Decision making: Marcie is deciding to take action.
3. Evaluating: Marcie is evaluating operations by comparing actual results against expectations.
4. Controlling: Marcie is monitoring daily operations to ensure that processes are operating as expected.

Different Strategies, Different Information

GUIDED UNIT PREPARATION

Answering the following questions while you read this unit will guide your understanding of the key concepts found in the unit. The questions are linked to the learning objectives presented at the beginning of the chapter.

- LO 4**
1. How does information assist in achieving corporate strategy?
 2. How does corporate strategy influence the selection of information used in decision-making activities?

Have you ever heard the saying “If you don’t know where you’re going, you’ll probably end up somewhere else”? Well, that adage certainly applies to business. Companies that want to be successful have to know what they want to accomplish and how they are going to achieve it. That is, they must have goals and a strategy for achieving those goals. Without goals and a strategy, a company will flounder and may even be forced out of business. Managerial accounting information is an invaluable tool that provides feedback about how well the organization is implementing its strategy and achieving its goals.

Matching Accounting Information to an Organization’s Strategy

In his book *Competitive Advantage*, management strategy expert Michael Porter argues that one important characteristic of effective management is a set of clear strategic priorities. But if those priorities are to be realized, the organization must develop supporting business processes and information systems. Managers must also realize that as strategies change, so must the accounting information that is used to monitor their achievement.

Product Differentiation versus Low-Cost Production

Porter developed a strategic framework in which the firm has two ways to develop a competitive advantage: product differentiation and low-cost production.⁸ If the company follows a strategy of product differentiation, it will seek ways to set its products apart from those of its competitors in terms of quality, design, or service. If it chooses to follow a low-cost production strategy, the company will set itself apart from competitors in terms of a lower sales price.

Monitoring these two strategies requires different accounting information. For the product differentiation strategy, companies will want information on

REALITY CHECK—*What's the price tag for a new strategy?*

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While early results of the new strategy were promising, implementing the new strategy has been costly on several fronts.

Strategic planning lies at the heart of successful organizations, whether for-profit or not-for-profit. Articulating the strategic direction of the organization allows managers to translate that strategy into an operating plan and then take action.

Sometimes organizations change their strategic direction, as J. C. Penney did when it rolled out its new Fair and Square™ pricing strategy on February 1, 2012. In an attempt to revitalize the company, new CEO Ron Johnson devised the new pricing strategy that offered three price points. “Everyday prices” promised consumers a fair price every day of the year and were set at an average 40% markdown of previous listed prices. “Month-long prices” were specific month-long sales promotions. Finally, “best prices” were clearance prices that were announced on the first and third Fridays of each month.

Why is this new strategy a challenge? J. C. Penney’s customers were accustomed to frequent sales—the company had featured 590 unique promotions in the previous year. And customers were used to not paying the list price—almost 75% of the company’s revenue had been from products sold at 50% or more off the original ticket price.

While early results of the new strategy were promising, implementing the new strategy has been costly on several fronts. Sales revenue declined dramatically in 2012, and after three straight quarters of losses, the company’s stock price was down 62% and its credit rating was at “junk” status. As a result, Johnson eliminated one of the price levels and labeling periodic sales as “clearance” prices.

But this change was too little too late. The company’s board of directors fired Johnson in April 2013 and brought back former CEO Mike Ullman. Ullman quickly reinstated the company’s previous promotional pricing model, but the pricing woes were far from resolved. The company faced a class action lawsuit for marking up prices just so it could mark them down, which it settled for \$50 million in November 2015.

Sources: J. C. Penney Company, Inc. 2011 Annual Report; Anne D’Innocenzio, “JC Penney CEO Tries to Change the Way We Shop,” *U.S. News and World Report*, November 17, 2012, <http://www.usnews.com/news/us/articles/2012/11/17/jc-penney-ceo-tries-to-change-the-way-we-shop> (accessed June 28, 2016); Gail Hoffer, “JCP Teaches a ‘Fair and Square’ Lesson on Pricing, Marketing and Image,” *RetailingToday.com*, July 27, 2012, <http://www.retailingtoday.com/article/jcp-teaches-%E2%80%99fair-and-square%E2%80%99-lesson-pricing-marketing-and-image> (accessed November 26, 2012); Susanna Kim, “J.C. Penney Returns to Coupons and Marks Up Prices,” *abcnews.go.com*, June 5, 2013, <http://abcnews.go.com/Business/jc-penney-admits-marking-prices-order-customers-discounted/story?id=19323843> (accessed June 11, 2013); Hiroko Tabuchi, “J.C. Penney Settles Shoppers’ Suit Over False Advertising,” *The Wall Street Journal*, November 11, 2015, http://www.nytimes.com/2015/11/12/business/jc-penney-settles-shoppers-suit-over-false-advertising.html?_r=0 (accessed February 2, 2016); Brad Tuttle, “The Price is Righter,” *Time*, February 13, 2012, <http://www.time.com/time/magazine/article/0,9171,2105961,00.html?pcd=pw-ml> (accessed November 26, 2012).

quality, such as defect rates, percentage of on-time deliveries, and customer satisfaction. For a low-cost production strategy, managers will be more interested in monitoring the production process. That doesn’t mean, however, that other kinds of information should be neglected. A company that focuses on product differentiation must monitor product costs because, if too much money is spent on quality, the sales price will be too high to be competitive. Likewise, even a low-cost producer must monitor product quality because consumers demand a certain level of quality. Either way, managers must monitor external information, such as competitor actions, to evaluate the likelihood of successfully implementing the strategy.

Market Share: Build, Hold, Harvest, or Divest

Strategies can also be classified based on a firm's approach to market share growth,⁹ or the trade-off between short-term earnings and market share. There are four such strategies: build, hold, harvest, and divest. Under a build strategy, a company aims to increase its market share and competitive position relative to others in the industry, even at the expense of short-term earnings and cash flows. Under a hold strategy, a company seeks to maintain its current market share and generate a reasonable return on investment. A harvest strategy focuses on short-term profits and cash, even at the expense of market share. A divest strategy is appropriate when a company desires to exit a particular market.

Companies that want to build market share need information about sales volumes, sales growth, market share growth, sales from new customers, and customer satisfaction. Managers who understand the firm's strategy won't worry when cash balances decrease over the short term. However, they will need to monitor those cash balances to know when to borrow money in order to avoid a cash crisis. Useful information for monitoring a hold strategy would include percentage of sales from repeat customers, market share, return on investment, and gross margin. To monitor a harvest strategy, managers will want to know about gross margin and cash sales.

Monitoring Strategic Performance

Information can be provided to managers who are monitoring strategic progress using several tools and management philosophies. Many of these are relatively new to managerial accounting; some of the more common are introduced here.¹⁰

The Balanced Scorecard

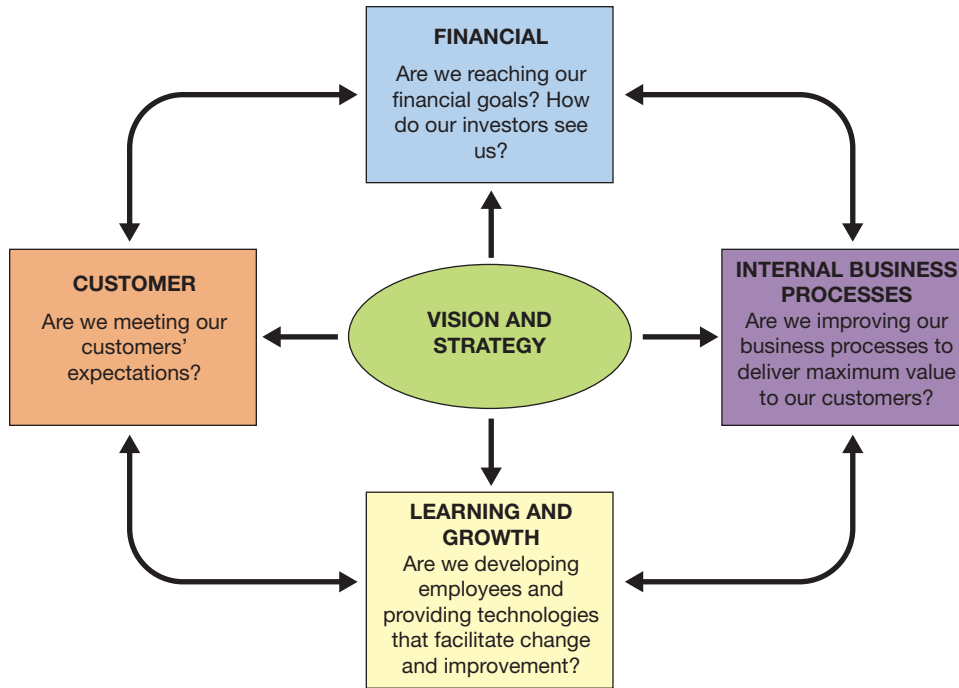
One tool that managerial accountants have developed to assist in monitoring organizational performance is the **balanced scorecard**. Developed in the early 1990s by David Norton and Robert Kaplan, the balanced scorecard is a collection of performance measures that track an organization's progress toward achieving its goals.¹¹ The selection of performance measures to be included on the scorecard is driven by the organization's strategy. The balanced scorecard is then used to communicate the corporate strategy throughout the organization.

Historically, firms have measured their performance through financial measures, such as stock price and sales revenue. While the balanced scorecard uses some financial performance measures, it places equal emphasis on non-financial performance measures, such as customer satisfaction, on-time delivery percentage, and employee turnover. These measures are grouped into four categories: financial, customer, internal business processes, and learning and growth (see Exhibit 1-5). We will explore the balanced scorecard in more detail in Chapter 11. What is important to understand at this point is that managers should not be limited to what financial results or projections imply. Instead, financial data should be balanced by customer and operational data, and all data should be evaluated based on the company's strategy.

In a recent survey of global business executives, Bain & Company found that almost 40% of the firms represented were using a balanced scorecard.¹² Although the balanced scorecard was originally developed to measure the performance of for-profit organizations, it has also been applied to nonprofit organizations, governmental units, and service organizations. Among the organizations that use balanced scorecards are BMW Financial Services, Duke University Hospitals, DuPont, General Electric, Hilton Hotels, Royal Canadian Mounted Police, Philips Electronics, UPS, and Walt Disney World Company.

EXHIBIT 1-5

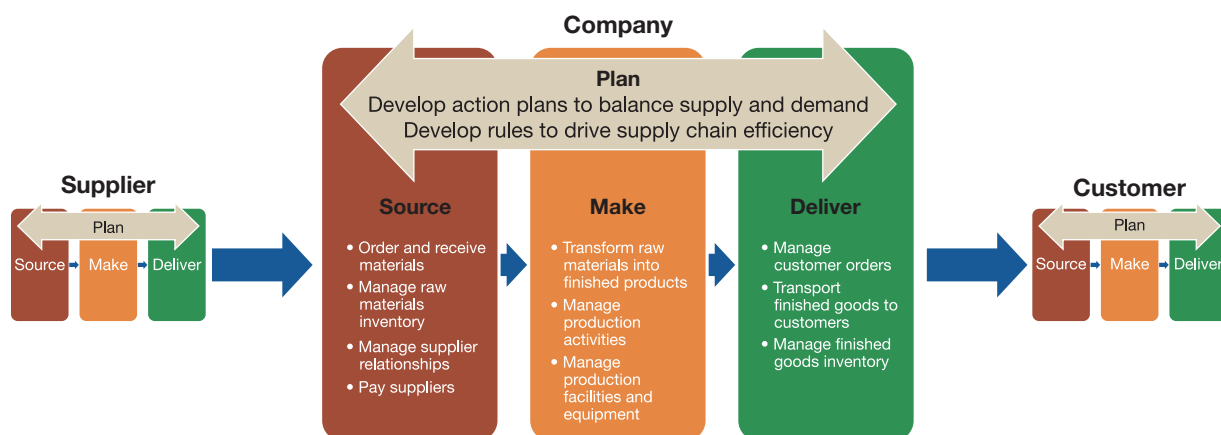
The balanced scorecard.



Supply Chain Management

Organizations operate within an interdependent system of suppliers and customers that is called a **supply chain**. A supply chain is a network of facilities that procure raw materials, transform them into intermediate goods and then into final products, and deliver the final products to customers through a distribution system.¹³ The supply chain's goal is to get the right product to the right location, in the right quantities, at the right time, and at the right cost. A simple supply chain may include as few as three trading partners—one supplier, one company, and one customer. A more complex supply chain might include hundreds of trading partners including multiple raw materials producers, manufacturers, service providers, distributors, retailers, and end users.

The Supply Chain Council (supply-chain.org) describes supply chains with its Supply Chain Operations Reference (SCOR[®]) model. This model includes the four major operational categories—plan, source, make, and deliver—shown in Exhibit 1-6. Notice that all trading partners within the supply chain carry out



Source: Adapted from Michael Hugos, *Essentials of Supply Chain Management*, John Wiley & Sons, 2003.

EXHIBIT 1-6 Typical supply chain operations.

these operations within their own organization, and the operational decisions made within the organization are affected by similar decisions made by other trading partners within the supply chain.

To assist in developing and monitoring relationships within the supply chain, many companies have turned to supply chain management systems for economic or strategic advantage. In implementing such systems, managers develop a strategy for managing all the resources needed to meet customer demand. The systems include metrics, or performance measures, that enable managers to monitor the supply chain's efficiency and effectiveness.

Walmart and Procter & Gamble were among the first companies to exploit supply chain management. Today, these two companies share information freely. If a Walmart distribution center is running low on Tide® laundry detergent, the supply chain management system alerts Procter & Gamble to ship more Tide to the center. At some stores, real-time information is sent to Procter & Gamble as products are scanned at the register. In turn, Procter & Gamble monitors its own inventory of Tide as shipments are made to Walmart to determine when more needs to be produced. All this sharing of information reduces inventory and ordering costs at both companies. As a result, Walmart customers benefit from lower prices and better product availability.

THINK ABOUT IT 1.2

ProFlowers.com is an Internet florist. One of its print advertisements estimates that for a traditional florist, the time between flowers being cut in the field and reaching the customer averages from 8 to 12 days. ProFlowers claims that its average time from field to customer is only 1 to 3 days. How do you think ProFlowers has been able to eliminate so much time from the delivery cycle?

Just-In-Time (JIT) Inventory

Just-in-time inventory management (**JIT**) is an inventory strategy that focuses on reducing waste and inefficiency by ordering inventory items so that they arrive just when they are needed. Since goods are produced to customer order, not to anticipated demand, they are put into production as soon as the order arrives. As soon as they are completed, the products are shipped directly to the customer. This strategy greatly reduces warehousing costs. While many people credit Toyota Motor Company with development of JIT in the 1950s, its roots can be traced back to Henry Ford. In his book *My Life and Work* (1922) Ford writes:

We have found in buying materials that it is not worth while to buy for other than immediate needs. We buy only enough to fit into the plan of production, taking into consideration the state of transportation at the time. If transportation were perfect and an even flow of materials could be assured, it would not be necessary to carry any stock whatsoever. The carloads of raw materials would arrive on schedule and in the planned order and amounts, and go from the railway cars into production. That would save a great deal of money, for it would give a very rapid turnover and thus decrease the amount of money tied up in materials. (p. 143)

Traditionally, inventory managers stockpiled large amounts of inventory as a buffer against unexpected problems in delivery, manufacturing, or distribution. As a consumer, that strategy works for you—products are available when you want

REALITY CHECK—A *supply chain touchdown*

BRIAN SNYDER/Reuters/Landov



This model allows Reebok to do a better job of ordering raw materials and blank jerseys to meet unexpected demand.

Retail sales can be a very tricky business, particularly when you are selling NFL jersey replicas. One season-ending injury or an unexpected march to the Super Bowl can turn demand upside down, leaving a retailer with too much or too little inventory on hand. Reebok Apparel faces just this situation each year.

In the past, [Reebok Apparel's](#) supply chain created problems for the company—problems that translated into lost dollars when sales were missed or too much money was invested in inventory that didn't sell. To solve these problems, Reebok made several changes in its supply chain. Previously, Reebok had contracted with manufacturers in Vietnam, Korea, and Central America for blank team jerseys. The blanks were shipped to a Reebok facility in Indiana for customization with players' names and numbers. This process was 50% more costly than if the original manufacturers produced the entire jersey. So managers asked the foreign manufacturers to retool and complete the entire jersey. Reebok then shared the resulting cost savings with retail customers.

Another change managers made was to begin ordering extra blank jerseys for popular teams, to keep on hand for unexpected surges in demand. This practice paid off in 2002, when the New England Patriots' starting quarterback, Drew Bledsoe, was injured early in the season and replaced with future Super Bowl MVP Tom Brady. Without the blank Patriots jerseys on hand, Reebok would not have been able to meet customer demand for Tom Brady jerseys.

Reebok now uses a sales forecasting model that includes previous years' demand by player, historical team demand, and previous team records. This model allows Reebok to do a better job of ordering raw materials and blank jerseys to meet unexpected demand. In 2004, the company was able to ship 150,000 Ben Roethlisberger jerseys after he unexpectedly led the Pittsburgh Steelers on a winning streak, even though the original forecast had predicted demand at only about 1,200.

Source: Anne Field, "When Delaying Decisions Is Good," June 2005 *Supply Chain Strategy Newsletter*, Harvard Business Review Press, Vol. 1, no. 4, pp. 5–7.

them. For a company, it is an expensive strategy. More inventory space is needed, meaning more rent and/or property costs like taxes and insurance are incurred. Having funds tied up in inventory means cash isn't as readily available for other investments. Just-in-time inventory systems eliminate that extra inventory. Some companies have found they can reduce inventory levels by as much as 50 to 60 percent without affecting their ability to meet customer demand for the final product. Besides reducing inventory levels, managers have also reworked manufacturing processes to eliminate unnecessary steps and enhance efficiency. The end result is a shorter production cycle and reduced financial investment in inventory.

Just-in-time inventory systems take time and effort to implement, and there is no guarantee that the final system will work for everyone. In a typical JIT system, products are completed in small batches in response to customer requests. To make these smaller production runs successful, companies must often rearrange the layout of equipment on the factory floor and work with employees to develop more efficient setup procedures. A quality program is also a must because no safety stock is available in the event that several units are found to be defective.

Shoemaker [Allen-Edmonds](#) tried JIT in 1991, but had to back off after discovering the company did not have the clout to force leather suppliers to make

small, weekly deliveries.¹⁴ Managers were also unsuccessful in developing an appropriate culture among workers, many of whom had been put on salary in lieu of compensation by the finished piece. A second try in 2004 was successful, however. The company now produces to customer orders rather than maintaining an inventory. As a result of its new lean manufacturing system, Allen-Edmonds achieved a 30% increase in productivity, a 15% reduction in direct labor and overhead costs, and a 100% on-time delivery rate.¹⁵

Enterprise Resource Planning (ERP) Systems

When businesses first began to computerize their operations, functional areas such as marketing and production created automated systems to meet their own needs. The problem was that each area developed its own system, without considering the needs of other areas for the same information. The result was often a collection of mismatched or even redundant systems that could not easily communicate across departments.

Today, many companies use **enterprise resource planning (ERP)** systems such as **SAP** and **Oracle** to accumulate data and provide information to decision makers on a companywide basis. The goal of an ERP system is to integrate all data from the company's many business processes into a single information system. The result is a system that can easily share production data with the accounting department and sales data with the production department. Now, when a salesperson enters an order, she can easily see the customer's credit status and the number of units on hand to fulfill the order—information that would require at least two different systems in a non-ERP environment.

UNIT 1.2 REVIEW

KEY TERMS

Balanced scorecard p. 16

Enterprise resource planning (ERP) p. 20

Just-in-time inventory (JIT) p. 18

Supply chain p. 17

PRACTICE QUESTIONS

1. **LO 4** A company whose strategy is to build market share would be *least* interested in knowing its
 - a. market share.
 - b. percentage of sales from new customers.
 - c. short-term profits.
 - d. number of units sold.
2. **LO 4** Which of the following is *not* an area of focus on a balanced scorecard?
 - a. Financial
 - b. Internal business processes
 - c. Customer
 - d. Suppliers
3. **LO 4** Which of the following would be considered part of **Nike's** supply chain?
 - a. **Finish Line**, an athletic shoe retailer
 - b. Athletic shoe manufacturer in China that makes Nike shoes
 - c. Marine transportation company that ships shoes from China to the United States
 - d. All of the above are in Nike's supply chain
4. **LO 4** A company that utilizes a just-in-time inventory system will not report any inventory on the balance sheet. True or False?

UNIT 1.2 PRACTICE EXERCISE

For each of the following scenarios, indicate the management tool being implemented.

	JIT	ERP	SUPPLY CHAIN MANAGEMENT	BALANCED SCORECARD
1. A company replaces its accounting information system, marketing information system, sales information system, and production information system with a single, integrated software solution.				
2. A company begins to evaluate its performance using metrics such as customer satisfaction, training hours per employee, and average cycle time in addition to traditional financial measures, such as earnings per share.				
3. A company requires its suppliers to deliver components in orders of 25 every two hours rather than in orders of 2,000 once every month.				
4. A company decides to implement a system of regional distribution centers to better meet the delivery needs of customers.				

SELECTED UNIT 1.2 ANSWERS

Think About It 1.2

ProFlowers.com gets its flowers directly from the grower and ships them directly to the customer. The typical floral supply chain includes an importer, a wholesaler, and a florist between the fields and the customer. Since ProFlowers

shipments don't have to go through as many hands, the time they take to reach the customer decreases, and the flowers arrive fresher.

Practice Questions

1. C
2. D
3. D
4. False

Unit 1.2 Practice Exercise

1. Enterprise resource planning (ERP)
2. Balanced scorecard
3. Just-in-time inventory management
4. Supply chain management

Ethical Considerations in Managerial Accounting

GUIDED UNIT PREPARATION

Answering the following questions while you read this unit will guide your understanding of the key concepts found in the unit. The questions are linked to the learning objectives presented at the beginning of the chapter.

- LO 5**
1. Why is it important for an organization to have a code of conduct?
 2. How can an employee's unethical behavior affect an organization?

“Accountant Arrested for Sham Audits.” “Madoff Aide Allegedly Got Fake Trading ‘Tickets’.” “Former CEO Bennett Is Indicted in Refco Collapse.” “U.S. Probes Possible Fraud by Pharmacies.” “How Some Doctors Turn a \$79 Profit from a \$30 Test.” “Boeing Could Avoid Prosecution, Pay Up to \$500 Million to U.S.” “Volkswagen Blames ‘Chain of Mistakes’ for Emissions Scandal.” As these headlines from *The Wall Street Journal* attest, one doesn’t have to look long or hard to find unethical behavior in business or to see its dramatic effects on companies and individuals. The names [Enron](#), [WorldCom](#), and [Adelphia](#) will forever be linked to fatal lapses in ethical behavior. In 2002, Congress passed the Sarbanes–Oxley Act, a reaction against and an intended deterrent to unethical business practices.

Exactly what is **ethical behavior**? Basically, it is knowing right from wrong and conducting yourself accordingly, so that your decisions are consistent with your own value system and the values of those affected by your decisions. The Institute of Business Ethics (<http://www.ibe.org.uk>) poses three simple tests of an ethical business decision: (1) “Do I mind others knowing what I have done?” (2) “Who does my decision affect or hurt?” and (3) “Would my decision be considered fair by those affected?”

Ethical business behavior is not the same as mere compliance with the law. It is doing the *right* thing, not just doing what you are *required* to do. In ethical behavior, the spirit of the law is more important than the letter of the law, and moral values and codes are more important than rules and policies. Of course, that doesn’t mean that you can ignore company rules and policies.

As an employee of an organization, you will be directed by your firm’s **code of conduct**, which is based on a set of core values that are meant to guide employees’ behavior. Some companies require employees to review the code of conduct annually and sign an acknowledgment that they understand and will adhere to it. Exhibit 1-7 lists the typical components of a code of conduct.

EXHIBIT 1-7

*Typical components
of a code of conduct.*

Compliance, Integrity and Anticorruption	
• Accuracy of corporate finances and financial reporting • Employee records and expense reports	• Bribes • Political contributions
Conflicts of Interest	
• Gifts and gratuities • Political activity • Outside employment	• Family members • Disclosure of financial interests
Employee, Client and Vendor Information	
• Maintaining records and information • Privacy and confidentiality • Disclosure of information	
Employment Practices	
• Workplace harassment • Equal opportunity • Diversity • Fair treatment of staff • Work-family balance • Discrimination • Fair labor practices	• Illegal drugs and alcohol • Use of organization property and resources • Proper exercise of authority • Employee volunteer activities • Romantic relationships with coworkers • Incentives and recognition systems
Environmental Issues	
• Commitment to sustainability • Employee health and safety	
Ethics and Compliance Resources	
• Ethics advice helpline • Reporting procedures • Anonymous/confidential reporting hotline • Summary of investigations process	• Anti-retaliation policy and protections for reporters • Accountability and discipline for violators • Ombuds program
Internet, social networking and social media	
• Internet and social network use at work • Prohibited sites and content • Policies regarding posts about company, work products or coworkers	• Online relationships between managers and their reports
Relationships with third parties	
• Procurement	• Negotiating contracts

Source: Ethics Resource Center Common Code Provisions website, <https://www.ethics.org/eci/research/free-toolkit/code-provisions> (accessed June 28, 2016). Courtesy of ECIconnects

In the 2011 *National Business Ethics Survey*, 82% of respondents indicated that their employers had a written code of conduct—up from 67% in the 1994 survey.¹⁶ One company that displays its code of conduct on its corporate website is Google. The value that Google places on ethical behavior is easy to see: “Don’t be evil . . . is about doing the right thing more generally—following the law, acting honorably and treating each other with respect” (<https://abc.xyz/investor/other/google-code-of-conduct.html>).

Section 406 of the Sarbanes–Oxley Act now requires that all publicly traded companies disclose whether the “principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions” are subject to a corporate code of ethics. The code must be published in the annual report or on the corporate website, or provided without charge upon request to any individual. In addition, companies must disclose all instances in which these codes have been waived for a particular individual, as well as all

changes to the code. A company that does not have a written code of ethics is required to publish a disclosure explaining why no code has been adopted.

If you are a member of a professional organization, you will be directed by that organization's code of professional conduct. One such organization is the Institute of Management Accountants (IMA), the leading professional organization for managerial accountants, which offers the Certified Management Accountant (CMA®) designation. Exhibit 1-8 provides the current version of the IMA's Statement of Ethical Professional Practice. The result of a three-year revision process that culminated in 2005, it is consistent with the Sarbanes–Oxley Act of 2002 and incorporates the principles of the International Federation of Accountants, of which the IMA is a member.¹⁷ The IMA's statement is just one example of a professional code of conduct, however. Other organizations, such as the American Institute of Certified Public Accountants, the American Marketing Association, the Financial Executives Institute, the Financial Planning Association, and the Society for Human Resource Management, have similar codes of conduct.

EXHIBIT 1-8

IMA Statement of Ethical Professional Practice.

IMA STATEMENT OF ETHICAL PROFESSIONAL PRACTICE

Members of IMA shall behave ethically. A commitment to ethical professional practice includes: overarching principles that express our values, and standards that guide our conduct.

PRINCIPLES

IMA's overarching ethical principles include: Honesty, Fairness, Objectivity, and Responsibility. Members shall act in accordance with these principles and shall encourage others within their organizations to adhere to them.

STANDARDS

A member's failure to comply with the following standards may result in disciplinary action.

I. COMPETENCE

Each member has a responsibility to:

1. Maintain an appropriate level of professional expertise by continually developing knowledge and skills.
2. Perform professional duties in accordance with relevant laws, regulations, and technical standards.
3. Provide decision support information and recommendations that are accurate, clear, concise, and timely.
4. Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

II. CONFIDENTIALITY

Each member has a responsibility to:

1. Keep information confidential except when disclosure is authorized or legally required.
2. Inform all relevant parties regarding appropriate use of confidential information. Monitor subordinates' activities to ensure compliance.
3. Refrain from using confidential information for unethical or illegal advantage.

III. INTEGRITY

Each member has a responsibility to:

1. Mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts.
2. Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
3. Abstain from engaging in or supporting any activity that might discredit the profession.

IV. CREDIBILITY

Each member has a responsibility to:

1. Communicate information fairly and objectively.
2. Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
3. Disclose delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.

RESOLUTION OF ETHICAL CONFLICT

In applying the Standards of Ethical Professional Practice, you may encounter problems identifying unethical behavior or resolving an ethical conflict. When faced with ethical issues, you should follow your organization's established policies on the resolution of such conflict. If these policies do not resolve the ethical conflict, you should consider the following courses of action:

1. Discuss the issue with your immediate supervisor except when it appears that the supervisor is involved. In that case, present the issue to the next level. If you cannot achieve a satisfactory resolution, submit the issue to the next management level. If your immediate superior is the chief executive officer or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with your superior's knowledge, assuming he or she is not involved. Communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate, unless you believe there is a clear violation of the law.
2. Clarify relevant ethical issues by initiating a confidential discussion with an IMA Ethics Counselor or other impartial advisor to obtain a better understanding of possible courses of action.
3. Consult your own attorney as to legal obligations and rights concerning the ethical conflict.

Source: IMA Statement of Ethical Professional Practice, available online at http://www.imanet.org/docs/default-source/press_releases/statement-of-ethical-professional-practice_2-2-12.pdf?sfvrsn=2 (accessed January 29, 2016). Courtesy of Institute of Management Accountants

EXHIBIT 1-8

(continued)

Unfortunately, it takes more than a code of ethics to promote ethical business behavior. In *Politics, Book IV*, Aristotle cautioned, "But we must remember that good laws, if they are not obeyed, do not constitute good government. Hence there are two parts of good government; one is the actual obedience of citizens to the laws, the other part is the goodness of the laws which they obey." Enron had a code of ethics that specified the desired behavior, but top managers chose to ignore it. The result was catastrophic for thousands of innocent employees and shareholders.

A key component of a positive ethical environment, in fact, is the "tone at the top," or management's commitment to ethical behavior. If employees are to act ethically, managers must not only "talk the talk," but "walk the walk." Employees who witness managers engaging in unethical behavior will assume that while the company may have a corporate code of ethics, it doesn't really matter. In the 2011 *National Business Ethics Survey*, only 62% of the respondents had confidence in their company's senior management. And 34% of the respondents believed that their manager did not exhibit ethical behavior, up from 24% in 2009. As Ira Lipman, chairman and president of *Guardsmark, LLC*, commented in an October 12, 2005, press release, "The leadership of corporate America should see ethics as one of their top responsibilities, and as an integral part of their stewardship and service to shareholders and customers."¹⁸

THINK ABOUT IT 1.3

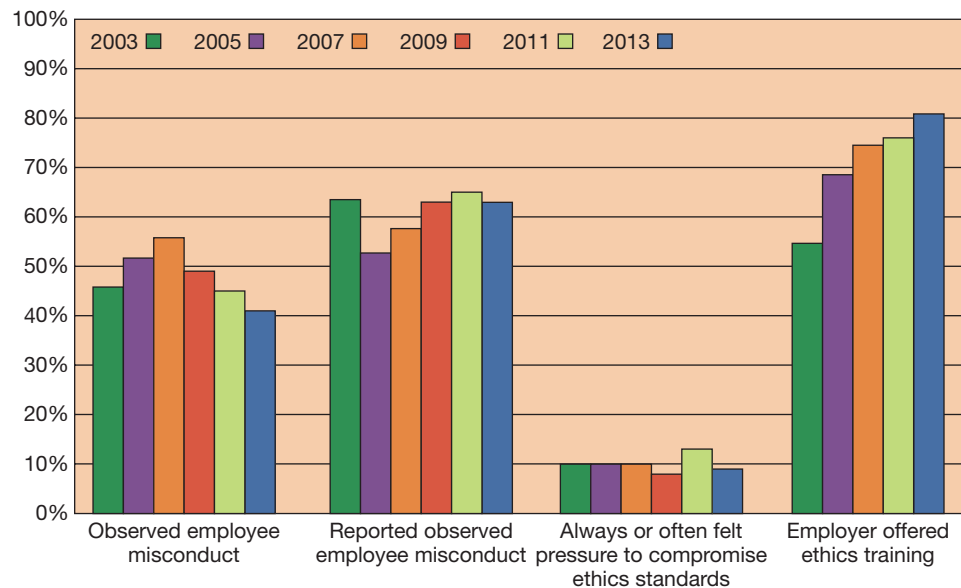
You work for an interior design firm. The company has an agreement with several up-and-coming artists in the area to buy their paintings and resell them to clients. The difference between the purchase price and the resale price is split between the artist and the company. You have noticed recently that a designer is telling the artists that he is purchasing a painting for his personal collection, so that the artists do not expect an additional payment for its resale. The designer then sells the painting to a client, and the company keeps the entire profit. The designer says his practice is good for the company (it receives a higher profit) and good for the artists (their work is being sold). Do you regard the designer's behavior as ethical? Why or why not? If you believe it is unethical, what are the next steps you should take?

Based on Amy Joyce, "But It Was Only a Few Pens, Officer," *The Washington Post*, November 10, 2002.

What is the current state of ethical behavior in business? The Ethics Resource Center (<http://www.ethics.org>) repeats the *National Business Ethics Survey* periodically to determine the answer to this question. Exhibit 1-9 compares the results from recent surveys. Observed incidences of unethical behavior reported in the survey reached an all-time low in 2013, with only 41% of respondents having observed such behavior. Of those in the 2013 survey who witnessed unethical behavior, only 63% reported it—down from 65% in 2011.

EXHIBIT 1-9

National Business Ethics Survey results, 2003–2013.



Sources: Ethics Resource Center, *National Business Ethics Survey: How Employees View Ethics in Their Organizations 1994–2005* (Arlington, VA: Ethics Resource Center, 2005) and Ethics Resource Center, *National Business Ethics Survey: An Inside View of Private Sector Ethics, 2007* (Arlington, VA: Ethics Resource Center, 2007); Ethics Resource Center, *2009 National Business Ethics Survey: Ethics in the Recession* (Arlington, VA: Ethics Resource Center, 2009); Ethics Resource Center, *2011 National Business Ethics Survey: Workplace Ethics in Transition* (Arlington, VA: Ethics Resource Center, 2011); Ethics Resource Center, *National Business Ethics Survey of the U.S. Workforce* (Arlington, VA: Ethics Resource Center, 2014).

You may wonder what kind of unethical conduct employees observe. Based on the 2013 survey, the top five observed unethical behaviors are abusive or intimidating behavior (18%), lying to employees (17%), conflict of interest (12%), violating company policies related to Internet use (12%), and discriminating against

REALITY CHECK—*Blowing the whistle*



© cosmonaut/iStockphoto

As you may have gathered from these stories, whistleblowing is not for the faint-hearted.

Whistleblowers were elevated to a new status when *Time* named Sherron Watkins of Enron, Cynthia Cooper of WorldCom, and Coleen Rowley of the FBI as its 2002 Persons of the Year. The Securities and Exchange Commission receives approximately 4,000 tips annually through its whistleblower program. But what does it take to “blow the whistle” on your employer, and what could happen if you do?

The Corporate and Criminal Fraud Accountability Act of 2002, part of the Sarbanes–Oxley Act (Section 806), was passed to protect whistleblowers in publicly traded companies against retaliation. According to an August 1, 2005, *USA Today* article, hundreds of whistleblowers have filed complaints of retaliation under the act. But while they may have thought their jobs were protected under the act, only some of them have actually returned to work. Others have settled their complaints out of court or are still waiting to be reinstated.

Linda Kimble, an agent with *Hertz*, and Schott Bechtel, a vice president of *Competitive Technologies*, are two employees who have returned to the office after being fired. Both were out of work for at least 18 months while their claims were being investigated. Others, such as David Welch, former CFO of the *Bank of Floyd*, and David Windhauser, former controller of *Trane*, have not fared as well. Windhauser was out of work for several months before he secured a temporary job that eventually became a full-time position, at a 25% cut in pay. He eventually agreed to an out-of-court settlement with Trane. Welch was not rehired by the Bank of Floyd, even though the bank was ordered to reinstate him, and he remained unemployed until 2007, when he changed professions and joined the Franklin University faculty. While the law requires reinstatement, there is no penalty for a company’s failure to comply.

As you may have gathered from these stories, whistleblowing is not for the faint-hearted. Many whistleblowers become the target of personal and professional attacks—the 2013 *National Business Ethics Survey* found 21% of whistleblowers experienced some form of retaliation at work. If you find yourself thinking of blowing the whistle on unethical or illegal activity, Professor Brian Martin recommends that you take the following actions: document the problem, know the context, propose solutions, and get advice and support.

Sources: 2013 *National Business Ethics Survey*: Ethics Resource Center, Brian Martin, *The Whistleblower’s Handbook: How to Be an Effective Resister* (Charlbury, UK: Jon Carpenter Publishing, 1999); Jayne O’Donnell, “Blowing the Whistle Can Lead to Harsh Aftermath, Despite Law,” *USA Today*, August 1, 2005, 1B; Stephen Taub, “Five Years Out of Work,” *CFO.com*, <http://cfo.com/printable/article.cfm/9210493/> (accessed June 28, 2016); Curtis Verschoor, “To Blow the Whistle or Not Is a Tough Decision,” *Strategic Finance*, 87 (October 2005): 21–22; “With the Whistleblower Provision, No One Wins,” *Banking Wire*, 13 (August 8, 2005): 8; “The Age of the Whistleblower,” *The Economist*, December 5, 2015, <http://www.economist.com/news/business/21679455-life-getting-better-those-who-expose-wrongdoing-companies-continue-fight> (accessed February 10, 2016).

employees (12%). A troubling finding is that 60% of misconduct involved managers, and 24% involved senior-level managers. This high rate of managerial misconduct brings into question the “tone at the top.”

Clearly, failing to follow a corporate code of ethics can lead to serious consequences. But what happens in companies that demonstrate a commitment to ethical behavior? At least one researcher has found a positive financial impact from corporate ethical behavior. In a 1998 study of the 500 largest U.S. companies (based on their 1996 sales revenue), those companies that openly committed themselves to ethical standards in their annual reports experienced better financial performance than those that failed to make a public commitment.¹⁹

UNIT 1.3 REVIEW

KEY TERMS

Code of conduct p. 22

Ethical behavior p. 22

PRACTICE QUESTIONS

1. **LO 5** Which of the following is not a typical component of a code of conduct?
 - a. Fair employment practices
 - b. Salary scales
 - c. Conflicts of interest
 - d. Privacy
2. **LO 5** Ethical behavior is governed by laws and rules. True or False?
3. **LO 5** If an organization has a published code of conduct, its employees will not become involved in unethical behavior. True or False?

UNIT 1.3 PRACTICE EXERCISE

Darlene Matthews is president of a regional chain of doughnut shops. During a recent interview, a candidate for the chief financial officer's position asked to see the company's code of conduct. Darlene responded, "This isn't a Fortune 500 company, so we don't need a code of conduct. Besides, I interview all employees and hire only good people." Do you think Darlene's position is justified? Why or why not?

SELECTED UNIT 1.3 ANSWERS

Think About It 1.3

The designer is misrepresenting his intentions to the artists. While his actions may ultimately increase the popularity of their works, he is cheating the artists out of some of their income. The designer is showing a lack of integrity, as well as a lack of credibility (because he isn't accurately disclosing all the information to the artists). You should discuss the matter with him.

If your discussion does not resolve the matter, you should refer it to your supervisor. If a resolution still cannot be reached, continue to the next level of management. You

may wish to confer confidentially with an impartial adviser. You may also wish to speak with your attorney concerning any legal implications of your actions.

While these general steps may apply in any ethical conflict, your actions should also be guided by the company's corporate code of conduct, if one exists. In addition, if you belong to a professional organization, then you are bound by its code of professional ethics, which may specify the steps to follow in resolving an ethical conflict.

Practice Questions

1. B
2. False
3. False

Unit 1.3 Practice Exercise

Darlene is incorrect in her assumption. Firms of all sizes benefit from a code of conduct. The code of conduct communicates the organization's core values to its employees and guides their behavior. Darlene's conviction that she hires only "good" people doesn't mean that those people

are "good." Even "good" people may not always recognize that a particular action is inconsistent with the organization's core values if those values have not been communicated to them explicitly.

CHAPTER SUMMARY

In this chapter you learned some important terms and techniques that will be relevant throughout the rest of this book. Specifically, you should be able to meet the learning objectives set out at the beginning of the chapter:

1. Define managerial accounting. (Unit 1.1)

There are several formal definitions of managerial accounting. A simple one is “the generation of relevant information to support management’s decision-making activities.”

2. Describe the differences between managerial and financial accounting. (Unit 1.1)

Managerial accounting’s primary users are managers and decision makers within an organization, whereas financial accounting is aimed primarily at external users. Unlike GAAP that guides financial accounting, there are no mandated rules in managerial accounting. Managerial accounting reports focus on operating segments, while financial accounting statements report results for the organization as a whole. Managerial accounting is concerned more with projecting future results than reporting past results. Managerial accounting information is prepared to take advantage of a window of opportunity, even if some accuracy must be sacrificed. Financial accounting information is balanced to the penny and is delivered after the end of the accounting period.

3. List and describe the four functions of managers. (Unit 1.1)

Planning means setting a direction for the organization. Long-term, or strategic, planning provides direction for a five- to ten-year period. Short-term, or operational, planning provides more detailed guidance for the coming year; it translates the company’s strategy into action steps. Controlling is the monitoring of day-to-day operations to identify any problems that require corrective action. Evaluating is the process of comparing a particular period’s actual results to planned results, for the purpose of assessing managerial performance. Decision making means choosing between alternative courses of action.

4. Explain how the selection of a particular business strategy determines the information that managers need to run an organization effectively. (Unit 1.2)

To run a business effectively, managers need information that shows how well operations are meeting the organization’s strategic goals. For instance, if the organization’s strategy is to be a low-cost producer, information about product costs and cost variances will be more useful to managers than information about research and development.

5. Discuss the importance of ethical behavior in managerial accounting. (Unit 1.3)

Ethical behavior means knowing right from wrong and then doing the right thing. Many companies and most professional organizations have codes of conduct to guide employees’ actions. Acting unethically can lead to illegal activity and ultimately to the destruction of the firm. Furthermore, research has shown that a public commitment to ethical behavior can lead to superior financial performance.

KEY TERMS

Balanced scorecard (Unit 1.2)

Code of conduct (Unit 1.3)

Controlling (Unit 1.1)

Decision making (Unit 1.1)

Enterprise resource planning (ERP)
(Unit 1.2)
Ethical behavior (Unit 1.3)
Evaluating (Unit 1.1)
Generally accepted accounting principles
(GAAP) (Unit 1.1)

Just-in-time inventory (JIT) (Unit 1.2)
Long-term planning (Unit 1.1)
Managerial accounting (Unit 1.1)
Short-term (operational) planning
(Unit 1.1)
Supply chain (Unit 1.2)

EXERCISES

1-1 Understanding how managers use managerial accounting information

(LO 1) Managerial accounting information is not just for accountants. All areas within an organization can use the information to support decision making. Choose a position in an organization that is appealing to you and identify several decisions that you might be asked to make in that position. What kind of managerial accounting information would you need to make those decisions?

1-2 Discriminating between managerial and financial accounting (LO 2) In each of the following situations, identify whether the setting is primarily financial accounting or managerial accounting.

- a. **Volkswagen** has experienced a decline in U.S. sales, which dropped 18% in 2005 and 24% between 2002 and 2004. Then chief executive, Bernd Pischetsrieder, believed the biggest problem at Volkswagen was the cost incurred to produce a car, which was not competitive with other automakers. The company tried to get German workers to agree to pay cuts to reduce the cost. (*Source*: Stephen Power, “Once Hot Volkswagen Attempts to Reverse U.S. Sales Decline,” *The Wall Street Journal*, September 8, 2005.)
- b. In reporting a 2.1% drop in quarterly income from the previous year’s second quarter, Oracle Corp. noted that a weaker dollar affected revenue in its database segment. A weaker dollar makes Oracle’s products more expensive overseas and lowers the company’s revenue after currency conversion. (*Source*: David P. Hamilton, “Oracle Profit Slips 2.1% on Costs Tied to PeopleSoft Acquisition,” *The Wall Street Journal*, December 16, 2005.)
- c. **Cerner** is a developer of information technology for the health care industry. As the company incurs expenses to develop a software package, it capitalizes those costs as an asset. Beginning in the year after the software is released, it then amortizes those costs over a five-year period. Normal practice in the software industry is to amortize these costs over a three-year period. (*Source*: Jesse Eisinger, “Cerner’s Growth Has Been Healthy, But Its Accounting Could Be Ailing,” *The Wall Street Journal*, December 14, 2005.)
- d. **BNSF Railway** was experiencing an increase in demand for information technology resources even though, overall, the company’s business wasn’t growing. In an effort to understand the technology group’s operations, Chief Information Officer Jeff Campbell developed a balanced scorecard for the IT group. Among the measures he tracked were monthly performance against operating budget, percentage of projects delivered on time, employee absenteeism, and internal rate of return on IT projects. Now everyone in the company understands how much it costs to provide the technology support for a particular business application. (*Source*: Meredith Levinson, “Why You Keep Score,” *CIO.com*, July 19, 2007, http://www.cio.com/article/124652/CASE_STUDY_3_Why_You_Keep_Score.)

1-3 Classifying managerial functions (LO 3) Classify each of the following activities as planning, controlling, evaluating, or decision making.

- a. A corporate chef prepares a menu and shopping list for the upcoming board of directors meeting.
- b. The human resources manager reviews the monthly payroll report and identifies departments that paid overtime to workers.
- c. The production supervisor notices that the pressure in a sauerkraut fermenting vat is too high and opens the release valve to lower the pressure.
- d. The marketing director considers whether to offer a \$0.50 coupon or a \$0.75 coupon through a direct mail campaign.
- e. At the end of the coupon campaign, the marketing director determines the number of coupons redeemed and the additional unit sales achieved through the campaign.
- f. The sales manager prepares the sales forecast for the coming year.
- g. The divisional vice president determines which employees should receive a performance bonus.

1-4 Meeting managers' need for information (LO 4) For each of the following managers, identify the information that would be useful for monitoring strategic performance.

- a. The store manager of a **Wendy's** in Austin, Texas
- b. The regional manager for all Wendy's restaurants in the state of Texas
- c. Wendy's executive vice president of operations

1-5 Understanding a supply chain (LO 4) Choose a company you are familiar with and diagram its supply chain. For each entity in the supply chain, identify one or two specific decisions that might affect other members of the supply chain.

1-6 Constructing a balanced scorecard (LO 4) For each of the following measures that could be incorporated into a balanced scorecard, identify which of the four balanced scorecard perspectives it would most likely belong to.

- a. Training hours per employee
- b. Average time to answer a customer complaint
- c. Gross profit
- d. Number of new products in development
- e. Number of defective units produced
- f. Percentage of orders delivered on or before due date
- g. Employee turnover
- h. Number of new customers
- i. Market share
- j. Return on investment

1-7 Applying the IMA's Statement of Ethical Professional Practice (LO 5) (Adapted from M. Elizabeth Haywood and Donald E. Wygal, "Corporate Greed vs. IMA's Ethics Code," *Strategic Finance*, November 2004, 45–49).

The IMA's Statement of Ethical Professional Practice was designed to help finance professionals "to link ethical perspectives directly to their ongoing workplace responsibilities." Unfortunately, some individuals may choose to act unethically and perhaps cause great harm to other individuals and organizations. In each of the following examples, determine which of the four standards of ethical conduct has been violated. Some examples may violate more than one standard.

- a. Douglas Faneuil was a **Merrill Lynch** brokerage assistant who was involved in Martha Stewart's sale of **ImClone** stock. During the investigation, he lied to federal investigators, saying that there was a standing order to sell the stock if the share price fell below \$60. In return for lying, Mr. Faneuil reportedly received money, airplane tickets, and an extra week's vacation.

- b. The day after Sam Waksal, ImClone's CEO, learned that the Food and Drug Administration was not going to review ImClone's application for approval of a new cancer drug, family members sold \$10 million in ImClone stock. Mr. Waksal reportedly shared the information about the failed review with his family.
- c. Scott Sullivan, WorldCom's chief financial officer, recorded billions of dollars of operating expenses as capital assets. Depreciating these "assets" over time inflated the company's profits and hid the expenses from the company's auditors.
- d. Adelphia co-signed loans of \$3 billion with its founders, the Rigas family, who used the proceeds of the loans to purchase shares of Adelphia stock and other personal items. The family did not disclose the loans to the board of directors. When the company's auditors discovered the loans and asked the Rigases to report them to the board, the family refused. The auditors did not report the issue to Adelphia's audit committee.

PROBLEMS

1-8 Using managerial accounting information (LO 1, 3, 4) John Dough's bakery in Waxahachie, Texas, specializes in chocolate chip cookies. While John's business does not yet have a national presence, like *Mrs. Fields*, he does have a strong statewide reputation. Recently, John has been receiving some out-of-state orders through the company's website. He is beginning to think about the potential for growing his out-of-state business.

Required

- a. How can managerial accounting information be useful to John as he thinks about growing his out-of-state business?
- b. What decisions might John need to make if he decides to grow his out-of-state business?
- c. What managerial accounting information might John find useful as he decides how to grow his out-of-state business?

1-9 Corporate codes of conduct (LO 5) Use the Internet to find a corporate code of conduct. Compare the code you find to the list of typical components of a code of conduct in Exhibit 1-7. Does the code you examined cover all the components? If not, which components are missing? What business problems could result from the omission of those components?

CASES

1-10 Management activities (LO 3) After working for three different companies in ten years, Martin Long decided that he just wasn't cut out to be someone else's employee. For the next four years, he saved 25% of his salary and then opened his own graphic design firm. He intends to target small- and medium-sized businesses that need graphic design services for their letterhead, brochures, and packaging but who cannot afford to employ a full-time graphic artist.

Martin plans to build customer relationships based on his design skills and advertising expertise. Companies can hire him for design work only or for creating a comprehensive print strategy that includes the design and production of print materials. Martin will out-source the production of his print materials to a local printing company.

Required

- a. Diagram a supply chain that shows how brochures would be created for a company that cannot make them in house. Be sure to identify Martin's place in the supply chain.
- b. Assume that Martin will operate his business out of his home. Identify the costs he will incur in the first year to get the business up and running.
- c. Will Martin need to engage in planning, controlling, and evaluating even though he is a sole proprietor with no employees? If so, identify several specific activities he might perform. If not, explain why Martin will not need to perform these activities.
- d. Martin probably will not make a lot of money in the first few months of owning his business. What other measures will signal that his business is becoming successful?

1-11 Making ethical decisions (LO 5) Charlie Anderson recently began a new job as the office manager for a prominent medical clinic. He has just received a bill from Med-Count, one of the labs that performs tests for the clinic. In reviewing the bill, Charlie notices that the lab has charged the clinic \$25 for a complete blood count test. The clinic, however, bills patients or their insurance companies \$90 for the test, and that is the amount that most insurance companies will pay on the patient's behalf. Thus, the clinic is earning a \$65 profit on each blood test it orders. After a bit more investigation, Charlie finds similar profit margins on a number of other lab tests. He is concerned about the billing practice and suspects the clinic may have selected the lab based on its low cost rather than on the lab's qualifications and the accuracy of its test results. He also wonders if the tests' profit potential is driving doctors to order unnecessary tests.

Required

Read Opinion 8.09 of the American Medical Association's Code of Medical Ethics (<http://www.ama-assn.org/ama/pub/physician-resources/medical-ethics/code-medical-ethics/opinion809.page?>). Based on this opinion, do you believe that the clinic's billing for lab tests is an acceptable business practice? Discuss your reasoning.

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