

# Chapter 1

## Managerial Accounting and the Business Environment

### Solution to Discussion Case

Benefits to employees of having a code of conduct:

- Creates clarity as to how *all* employees are expected to behave. This should help employees avoid behaviours that the company prohibits.
- Provides protection for employees when dealing with superiors given the guidelines related to protection from discrimination and harassment.
- Establishes guidelines for workplace safety, which should help protect the health of employees.
- Provides information on the consequences of code violations, which will help employees understand the outcomes of prohibited behaviours, if detected.
- Provides guidance as to what employees should do if they witness a violation of the code and protects those employees who do report an incident.

Disadvantages to CIBC of having a code of conduct:

- May create the impression among employees that they are not trusted by senior management to act appropriately.
- The obligation to report violations could create a culture of suspicion and mistrust among employees.
- Enforcing the code may be costly and time consuming in large organizations such as CIBC. For example, investigations of possible violations could take weeks.

## Solutions to Questions

**1-1** In contrast to financial accounting, managerial accounting: (1) focuses on the needs of managers rather than outsiders; (2) emphasizes decisions affecting the future rather than the financial consequences of past actions; (3) emphasizes relevance rather than objectivity and verifiability; (4) emphasizes timeliness rather than precision; (5) emphasizes the segments of an organization rather than summary data concerning the entire organization; (6) is not governed by GAAP; and (7) is not mandatory.

**1-2** Managers carry out four major activities in an organization: planning, directing and motivating, controlling and decision-making. Planning involves establishing a basic strategy, selecting a course of action, and specifying how the action will be implemented. Directing and motivating involves mobilizing people to carry out plans and run routine operations. Controlling involves ensuring that the plan is actually carried out and is appropriately modified as circumstances change. Decision-making involves selecting a course of action from among two or more alternatives.

**1-3** A budget is a quantitative plan for the acquisition and use of financial and other resources over a specified future time period.

**1-4** Customer value propositions fall into three broad categories—customer intimacy, operational excellence, and product leadership. A company with a customer intimacy strategy attempts to better understand and respond to its customers' individual needs than its competitors. A company that adopts an operational excellence strategy attempts to deliver products faster, more conveniently, and at a lower price than its competitors. A company that has a product leadership strategy attempts to offer higher quality products than its competitors.

**1-5** The Planning and Control Cycle involves formulating plans, implementing plans, measuring performance, and evaluating differences between planned and actual performance.

**1-6** The Royal Bank of Canada could segment its companywide performance by individual-  
© McGraw-Hill Education Ltd. 2018. All rights reserved.

al customer, by geographic area (e.g., province or country), and by product line (e.g. asset management, personal loans, mortgages, etc.).

Procter & Gamble could segment its performance by product category (e.g., beauty and grooming, household care, and health and well-being), product line (e.g., Crest, Tide, and Bounty), and stock keeping units (e.g., Crest Cavity Protection toothpaste, Crest Extra Whitening toothpaste, and Crest Sensitivity toothpaste).

**1-7** Deere & Company is an example of a company that competes in terms of product leadership. The company's slogan "nothing runs like a Deere" emphasizes its product leadership customer value proposition.

Amazon.ca competes in terms of operational excellence. The company focuses on delivering products faster, more conveniently, and at a lower price than competitors.

TD Asset Management competes in terms of customer intimacy. It focuses on building personal relationships with clients so that it can tailor investment strategies to individual needs.

**1-8** Planning, controlling, and decision making must be performed within the context of a company's strategy. For example, if a company that competes as a product leader plans to grow too quickly, it may diminish quality and threaten the company's customer value proposition. A company that competes in terms of operational excellence would select control measures that focus on time-based performance, convenience, and cost. A company that competes in terms of customer intimacy may decide against outsourcing employee training to cut costs because it might diminish the quality of customer service.

**1-9** The six business functions that make the value chain are: (1) research and development; (2) product design; (3) manufacturing; (4) marketing; (5) distribution; and (6) customer service.

**1-10** Examples of things socially responsible organizations should provide for their employees

include: (1) safe working conditions; (2) fair compensation; (3) job-training; (4) opportunities for advancement; (5) the right to file grievances; and (6) adequate time off.

**1-11** Airlines face the risk that large spikes in fuel prices will lower their profitability. Therefore, they may reduce this risk by spending money on hedging contracts that enable them to lock-in future fuel prices that will not change even if the market price increases.

Steel manufacturers face major risks related to employee safety, so they create and monitor control measures related to occupational safety compliance and performance.

Restaurants face the risk that an economic downturn will reduce customer traffic and lower sales. They reduce this risk by choosing to create menus during economic downturns that offer more low-priced entrees.

**1-12** Having a good ethical reputation is important to companies in maintaining good relations with suppliers, employees and customers. Companies with a poor ethical reputation will likely have trouble finding suppliers for their raw materials, will have difficulty attracting and retaining employees, and will not be attractive to potential customers. Thus, in the long-run having good relations with each of these stakeholder groups is critical to a company's survival.

**1-13** Companies prepare a code of conduct to demonstrate their morals and values system, often in part to demonstrate corporate social responsibility. The code of ethics indicates what is expected of all employees and directors in their dealings with various stakeholders.

**1-14** Organizations are managed by people that have their own personal interests, insecurities, beliefs, and data-supported conclusions that ensure unanimous support for a given course of action is the exception rather than the rule. Therefore, managers must possess strong leadership skills if they wish to channel their co-workers' efforts towards achieving organizational goals.

**1-15** Enterprise risk management is a process used by organizations to actively identify and manage foreseeable risks. These risks can to

employee theft, financial reporting or even strategic decision making.

**1-16** Companies that use lean production only make units in response to customer orders. They produce units just in time to satisfy customer demand, which results in minimal inventories.

### Exercise 1-1 (20 minutes)

- i. Developing sales estimates of a product for use in the annual budget for a product is a *planning* activity since doing so will establish a goal for sales levels in the coming year.
- ii. The review of the monthly quality control reports is a *controlling* activity aimed at determining whether production processes are operating as planned. Identifying the team members to investigate the problem is a *directing and motivating* activity since it involves assigning tasks to specific individuals. The selection of team members is also a *decision-making activity* since the manager will need to determine which employees are best suited (e.g., which ones have the necessary skills, the time available, etc.) to conduct the investigation
- iii. Choosing from the two design alternatives for the speakers is a *decision-making activity*. It could also be argued that this is a *planning activity* since it will affect which speaker design the company decides to offer to its customers in future periods.
- iv. Reviewing the monthly performance report is a *controlling* activity. Determining the production schedule in the coming months is both a *planning* and *directing and motivating* activity since it involves the future scheduling of day-to-day activities related to manufacturing the televisions. Evaluating how to motivate retailers to improve sales is also a *directing and motivating* activity and has an element of *planning* as well assuming changes are going to be made to the current incentive system. The evaluation also involves *decision-making* with respect to continuing or discontinuing the plasma television line, and *planning* activities such as setting budgets for future sales of plasma televisions if the product continues to be offered.

### **Exercise 1-2 (15 minutes)**

- i. Primarily financial accounting since it involves the preparation of an income statement for use by the tax authorities (Canada Revenue Agency), an outside body.
- ii. Primarily managerial accounting since it involves the use of information for specific internal purposes related to resource allocations, marketing and production scheduling.
- iii. Primarily financial accounting since the information is being used to develop an account balance (allowance for doubtful accounts) for use in the year-end financial statements.
- iv. Primarily management accounting since the information is being used to evaluate customer satisfaction. Preparing this information is not a financial reporting requirement but it could be useful for internal decision-making purposes regarding pricing of products, product enhancements, etc.
- v. Primarily management accounting since the information will be used to determine possible changes to credit terms offered to major customers. Note that essentially the same information is being used in item iii above but in this case the use is entirely for internal decision-making purposes, not for purposes of preparing the financial statements.

**Exercise 1-3** (15 minutes)

<i>Industry</i>	<i>Type of Risk</i>	<i>Control</i>
Airlines	An airplane might crash.	Implement a preventive maintenance program.
Pharmaceutical drugs	A customer might be harmed by a drug.	Design tamper-proof packaging.
Package delivery	A package may get lost.	Implement an electronic package tracking system.
Banking	Customer credit card numbers may be stolen.	Implement computer system firewalls to foil computer hackers.
Oil & gas	An oil spill may damage the environment.	Create contingency response plans in the event of an oil spill.
E-commerce	The company's website might crash.	Develop a backup system that can be easily activated.
Automotive	Customers may not like the appearance of a new car model.	Use focus groups to assess reactions to new model prototypes.

**Problem 1-4** (15 minutes)

The type of cognitive bias revealed by this data is called self-enhancement bias. This bias occurs when people overstate their strengths and understate their weaknesses relative to others. This bias may cause managers to be overly-optimistic when making plans for the future. This bias might also cause managers to readily blame others if control data indicates unsatisfactory performance. It can also lead managers to make poor decisions because they believe their managerial prowess can overcome any potential obstacles revealed by an objective data analysis. Managers can help reduce the potential adverse consequences of self-enhancement bias by establishing a “devil’s advocate” team of managers that are charged with challenging proposed courses of action.

### **Problem 1-5** (20 minutes)

Some possible examples for each activity:

#### *Planning activities:*

1. Estimating the advertising revenues for a future period.
2. Scheduling the designated broadcast time slot for games, special programming, news shows, etc.
3. Estimating total expenses for future periods including salaries of news desk anchors, play-by-play analysts, researchers, camera crew personnel, etc.

#### *Directing and motivating activities:*

1. Scheduling news desk anchors for each day's news broadcasts.
2. Assigning camera crew employees to cover specific events (e.g., games, press conferences, etc.).
3. Reviewing scripts used by news desk anchors for accuracy, clarity, etc.
4. Providing performance incentives for news anchors based on viewership numbers.

#### *Controlling activities:*

1. Contrasting the actual number of viewers for each show or game with its viewership projections.
2. Comparing the actual costs of producing a broadcast of a sporting event (e.g., hockey game) to its budget.
3. Comparing the advertising revenues earned from broadcasting a sporting event to the costs incurred to broadcast that event.

#### *Decision-making activities:*

1. Determining which news anchor personnel to sign to contracts.
2. Identifying which news items to include in the daily news broadcast and the order in which to present them.
3. Determining which specific games to broadcast in each sport carried by the network.



**Problem 1-6** (20 minutes)

The purpose of this exercise is to present students with an opportunity to debate the ethicality of competing courses of action. Some students may argue that the ethical choice is to tell the truth when speaking with the professor from B.C. University. Other students may argue that it is okay to be untruthful with the professor from B.C. University because it serves a “greater good” from the standpoint of future Central Manitoba University students that will be able to avoid Dr. Smith.

The power of rationalization is a very important topic when discussing ethics and decision-making. When students are asked a generic question about the ethicality of breaking the law or lying, they quickly condemn these actions as unethical. However, when given specific contexts, such as the one presented in this problem, many students will rationalize unlawful or dishonest conduct.

### **Problem 1-7** (20 minutes)

1. Numerous stakeholder groups have likely been negatively affected such as:
  - Customers who have vehicles that were recalled face the inconvenience of needing to take their vehicle to a dealer. Also, customers who suffered personal injury because their vehicles experienced problems (e.g., rapid acceleration) caused by the defect.
  - Toyota employees who were laid off because of reduced production resulting from lower demand for the product.
  - Toyota employees whose compensation (salary or bonus) declined as the result of Toyota's reduced profitability caused by the recalls.
  - Shareholders who suffered investment losses as the result of the drop in Toyota's share price.
  - Suppliers of parts and raw materials used in the production of Toyota's vehicles. As Toyota's production levels dropped, so too would demand for parts and raw materials.
  - Companies to whom Toyota had outsourced production for some aspect of their vehicles (e.g., accelerator pedals).
  - Regulators and government agencies who participated in the parliamentary hearings involving Toyota. Although such participation is part of their jobs, it would have reduced the time or attention these individuals could give to other important issues.
2. If managers at Toyota were receiving significant monetary incentives for increasing sales it is possible that they achieved this outcome by reducing quality, which in turn could reduce costs and allow the company to sell its vehicles at more competitive prices. This is the risk of using extrinsic incentives to motivate a specific outcome such as sales growth as it may lead to dysfunctional behavior related to other product attributes such as quality.

**Problem 1-8** (20 minutes)

1. This question gives students a platform for discussing the merits of extrinsic motivators in organizations. Student responses should differ regarding the effectiveness of extrinsic rewards in creating an enduring commitment to a set of values or a course of action, thereby enabling a lively debate.
2. This question gives students an opportunity to discuss the roles of intrinsic motivation and extrinsic motivation in organizational management.
3. This question gives students an opportunity to discuss the implementation of compensation systems within organizations. To enrich this discussion, professors can ask students questions such as: (1) Would your incentives be tied to individual performance or team-based performance? (2) Would your incentives be tied to easily attainable goals or stretch targets? and (3) How would you handle the fact that financial incentive systems are often influenced by factors that are beyond the control of those being evaluated?

## **Problem 1-9** (30 minutes)

### 1. Benefits and challenges of performing value chain analysis:

#### Benefits:

- Provides a complete picture of product profitability since it incorporates all major functions of the value chain involved in developing, manufacturing and servicing products.
- Can lead to the identification of the most and least profitable products. This could result in actions taken to improve less profitable products such as reducing manufacturing costs, increasing advertising or improving customer service.
- Could lead companies to allocate resources to more profitable products (e.g., increased marketing or customer service) to further enhance their performance.
- Could lead to the discontinuation of unprofitable products if management concludes that cost reductions across the value chain are not possible or feasible.

#### Challenges:

- Some costs may be difficult to separately track for each major product line. For example, marketing costs often relate to advertising campaigns for a company's products as a whole rather than for individual products (e.g., BMW advertisements are often for the brand rather than a specific model).
- The timing of some value chain costs will occur in different periods than the related product revenues. For example, research and development costs will be incurred before a product is brought to market and customer service costs will be incurred after the product has been sold. Therefore to accurately assess product profitability using value chain analysis, managers will have to conduct the analysis on a long-term basis over multiple reporting periods (years) to fully match revenues with the related costs.

### **Problem 1-9** (continued)

- Could lead managers to reduce costs in certain areas such as customer support that could improve product profitability in the short-run but would have negative consequences longer-term if product quality or customer service levels suffer as a result. Note, a good control system would mitigate this behavior by rewarding managers in part based on the longer-term performance of the company.

#### 2. Change in value chain costs over the life of a product:

- Research and development costs are primarily incurred before a product is brought to market and so will be low or non-existent for more mature products.
- Product design costs will be considerably lower as a product matures but some may continue to be incurred such as design changes aimed at improving quality or functionality.
- Manufacturing costs may decline on a per unit basis for more mature products as a result of improvements to production activities or because higher volumes are produced allowing for greater economies of scale (e.g., lower unit costs for raw materials).
- Marketing costs will likely be higher for new products but decrease as products mature since customers will be aware of their existence and features. Marketing costs could also increase as a product matures in response to increased competition.
- Distribution costs may increase as a product matures as managers seek new markets in which to increase sales.

## **FRS INC.**

“Last month’s warehouse fire was a disaster!” exclaimed Paul May, FRS Inc.’s Chief production officer. “We need to fill out the insurance forms as soon as possible to get back all our lost inventories. It seems the fire destroyed our accounting system as well as backup production documentation”, he continued.

John Christensen, the company’s controller walks into Mr. May’s office and shouts “I was able to salvage some of last year’s data. Have a look.”

John’s data contained the following:

Beginning Inventories:

Direct Materials:	\$40,000
Finished Goods Inventory:	\$48,000
Work-in-Process:	\$64,000.

“I also know that our gross profit percentage is 40% and that prime costs are 60% of manufacturing costs” continued John.

“That sounds about right” replies Paul May. “I was also told that overhead costs amount to 40% of conversion costs. Also, I’d say that our ending work-in process inventories were about 20% of the monthly manufacturing costs.”

After further discussions, it was revealed that last year’s sales were \$1,000,000 and that direct labour costs and direct material purchase costs amounted to \$400,000 and \$550,000 respectively.

“John, can you get back to me by tomorrow letting me know how much we can expect to get from our insurance company? I know that they won’t pay for any scrap incurred during the production process, which I estimate to be 10% of production.”

### **Required:**

Assume the role of John Christensen and estimate the amount recoverable in insurance proceeds.

# Chapter 1

## Managerial Accounting and the Business Environment

### Learning Objectives

- LO1. Describe the functions performed by managers.
- LO2. Identify the major differences and similarities between financial and managerial accounting.
- LO3. Explain the basic concepts of lean production and enterprise risk management.
- LO4. Explain the nature and importance of ethics for accountants and the role of corporate social responsibility.
- LO5. Explain how intrinsic motivation, extrinsic incentives, and cognitive biases affect employee behaviour.

### Chapter Overview

This chapter serves **four main purposes**:









- It explains the nature of managerial accounting in providing internal accounting information to support the work of management—planning, directing and motivating, and controlling.
- It describes the nature of organizations and the role of management accountants in an organization.
- It explains how companies are responding to a changing business environment by improving business process with the following four approaches:
  - Lean Production
  - Enterprise Risk Management
- It discusses the importance of upholding ethical standards.

### Service-Related Examples

<i>Company</i>	<i>Type of Business</i>	<i>Text Reference</i>
Certified Professional Accountants	Accounting	Introduction
Canadian Pacific	Railway	In Business
CIBC	Bank	Ethics/Discussion Case

## Assignment Topic Grid

### Chapter 1

<i>Problem</i>	<i>Topic</i>	<i>LO1: Functions of managers</i>	<i>LO2: Financial vs. managerial accounting</i>	<i>LO3: Lean production and enterprise risk management</i>	<i>LO4: Nature and importance of ethics for accountants</i>	<i>LO5: Intrinsic motivation, extrinsic incentives, and cognitive biases</i>	<i>Service industry</i>	<i>Writing component</i>	<i>CPA adapted</i>
E1-1	Functions Performed by Managers	✓							
E1-2	Financial and Managerial Accounting		✓						
E1-3	Enterprise Risk Management			✓					
P1-4	Cognitive Biases					✓			
P1-5	Planning and Control Activities	✓					😊		
P1-6	Ethics in Business				✓				
P1-7	Corporate Social Responsibility				✓				
P1-8	Intrinsic Motivation and Extrinsic Incentives					✓			
P1-9	Value Chain Analysis			✓					

## Video Link

### Comparison of Financial and Managerial Accounting

LO1, LO2

“Managerial Accounting 1.1: Managerial vs Financial Accounting” found on YouTube  
<https://www.youtube.com/watch?v=8gmfuhB5-7g> (3:23 min.)

This video summarizes the key differences between managerial and financial accounting.

### Discussion Question

Why does managerial accounting not need to follow GAAP?

Explain your answer by emphasizing the major differences between financial and management accounting.