# Answers to Questions

**1. Financial accounting deals with regulated, historical, financial information that pertains to the whole company and is designed primarily to meet the information needs of outsiders. Managerial accounting is concerned with unregulated financial, economic, and nonfinancial data, which pertains more to the sub-units of the organization, that is current and future oriented, and that is designed primarily to meet the information needs of insiders.**

**2. The value-added principle means that management accountants are free to engage in any information gathering and reporting activity so long as the activity adds value in excess of its cost. Estimates of future product costs are permissible in managerial accounting reports for budgeting and product costing but would not be allowed by financial regulations in financial accounting.**

**3. The two dimensions of the TQM program are: (1) management should follow a continuous, systematic problem-solving philosophy that encourages achievement of zero defects in production and engages all employees to eliminate waste and errors and to simplify the design and delivery of products and services to customers, and (2) organizations need a strong commitment to customer satisfaction. TQM is being used in business to maintain profitability in an increasingly competitive global market. In this environment, profit margins are tight, and therefore, inefficiencies can more easily erode business profits. To eliminate waste, errors, and dissatisfied customers, information must be timely and relevant in order to prevent or discover and correct mistakes immediately.**

**4. Both financial and managerial accountants need cost information about the company’s products and services. In managerial accounting cost information is useful in product pricing decisions and is an essential part of cost control (comparing actual product cost to budgeted product cost to assess needed improvement) and performance evaluation (assess managers’ success in controlling and eliminating unnecessary cost). In financial accounting, cost information about the product is needed to determine ending inventory on the balance sheet and cost of goods sold on the income statement. Product costing in financial accounting can impact the decisions of not only managers but also outsiders such as investors, creditors, and taxing authorities. Product costing information in managerial accounting can affect the product’s selling price as well as management’s decisions as to whether cost correction changes are needed.**

**5. Costs are assets used in the process of earning revenue but not all costs of the earning process are used in the same period in which they are incurred. Therefore, a cost that is used in the process of earning revenue is recorded as an expense (e.g. administrative salaries and product cost for products sold) and a cost that has future benefit in the earning process is recorded as an asset in the period that it is incurred.**

**6. The cash paid to production workers has not been used to produce revenue but to produce inventory. The revenue is earned when the inventory is sold at which time the cost of salaries associated with those products sold should be expensed as cost of goods sold.**

**7. Product costs associated with goods that have not been sold are recorded in the account called inventory. Inventory cost is shown on the balance sheet as an asset. The amount of total assets and net income will be higher if a product cost is classified as an asset than if it is expensed. Product cost associated with goods that have been sold should be recorded in the account called cost of goods sold. Cost of goods sold is an expense shown on the income statement. The amount of total assets and net income will be lower if a product cost is classified as an expense as opposed to being classified as an asset.**

**8. An indirect product cost cannot be easily or economically traced to a specific product. Product costs that would be considered indirect include costs such as production supplies, salaries of production supervisors, and depreciation, rent, and utilities on factory facilities.**

**9. Product costs are all costs incurred to obtain a product or provide a service. These costs are treated as assets, recorded in inventory, and expensed when the associated products are sold. Period costs are all costs not associated with a product. They are associated with the general, selling, and administrative functions of the business and most are expensed in the period in which the associated economic sacrifice is made. A product cost would be the cost of direct materials used in the production of a product. A period cost would be rent on administrative facilities.**

**10. The effects of cost classification on the financial statements can have important implications with respect to the following:**

**(1) The availability of financing - Investors and creditors use financial statement data to predict businesses’ future earnings. Favorable financial statements provide evidence of favorable future performance whereas unfavorable financial statements are an indication of possible poor future financial performance. A company with favorable financial performance is more likely to generate sufficient cash flows to make interest payments, to repay the principal balance of its liabilities, and to pay dividends. Hence, investors and creditors believe they have a greater probability of receiving interest payments, the return of principal, and return on investment when companies show favorable financial statements. Since expenses reduce profit and financial performance, classifying a cost as an expense will inhibit the company’s ability to obtain financing. Classifying a cost as an asset, which will increase profit, total assets, and equity, enhances businesses’ ability to obtain financing.**

**10. (Continued)**

**(2) Management motivation - Executive compensation may be affected by financial statement data. Many managers’ bonuses are based on a percentage of net income. If costs are classified as expenses, net income will be reduced which in turn affects managerial income. Managers may even be tempted to misclassify costs in order to manipulate financial statement data to their advantage.**

**(3) Income tax considerations - With respect to taxes, managers prefer to classify costs as expenses rather than assets. Classifying a cost as an expense reduces net income and in turn reduces income taxes, which are determined by computing a designated percentage of taxable income.**

**11. Cost allocation is the process of dividing a total cost into parts and assigning the parts to relevant objects. The determination of interest expense on a note payable is an allocation. If the note pays $1,200 of interest a year and has been outstanding for 3 months, then 3/12 or $300 of the $1,200 total interest expense should be allocated to interest expense for the three-month period. The remaining 9/12 of interest would be allocated to interest expense for the remaining 9 months of the year.**

**12. In recognition of its responsibility to uphold high ethical standards of conduct, the Institute of Management Accountants issued a Statement of Ethical Professional Conduct. The statement sets forth professional ethical standards covering the areas of competence, confidentiality, integrity, and objectivity that management accountants are required to abide by in order to maintain their professional and personal integrity.**

**13. Some of the more common ethical conflicts encountered by accountants include the following:**

**(1) Pressure to perform duties for which they are not competently trained.**

**(2) Pressure to disclose confidential information.**

**(3) Pressure to engage in falsification, embezzlement, and bribery.**

**(4) Pressure to issue misleading or incomplete reports.**

**14. A pricing decision must include all costs associated with the product. The manufacturing product cost as well as all upstream costs (costs that occur before the manufacturing process begins, e.g., research and development costs) and downstream costs (costs that are incurred after the manufacturing process, e.g., sales commissions) must be covered by the product’s revenues in order for the company to be profitable.**

**15. JIT inventory system is a reengineering principle where inventory is made available for customer consumption at the time of customer demand. A JIT inventory system is designed to eliminate the storage of large amounts of inventory. By eliminating the storage of inventory, costs related to inventory such as financing, warehouse space, security and maintenance, theft, damage and obsolescence can be reduced or eliminated.**

**16. Reengineering is the term used to explain companies’ responses to world-wide competition by changing production and delivery systems so as to eliminate waste, reduce errors, and minimize costs. Some of the best practices used by world-class competitors include activity-based management, value-added activities, and just-in-time inventory acquisition.**

**17. In traditional costing systems, indirect costs are assigned to products, services, or customers using some allocation base measured in volume such as direct labor hours. In activity-based costing a different allocation system is used to improve the accuracy of allocations. With activity-based costing, indirect costs are first assigned to organizational activities and then to products, services, or customers based on their use of that activity. There is usually a two-level allocation process and more than one allocation base may be used.**

**18. A value chain is the sequence of activities through which an organization provides products to its customers.**

**19. A value-added activity is any unit of work that contributes to a product’s ability to satisfy customer needs. Value-added activities include the following:**

**(1) Input activities - research and development, product design, and hiring and training.**

**(2) Processing activities - assembly, inspection, and storing.**

**(3) Output activities - marketing, distribution, and customer relations.**

**(4) Administrative activities - accounting and legal services, personnel management, and public relations.**

**Nonvalue-added activities are tasks undertaken that do not contribute to a product’s ability to satisfy customer needs. Examples would include the following:**

**(1) Maintaining excess quantities of inventories.**

**(2) Transporting materials and products during production and storage stages.**

**(3) Machine set-ups.**