
Contents

Preface xvii

INTRODUCTION 1

- Origins of Cost Management Systems 2
- The Scientific Management Movement 3
- Management Control for Diversified Organizations 6
- From Cost Management to Cost Accounting 7
- Recent Developments in Manufacturing and Service Companies 8
- Contemporary Management Accounting Developments 9
- Summary 10

I UNDERSTANDING COST BEHAVIOR 12

- The Role of Management Accounting 12
- Understanding Cost Behavior 13
- An Example of Cost Structure 14
 - Deriving the Total Cost Function 16*
 - Determining the Cost per Unit of Service Provided 17*
- Handling Indirect (Common) Costs 22
- Computing the Cost of Unused Capacity 23
- Cost-Volume-Profit Analysis 24
- Summary 27 • Problems 28

2 SHORT-TERM BUDGETING, RESOURCE ALLOCATIONS, AND CAPACITY COST 33

The Example 33

Short-Term Planning and Budgeting 34

Activities, Resource Use, and Costs 35

Optimizing the Use of Short-Term Resources 35

Equal Sales Objective 35

Total Sales Objective 36

Short-Run Profit Objective 37

Opportunity Costs, Capacity Costs, and the Theory of Constraints 37

The Issue of Multiple Resources 38

Effects of Reengineering and Continuous Improvement on Profitability 40

The Role of Cost Information in Allocating Short-Term Resources 40

Budgeting Operations 43

Production and Resource Use 43

Cash Flows 43

Summary 46 • Problems 47 • Cases: *Choosing a Product Mix* 55 • *California Products Corporation: Analyze Product Profitability with Machine Constraints and Committed and Flexible Costs* 56

3 ASSIGNING RESOURCE COSTS TO PRODUCTION COST CENTERS 60

Why Assign Service Department Costs? 61

Measuring Costs of Using Service Departments 63

Avoid Estimates and Allocations for Cost Control 64

A Fundamental Cost Accounting Equation 65

Assigning Service Department Costs 66

Service Departments Not Directly Supporting Production Output 72

Primary and Secondary Activities 72

The Nature and Problems of Reciprocal Services 73

Fall River Company: A Numerical Example 74

The Economic Insights of the Reciprocal Method 76

The Treatment of Committed Costs 77

Make-or-Buy Decisions and Cost Assignments 77

Special Case for Arbitrary Allocations 78

Summary 79 • Appendix 3.1: The Reciprocal Cost Procedure 80 •

Problems 82 • Case: *Seligram, Inc.: Electronic Testing Operations* 90

4 ACTIVITY-BASED COST SYSTEMS 97

- Assigning Service Department Costs to Activities 98
 - Identifying Activities and Mapping Resource Costs to Activities* 101
 - Estimates or Allocations?* 102
- Assigning Service Department Costs: Some Fixed and Some Variable 103
- Activity Cost Drivers 104
 - Selecting Activity Cost Drivers* 108
- Designing the Optimal System 110
- Summary 112 • Cases: *The Classic Pen Company* 113 • *Western Dialysis Clinic* 116 • *Paisley Insurance Company: Activity-Based Costing in a Service Industry* 119 • *Bedford Mining* 123 • *The Rossford Plant* 125 • *The Portables Group* 131 • *John Deere Component Works (A)* 135

5 ACTIVITY-BASED MANAGEMENT 149

- The Product Profitability Whale Curve 150
- Pricing 150
 - Demand Curve Estimation* 152
 - Short-Term Pricing* 153
 - ABC Costing For a New Order* 154
 - Determining Profit Margins* 156
- Using ABC for Analyzing Customer Profitability 158
- Product Substitution 160
- Redesign Products 161
- Improve Processes and Operations Strategy 161
- Technology Investment 163
- Eliminate Products 163
- Summary 163 • Problems 164 • Cases: *Price Leadership in an Oligopoly* 168 • *Siemens Electric Motor Works (A)* 174 • *Kanthal (A)* 179 • *Indianapolis: Activity-Based Costing of City Services (A)* 187 • *The Co-operative Bank* 197 • *John Deere Component Works (B)* 213

6 COST BASED DECISION MAKING 222

- Target Costing 223
 - Customer Orientation* 224
 - The Target Costing Process* 225
 - Target Costing in Action: Toyota Motors* 227

<i>Tear-Down Analysis</i>	227
<i>Quality Function Deployment</i>	228
<i>Value Engineering</i>	228
<i>Reengineering</i>	229
Kaizen Costing	229
Target Costing: A Comprehensive Example	230
<i>Value Engineering</i>	233
<i>Functional Analysis</i>	234
<i>Reengineering</i>	235
Life Cycle Costing	236
Other Costing Tools	237
<i>Quality Cost</i>	237
<i>Taguchi Cost</i>	237
Environmental, Salvage, and Disposal Costs	238
Conclusion	238
• Problems	241
• Cases: <i>Piedmont Express Forms: Process Analysis for Strategic Decision Making</i>	246
• <i>Activity-based Management at Stream International</i>	254
• <i>MosCo, Inc.</i>	268

7 DECENTRALIZATION 288

Why Decentralize	290
<i>The Environment of the Firm</i>	290
<i>Information Specialization</i>	290
<i>Timeliness of Response</i>	291
<i>Conservation of Central Management Time</i>	292
<i>Computational Complexity</i>	292
<i>Training for Local Managers</i>	293
<i>Motivation for Local Managers</i>	293
Summary	293
Organization of Decentralized Units	293
<i>Standard Cost Centers</i>	294
<i>Revenue Centers</i>	295
<i>Discretionary Expense Centers</i>	295
<i>Profit Centers</i>	297
<i>Investment Centers</i>	297
Developing a Performance Measure for Decentralized Operating Units	298
<i>Problems of Goal Congruence</i>	300
<i>Problems of Externalities</i>	301
<i>Overconsumption of Perquisites</i>	302
Summary	303
• Problems	304
• Cases: <i>Pinnacle Mutual Life Insurance Company</i>	306
• <i>Wattie Frozen Foods, Ltd.: A New Zealand Case Study in</i>	

Management Accounting and Extreme Decentralization 321 • *Industrial Chemicals Company* 337 • *BP America: Cost Centers and Profit Centers* 342 • *Empire Glass Company* 346

8 THE BALANCED SCORECARD: MEASURING TOTAL BUSINESS UNIT PERFORMANCE 367

The Balanced Scorecard 368

Financial Perspective 368

Customer Perspective 368

Internal Business Process Perspective 371

Learning & Growth Perspective 374

Summary of Balanced Scorecard Perspective 375

Linking Multiple Scorecard Measures to a Single Strategy 376

Cause and Effect Relationships 376

Performance Drivers 377

Diagnostic Versus Strategic Measures 377

Four Perspectives: Are They Sufficient? 378

Summary 379 • Cases: *Chadwick, Inc.: The Balanced Scorecard* 380 • *Chemical Bank: Implementing the Balanced Scorecard* 383 • *United Way of Southeastern New England (UWSENE)* 397 • *Mobil USM&R (A1)* 409 • *Mobil USM&R (A2)* 417 • *Mobil USM&R (B): New England Sales and Distribution* 422 • *Mobil USM&R (C): Lubricants Business Unit* 428 • *Mobil USM&R (D): Gasoline Marketing* 435

9 FINANCIAL MEASURES OF PERFORMANCE 442

The Nature of Financial Control 442

Control in the Aggregate Using Financial Measures 442

Control in the Small Using Nonfinancial Measures 443

Operations Control and Management By Exception Using Variance Analysis 443

An Example: Jersey River Book Publishing Company 444

The Role of Variance Analysis 445

The Planning Variance 445

The Flexible Budget Variance 445

Flexible Budget Variances for Unit-Related Costs—Price and Quantity Effects 447

Flexible Budget Variances for Batch-Related Costs—Batch Size and Batch Cost Effects 448

Flexible Budget Variances for Product-Related Costs 448

Facility-Sustaining Costs 448

<i>Summary</i>	449
Organization Control Using Profit Measures	449
<i>Using Profits to Assess Organization Unit Performance</i>	449
<i>Choosing a Profit Index</i>	450
<i>Short Run Operating Margin</i>	450
<i>Controllable Contribution</i>	451
<i>Divisional Segment Margin</i>	451
<i>Divisional Profit Before Taxes</i>	452
<i>Common Revenues</i>	452
<i>Transfer Pricing</i>	453
<i>Market Prices</i>	454
<i>Using Marginal Cost Transfer Prices</i>	456
<i>Using Activity-Based Costs for Transfer Pricing</i>	457
<i>Full Costs</i>	458
<i>Dual-Rate Transfer Prices</i>	460
<i>Negotiated Market-Based Price</i>	460
<i>Transfer Pricing—A Summary of Practice</i>	461
<i>Domestic Versus International Transfer Pricing</i>	463
<i>Other Measures of Performance</i>	464
Productivity Measures	465
<i>Return on Investment</i>	466
<i>Material Yield</i>	466
<i>Labor Yield</i>	466
<i>Equipment Yield</i>	467
Summary	467 • Problems
<i>Cases: Transfer Pricing in an Automobile Dealership—Shuman Automobiles, Inc.</i>	479 • <i>Transfer Pricing Among Related Businesses—Kirkpatrick Associates, Incorporated</i>
<i>484 • Transfer Pricing in a Multinational Corporation—Del Norte Paper Company (A)</i>	486 • <i>Managing Profit Center Performance—Wilkinson Transport (B)</i>
<i>490 • Internal Transfer Pricing With an Outside Market—The New Brunswick Company</i>	496

10 FINANCIAL MEASURES OF PERFORMANCE: RETURN ON INVESTMENT (ROI) AND ECONOMIC VALUE ADDED (EVA™) 499

Relating Profits to Assets Employed	499
A Historical Perspective	500
The Matsushita Internal Capital System	502
The Danger of ROI Control	504
<i>A Simple Example</i>	504

Technical Shortcomings of the ROI Measure	505
Economic Value Added (Residual Income)	506
Expense Versus Capitalize	509
<i>Leased Assets</i>	511
Price-Level Adjustments	514
Depreciation Method	518
Summary of Technical Adjustments to ROI and EVA Calculations	520
Linking ABC to Economic Value Added: Assigning Assets	520
Summary	523
Problems	524
Cases: <i>Using EVA and MVA at Outsource, Inc.</i>	532
<i>Purity Steel Corporation, 1995</i>	537
<i>Western Chemical Corporation: Divisional Performance Measurement</i>	544

11 MEASURING CUSTOMER, INTERNAL BUSINESS PROCESS, AND EMPLOYEE PERFORMANCE 551

Customer Perspective	551
<i>Market and Account Share</i>	551
<i>Customer Retention</i>	552
<i>Customer Acquisition</i>	552
<i>Customer Satisfaction</i>	553
<i>Customer Profitability</i>	553
<i>Beyond the Core: Meeting Customer's Expectations</i>	553
Internal Business Perspective: Operations and Innovation Processes	557
<i>Operational Excellence: Time, Quality, and Cost Measurements</i>	558
<i>Innovation Measures</i>	564
Employee Capabilities	567
<i>Core Employee Measurement Group</i>	567
<i>Strategic Job Coverage</i>	568
Summary	569
Problems	570
Cases: <i>Draper Instruments</i>	578
<i>Texas Instruments: Materials and Control Group</i>	582

12 INVESTING TO DEVELOP FUTURE CAPABILITIES TECHNOLOGY 593

Is a New Theory Needed?	594
<i>Short Time Horizon</i>	595
<i>Excessively High Discount Rates</i>	595
<i>Risk Adjustments</i>	597
<i>Alternatives to New Investment</i>	598

<i>Incremental versus Global Analysis</i>	600
<i>Front-End Investment Costs</i>	600
<i>Benefits Invisible Using Traditional Cost Systems</i>	602
Measuring All The Benefits from the New Process	603
<i>Reduced Inventory Levels</i>	603
<i>Less Floor Space</i>	603
<i>Quality Improvements</i>	604
<i>More-Accurate, Less-Precise Estimates</i>	604
<i>The Difficult-to-Quantify Benefits</i>	604
Investing in Organizational Capabilities	605
<i>External Integration: Linking Design to the Customer</i>	605
<i>Internal Integration: Connecting Functions Within the Organization</i>	606
<i>Flexibility: Responsiveness to Change</i>	606
<i>Experimentation: Achieving Continuous Improvement</i>	607
<i>Cannibalization: Achieving Radical Improvement</i>	607
Summary on Building Organizational Capabilities	608 • <i>The Bottom Line</i> 609 • <i>Problems</i> 611 • <i>Cases: Othello Corporation (A): Capital Equipment Planning and Control</i> 613 • <i>Wilmington Tap and Die</i> 627 • <i>Stermon Mills Incorporated</i> 638 • <i>Burlington Northern: The ARES Decision (A)</i> 651 • <i>Burlington Northern: The ARES Decision (B)</i> 667

13 INCENTIVE AND COMPENSATION SYSTEMS 673

The Expectancy View of Behavior	673
Intrinsic and Extrinsic Rewards	674
Tying Rewards to Performance	675
<i>Rewards Based on Financial Performance</i>	675
<i>Rewards Based on Group or Individual Performance</i>	675
<i>Rewards Based on Nonfinancial Measures of Performance</i>	676
<i>Executive Compensation</i>	676
<i>Incentive Compensation and the Principal-Agent Relationship</i>	677
Important Attributes of Compensation Systems	681
<i>Role for Bonus and Incentive Contracts</i>	682
<i>Types of Incentives</i>	684
<i>Specific Forms Assumed by Monetary Compensation Plans</i>	684
<i>Evaluating Accounting-Based Incentive Compensation Schemes</i>	688
<i>Short-Term versus Long-Term Performance Measures</i>	692
<i>Are Chief Executives Overpaid?</i>	693

Rewarding Other Organization Members 695*Gainsharing 695**Piecerate Systems 696**Labor-Related Plans 696**Bonus Systems 697*

Summary 697 • Problems 699 • Cases: *McDonald's Corporation: Designing an Incentive System 708* • *Analog Devices, Inc. (A) 714* • *The Charles River Company 723* • *RKO Warner Video, Inc.: Incentive Compensation Plan 733* • *Duckworth Industries, Inc.—Incentive Compensation Programs 744*

14 FORMAL MODELS IN BUDGETING AND INCENTIVE CONTRACTS 764

Issues and Terms in Formal Incentive Models 764*Wealth Leisure and Risk Attitudes 764**Individual Honesty and the Role of Contract Monitoring 765**Choosing the Right Manager and the Role of Information 766**Balancing Incentive and Return Considerations 767***Problems of Obtaining Information for Standards and Budgets 768***Using Information for Rewards and Control—The Moral Hazard Problem 769**Moral Hazard and Information Impactedness 769***The Agency Model 770***The Setting 770**The Motivational Problem: Why a Flat Wage Will Not Do 771**The Principal's Problem: How to Tie Reward to Performance 771***Eliciting Honest Revelation of Privately Held Beliefs 773***The Role of Uncertainty in the Soviet Incentive Model 744**Limitations of the Truth-Inducing Budget Scheme 775**Truth-Inducing Schemes for Resource Allocation Decisions 777***The Role of Insurance 779**

Summary 780 • Problems 782

INDEX 793