Chapter 1
Managerial Accounting and the Business Environment

Solutions to Questions

1-1 Managerial accounting is concerned with providing information to managers for use within the organization. Financial accounting is concerned with providing information to stockholders, creditors, and others outside of the organization.

1-2 A strategy is a game plan that enables a company to attract customers by distinguishing itself from competitors. The focal point of a company's strategy should be its target customers.

1-3 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.

1-4 Managers carry out three major activities in an organization: planning, directing and motivating, and controlling. 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.

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

1-6 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.

1-7 A person in a line position is directly involved in achieving the basic objectives of the organization. A person in a staff position provides services and assistance to other parts of the organization, but is not directly involved in achieving the basic objectives of the organization.

1-8 The Chief Financial Officer is responsible for providing timely and relevant data to support planning and control activities and for preparing financial statements for external users.

1-9 The three main categories of inventories in a manufacturing company are raw materials, work in process, and finished goods.

1-10 The five steps in the lean thinking model are: (1) identify value in specific products and services; (2) identify the business process that delivers value; (3) organize work arrangements around the flow of the business process; (4) create a pull system that responds to customer orders; and (5) continuously pursue perfection in the business process.

1-11 Successful implementation of the lean thinking model should result in lower inventories, fewer defects, less wasted effort, and quicker customer response times.

1-12 In a pull production system, production is not initiated until a customer order is received. Inventories are reduced to a minimum by purchasing raw materials and producing products only as needed to meet customer demand.

1-13 Some benefits from improvement efforts come from cost reductions, but the primary benefit is often an increase in capacity. At non-constraints, increases in capacity just add to the already-existing excess capacity. Therefore, improvement efforts should ordinarily focus on the constraint.

1-14 Six Sigma is a process improvement method that relies on customer feedback and fact-based data gathering and analysis techniques to drive process improvement. The goal is to reduce defect rates below 3.4 defects per million.

1-15 The five stages in the Six Sigma DMAIC Framework are (1) Define; (2) Measure; (3) Analyze; (4) Improve; and (5) Control. The goals for the define stage are to establish the scope and purpose of the project, to diagram the flow of the current process, and to establish the customer's requirements for the process. The goals for the measure stage are to gather baseline performance data related to the existing process and to narrow the scope of the project to the most important problems. The goal in the analyze stage is to identify the root causes of the problems identified in the measure stage. The goal in the improve stage is to develop, evaluate, and implement solutions to the problems. The goals in the control stage are to ensure the problems remain fixed and to seek to improve the new methods over time.

1-16 An enterprise system is supposed to overcome the problems that result from having separate, unintegrated software applications that support specific business functions. It does this by integrating data across an organization in a single software system that enables all employees to have simultaneous access to a common set of data.

1-17 If people generally did not act ethically in business, no one would trust anyone else and people would be reluctant to enter into business transactions. The result would be less funds raised in capital markets, fewer goods and services available for sale, lower quality, and higher prices.

1-18 Corporate governance is the system by which a company is directed and controlled. If properly implemented, the corporate governance system should provide incentives for the board of directors and top management to pursue objectives that are in the best interests of the company's owners and it should provide for effective monitoring of performance.

1-19 Enterprise risk management is a process used by a company to proactively identify the risks that it faces and to manage those risks.

Exercise 1-1 (10 minutes)

1. Managerial accounting, financial accounting
2. Planning
3. directing and motivating
4. feedback
5. decentralization
6. line
7. staff
8. controller
9. budgets
10. performance report
11. Chief Financial Officer
12. precision; nonmonetary data

Exercise 1-2 (20 minutes)

1. strategy
2. Six Sigma
3. business process
4. corporate governance
5. enterprise risk management
6. just-in-time
7. Internet
8. constraint
9. nonconstraint
10. value chain
11. enterprise system
12. supply chain management
13. lean thinking model; pulls
14. customer value proposition
15. budget
16. non-value-added activity
17. Theory of Constraints

Exercise 1-3 (15 minutes)

If cashiers routinely short-changed customers whenever the opportunity presented itself, most of us would be careful to count our change before leaving the counter. Imagine what effect this would have on the line at your favorite fast-food restaurant. How would you like to wait in line while each and every customer laboriously counts out his or her change? Additionally, if you can't trust the cashiers to give honest change, can you trust the cooks to take the time to follow health precautions such as washing their hands? If you can't trust anyone at the restaurant would you even want to eat out?

Generally, when we buy goods and services in the free market, we assume we are buying from people who have a certain level of ethical standards. If we could not trust people to maintain those standards, we would be reluctant to buy. The net result of widespread dishonesty would be a shrunken economy with a lower growth rate and fewer goods and services for sale at a lower overall level of quality.

Problem 1-4 (20 minutes)

1. No, Sarver did not act in an ethical manner. In complying with the president's instructions to omit liabilities from the company's financial statements he was in direct violation of the IMA's *Statement of Ethical Professional Practice.* He violated both the "Integrity" and "Credibility" guidelines on this code of ethical conduct. The fact that the president ordered the omission of the liabilities is irrelevant.
2. No, Sarver's actions can't be justified. In dealing with similar situations, the Securities and Exchange Commission (SEC) has consistently ruled that "…corporate officers…cannot escape culpability by asserting that they acted as 'good soldiers' and cannot rely upon the fact that the violative conduct may have been condoned or ordered by their corporate superiors." (Quoted from: Gerald H. Lander, Michael T. Cronin, and Alan Reinstein, "In Defense of the Management Accountant," *Management Accounting,* May, 1990, p. 55) Thus, Sarver not only acted unethically, but he could be held legally liable if insolvency occurs and litigation is brought against the company by creditors or others. It is important that students understand this point early in the course, since it is widely assumed that "good soldiers" are justified by the fact that they are just following orders. In the case at hand, Sarver should have resigned rather than become a party to the fraudulent misrepresentation of the company's financial statements.

Problem 1-5 (30 minutes)

1. See the organization chart on the following page.

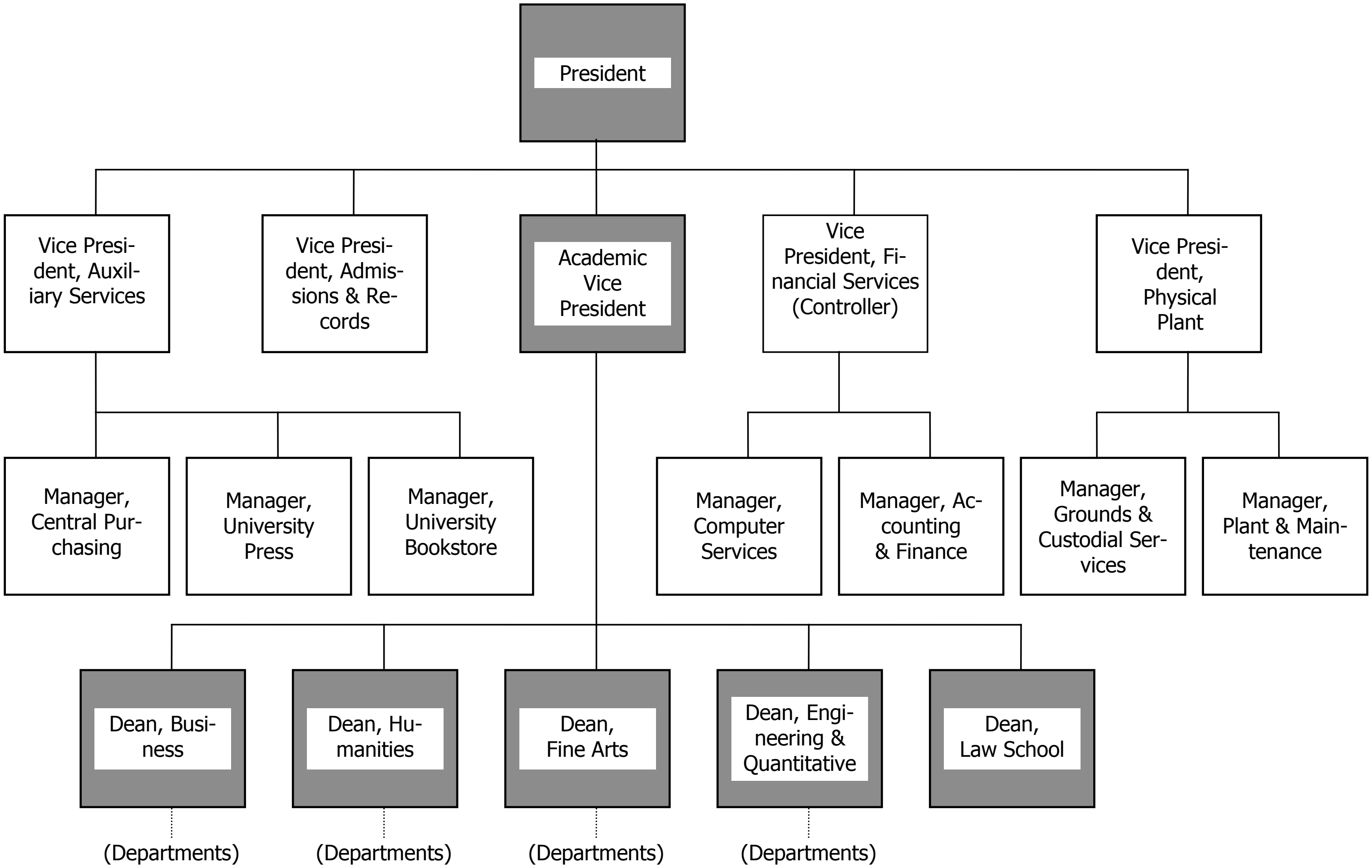
2. Line positions would include the university president, academic vice-president, the deans of the four colleges, and the dean of the law school. In addition, the department heads (as well as the faculty) would be in line positions. The reason is that their positions are directly related to the basic purpose of the university, which is education. (Line positions are shaded on the organization chart.)

   All other positions on the organization chart are staff positions. The reason is that these positions are indirectly related to the educational process, and exist only to provide service or support to the line positions.

3. All positions would have need for accounting information of some type. For example, the manager of central purchasing would need to know the level of current inventories and budgeted allowances in various areas before doing any purchasing; the vice president for admissions and records would need to know the status of scholarship funds as students are admitted to the university; the dean of the business college would need to know his/her budget allowances in various areas, as well as information on cost per student credit hour; and so forth.

Problem 1-5 (continued)

1. Organization chart:



Deleted: Problem 1-6 (30 minutes)

1. Adam Williams has an ethical responsibility to take some action in the matter of GroChem Inc. and the dumping of toxic wastes. The specific standards in the IMA's *Statement of Ethical Professional Practice* that apply are as follows.

- **Competence.** Management accountants have a responsibility to perform their professional duties in accordance with relevant laws, regulations, and technical standards.
- **Objectivity.** Management accountants must disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations.

Given that the dumping of toxic wastes in a residential landfill is illegal, there is a clear responsibility to bring this issue to the attention of management.

2. The IMA's *Statement of Ethical Professional Practice* indicates that the first alternative being considered by Adam Williams, seeking the advice of his boss, is appropriate. To resolve an ethical conflict, the first step is to discuss the problem with the immediate superior, unless it appears that this individual is involved in the conflict. In this case, it does not appear that Williams' boss is involved.

Communication of confidential information to anyone outside the company is inappropriate unless there is a legal obligation to do so, in which case Williams should contact the proper authorities.

Contacting a member of the Board of Directors would be an inappropriate action at this time. Williams should report the conflict to successively higher levels within the organization and turn only to the Board of Directors if the problem is not resolved at lower levels.

3. Adam Williams should report the problem to successively higher levels of management until it is satisfactorily resolved. There is no requirement for Williams to inform his immediate superior of this action because the superior is involved in the conflict. If the conflict is not resolved after exhausting all courses of internal review, Williams probably should consult his own attorney regarding his legal obligations and rights. ... [1]

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(CMA Unofficial Solution, adapted)

Page Break

Problem 1-7 (20 minutes)

1. If all automotive service shops routinely tried to sell parts and services to customers that they didn't really need, most customers would eventually figure this out. They would then be reluctant to accept the word of the service representative that a particular problem needs to be corrected—even when there is a legitimate problem. Either the work would not be done, or customers would learn to diagnose and repair problems themselves, or customers would hire an independent expert to verify that the work is really needed. All three of these alternatives impose costs and hassles on customers.

2. As argued above, if customers could not trust their service representatives, they would be reluctant to follow the service representative's advice. They would be inclined not to order the work done even when it is really necessary. And, more customers would learn to do automotive repairs and maintenance themselves. More-

over, customers would be unwilling to pay as much for work that is done since customers would have reason to believe that the work may be unnecessary. These two effects would reduce demand for automotive repair services. The reduced demand would reduce employment in the industry and would lead to lower overall profits.

Page Break

Problem 1-8 (30 minutes)

1. Line positions are in the direct chain of command and are directly responsible for the achievement of the basic objectives of an organization. These positions involve a direct relationship to the organization's product or service.

Staff positions are intended to provide expertise, advice, and support for line positions, being only indirectly related to the achievement of the basic objectives of the organization.

2. Reasons for conflict between line and staff positions include the following.

- Line managers perceive staff managers as threats to their authority, especially when staff persons have functional authority.

- Line managers may become uncomfortable when they grow dependent on staff expertise and knowledge.

- Line managers may perceive staff managers as overstepping their authority, having a narrow perspective, or stealing credit. Staff managers, on the other hand, may perceive line managers as not utilizing their expertise, not giving staff enough authority, or resisting staff's ideas.

Page Break

Problem 1-8 (continued)

3. a. and b. Listed below are the identification, explanation, and potential problems that could arise for each position described in the text.

Jere Feldon–Staff Liaison to the Chairperson. Feldon has a staff position as he is not in the direct line of activities. Feldon has a potential conflict between his two superiors because he reports directly to the chairperson yet he also works for the president.

Lana Dickson–Director of Self-Study Programs. Dickson's position is a line position as her job provides educational opportunities to members. Her potential problems include the marketing of the courses and acquisition of outside or accounting services because she needs to rely on the services of individuals from different departments where she has no line authority.

Jess Paige–Editor of Special Publications. This is a line function because the publication of educational materials and the sale of monographs are part of the organization's objectives. Paige's potential problems include difficulties he may experience in working with the Research Department as he has no authority over this department but is dependent on its work.

George Ackers–Manager of Personnel. Ackers has a staff position that provides services across the entire organization. Ackers' potential problems include being ignored due to his position being lower than the vice-president level in the organization, and attempting to take more authority than he is entitled.

(CMA Unofficial Solution, adapted)

Page Break

Research and Application 1-9 (240 minutes)

1. Whole Foods Market succeeds first and foremost because of its product leadership customer value proposition. The first boldface heading in the company's Declaration of Interdependence says "We Sell the Highest Quality Natural and Organic Products Available." Page 4 of the 10-K/A indicates that the real source of the company's product leadership position centers on perishable products (e.g., produce, dairy, meat, seafood, bakery, and prepared foods). Perishable product sales account for about 67% of total retail sales. Customers choose Whole Foods Market primarily because they are able to buy better natural and organic foods and higher-quality perishable products than in conventional supermarkets.

Customer service is also an important part of Whole Foods Market's success, but it is secondary in importance to product quality.

2. Whole Foods Market faces numerous business risks as described in pages 11-15 of the 10-K/A. Here are four of the more prominent risks with suggested control activities:

Risk: Customers will defect to conventional supermarkets that are beginning to stock more natural and organic foods. Control activities: Whole Foods Market can expand its selection of product offerings, particularly perishables, and continue to invest heavily in employee training and retention so that it offers market-leading levels of informed customer service.

Risk: Growth targets will not be realized due to failed new store openings. Control activities: Implement formal reviews of the sight selection, construction, and new employee hiring and training processes.

Risk: Adverse economic conditions could reduce consumer spending at retail locations. Control activities: Continue to develop private label product categories, such as the 365 Everyday Value category mentioned on page 8 of the 10-K/A, that are less expensive but meet rigorous quality standards.

Page Break

Research and Application 1-9 (continued)

Extended power outages could cause severe inventory losses because of the company's emphasis on perishable products. Control activities: Implement a contingency plan that specifies responses in the event of a power outage.

3. There are no absolute right and wrong answers to this question because the information available in the annual report is piecemeal. Nonetheless, students could make the following observations based on available information. First, the CEO (John P. Mackey) has a layer of senior managers that report to him including two Co-Presidents/Chief Operating Officers, and three Executive Vice Presidents. Second, there are ten Regional Presidents. In the organization chart shown below, we assume that the Regional Presidents report to the Chief Operating Officers. Third, each Regional President has a layer of management that reports to him or her. For example, the Global All-Stars include David Schwartz, who is the Vice President of the Midwest Region. He would report to the President of the Midwest Region. John Simrell is the Director of Finance for the South Region and he would report to the South Region President. Robin Graf is the Team Member Services Director for the Southern Pacific Region. She would report to the President of the Southern Pacific Region.

Fourth, each region has a manager/coordinator for each product category. For example, Theo Weening is the Meat Category Manager for the Mid-Atlantic Region and Bobby Turner is the Bakery Coordinator for the Midwest Region. In the organization chart shown below, we assume that these regional managers/coordinators report to a Vice-President at the regional level. Fifth, each region has Store Team Leaders for each retail location within the region. For example, John Robertson is the Store Team Leader in Charlottesville, Va. We have assumed that the store team leaders report to the regional vice-president level. Finally, each store location has various team leaders that report to the store team leader. For example, Rolando Alas is the Produce Team Leader at the Mill Valley Store location.

Page Break

Research and Application 1-9 (continued)

Based on insights such as these, students should be able to prepare an organization chart that resembles the one shown at the end of this solution.

The Global All-Stars include numerous line and staff employees. Three staff employees are Roberta Lang, General Counsel, Chris Pine, Vice President of Real Estate, and Jennifer McFarlin, Payroll Benefit Specialist, Madison. Three line employees are Rocco Terrazano, Meat Team Leader, Yorkville, Don Hosfeld, Grocery Team Leader, Ft. Lauderdale, and Joel Leonard, Prepared Foods Team Leader, Fresh Pond.

4. Both documents emphasize that the respective companies serve a broad range of stakeholders (e.g., customers, employees, suppliers, communities, and stockholders). Both companies mention that their most important stakeholder is the customer. The first sentence of the Johnson & Johnson Credo says "We believe our first responsibility is to the doctors, nurses, and patients, to mothers and fathers and all others who use our products and services." Whole Foods Market says "Our customers are the most important stake-

holder in our business. Therefore, we go to extraordinary lengths to satisfy and delight our customers."

The Whole Foods Market Declaration of Interdependence explicitly recognizes that satisfying all stakeholders' interests will require balance and making trade-offs. In fact, the company says "One of the most important responsibilities of Whole Foods Market's leadership is to make sure the interests, desires and needs of our various stakeholders are kept in balance… Any conflicts must be mediated and win-win solutions found." The Johnson & Johnson Credo does not explicitly acknowledge the need to strike a balance when managing the needs of its various stakeholders.

Page Break

Research and Application 1-9 (continued)

5. Whole Foods Market's mission statement differs from its Code of Conduct and Ethics in three important respects. First, the mission statement sets forth goals that the company strives to achieve. The tone of the document is positive because it focuses on goals the company hopes to achieve. The Code of Conduct and Ethics defines prohibited conduct. The tone of the document is appropriately negative because it describes those behaviors that are "out of bounds."

Second, the mission statement refers to a broader set of stakeholders (e.g., suppliers, customers, and communities) than the Code of Conduct and Ethics, which pertains primarily to Whole Foods Market Team Members and Directors. Third, the mission statement is values-based. It reflects a vision of what the company stands for. The Code of Conduct and Ethics is rule-based. The majority of the code is based on the rules of governing bodies such as the Securities and Exchange Commission (SEC), the Nasdaq stock exchange, and the Financial Accounting Standards Board (FASB).

6. The annual report and 10-K/A is primarily a financial accounting document. First, a 10-K (or 10-K/A as in the case of Whole Foods Market) is prepared for an external regulator—The Securities and Exchange Commission. Management accounting focuses on providing data to internal decision makers. Second, the financial statements included in the 10-K/A summarize transactions from the prior year. Management accounting focuses on decisions affecting the future. Third, the financial results presented in the 10-K/A have been "verified" by an independent auditor (Ernst & Young). Management accountants do not rely on auditors to verify the usefulness of information. Fourth, the financial results shown in the 10-K/A are presented for the company as a whole. Management accountants would be interested in segmented data such as year-to-year same store profitability. Fifth, the financial statements have been prepared according to GAAP. Managerial accounting does not have to conform to GAAP.

Page Break

Research and Application 1-9 (continued)

Note to the instructor: To help motivate the course, you may want to point out how Whole Foods Markets might benefit from managerial accounting information. We will provide five such examples.

1. Whole Foods Market is expanding by opening new stores. Capital budgeting techniques, such as those covered in Chapter 14, could be used to help decide which site locations should be chosen for new store openings.

2. The company is seeking to grow its private label product lines. Segmented income statements, such as those covered in Chapter 12, could be used to help analyze the profitability of business segments such as the 365 Everyday Value product line or the Whole Kids Organic product line.

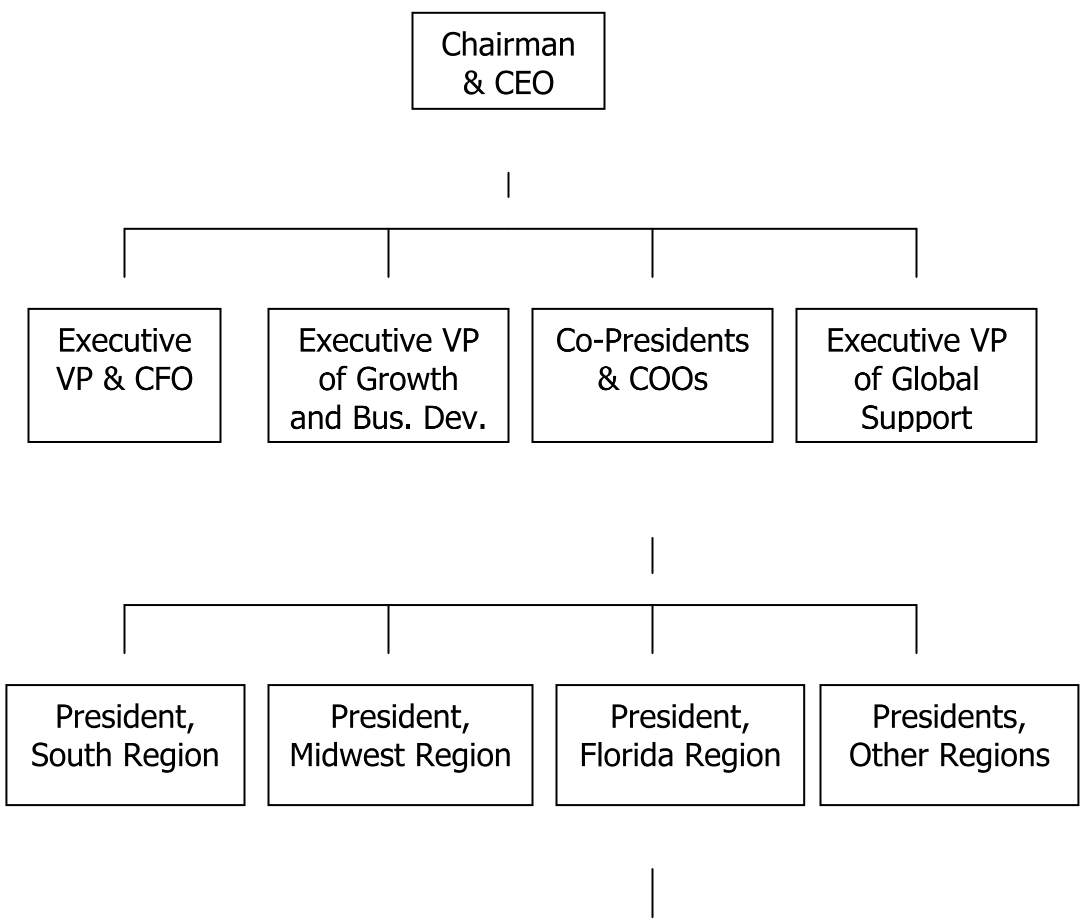
3. Relevant cost analysis, as discussed in Chapter 13, could be used to make keep/drop decisions with respect to these private label product lines.

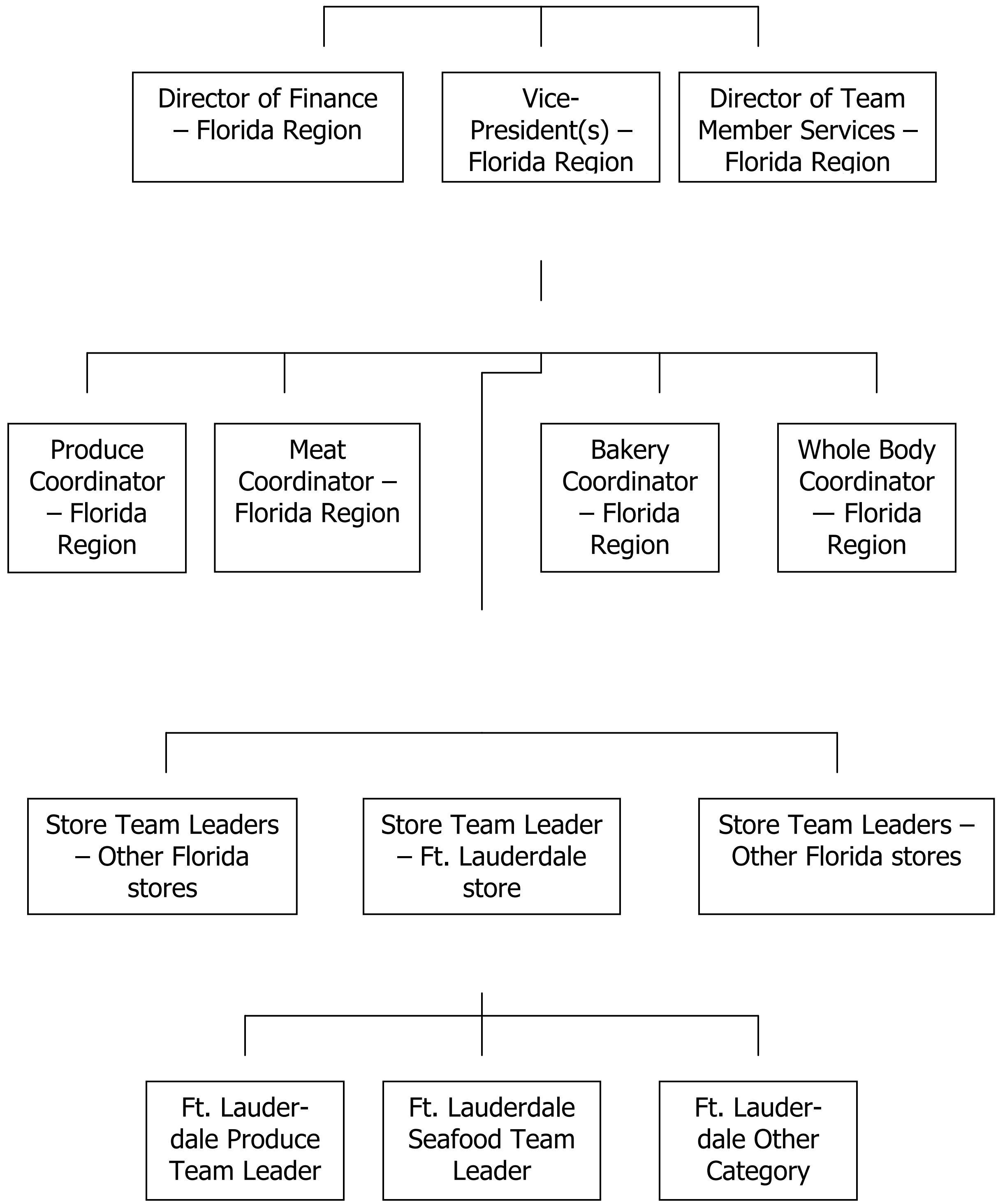
4. Responsibility accounting principles could be useful to Whole Foods Market. The company operates two produce procurement centers, three seafood processing and distribution facilities, a specialty coffee roaster and distributor, six regional commissaries, 12 bakehouse facilities, 10 regional distribution centers, and 163 retail locations. Each of the aforementioned could be managed and evaluated as a separate responsibility center.

5. The cost-volume-profit concepts discussed in Chapter 6 could be useful to the company as it contemplates the financial impact of adjusting selling prices or the overall product mix offered in its stores.

Page Break

Research and Application 1-9 (continued)




Director of Finance – Florida Region
Vice-President(s) – Florida Region
Director of Team Member Services – Florida Region
Produce Coordinator – Florida Region
Meat Coordinator – Florida Region
Bakery Coordinator – Florida Region
Whole Body Coordinator — Florida Region
Store Team Leaders – Other Florida stores
Store Team Leader – Ft. Lauderdale store
Store Team Leaders – Other Florida stores
Ft. Lauder-dale Produce Team Leader
Ft. Lauderdale Seafood Team Leader
Ft. Lauder-dale Other Category