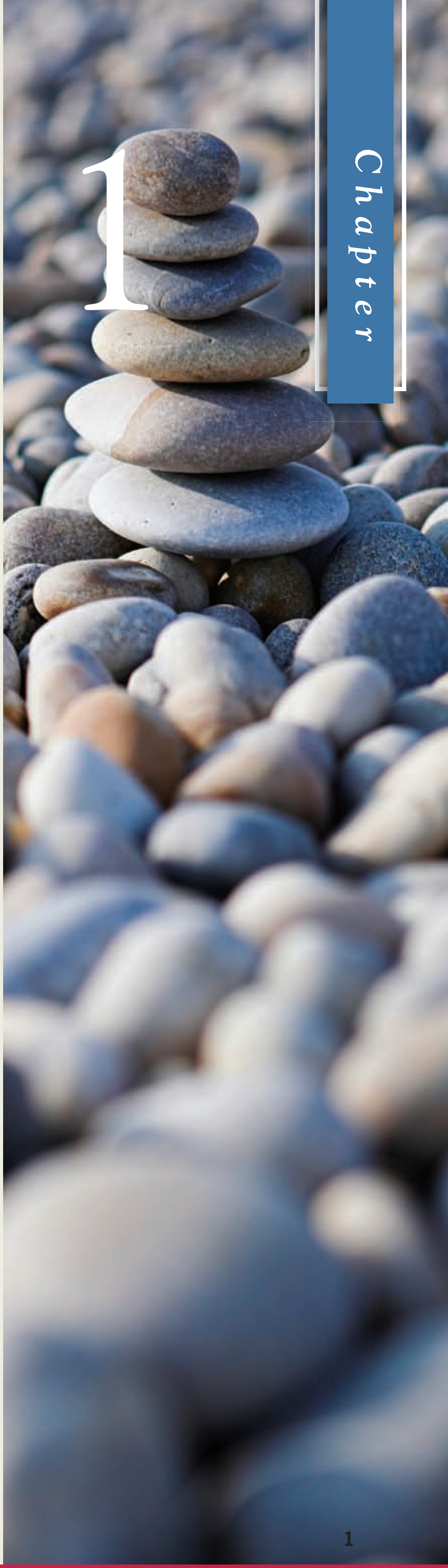
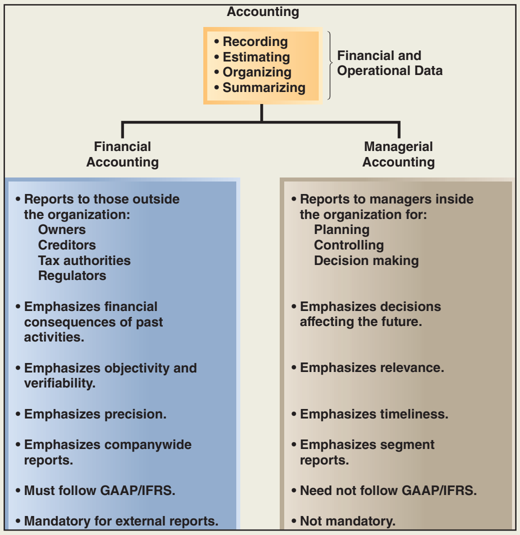


Managerial Accounting: An Overview

BUSINESS FOCUS

Managerial Accounting: It's More Than Just Crunching Numbers



"Creating value through values" is the credo of today's management accountant. It means that management accountants should maintain an unwavering commitment to ethical values while using their knowledge and skills to influence decisions that create value for organizational stakeholders. These skills include managing risks and implementing strategy through planning, budgeting and forecasting, and decision support. Management accountants are strategic business partners who understand the financial and operational sides of the business. They not only report and analyze financial measures, but also nonfinancial measures of process performance and corporate social performance. Think of these responsibilities as profits (financial statements), process (customer focus and satisfaction), people (employee learning and satisfaction), and planet (environmental stewardship). ■

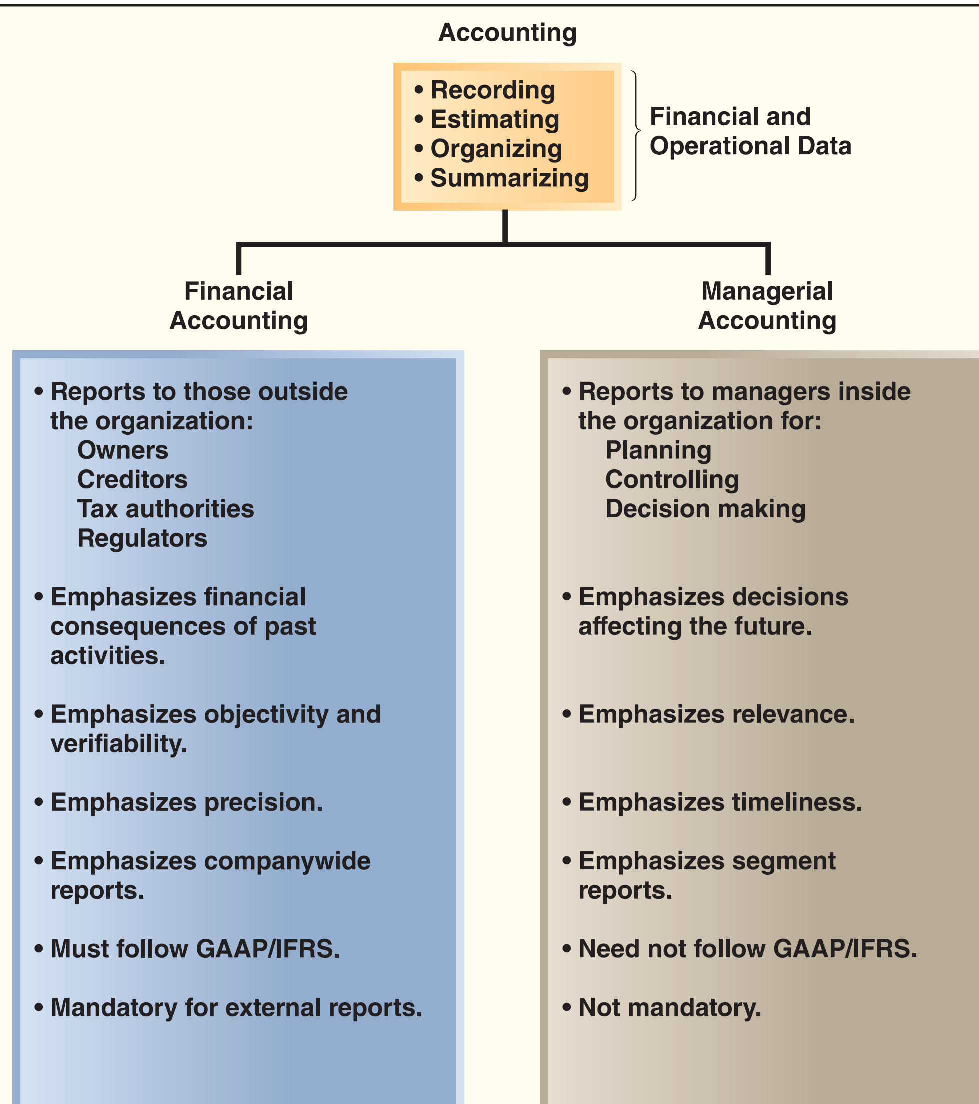
Source: Conversation with Jeff Thomson, president and CEO of the Institute of Management Accountants.

This chapter explains why managerial accounting is important to the future careers of all business students. It begins by answering three questions: (1) What is managerial accounting? (2) Why does managerial accounting matter to your career? and (3) What skills do managers need to succeed? It concludes by discussing two topics important to all managers—the role of ethics in business and corporate social responsibility.

What Is Managerial Accounting?

Many students enrolled in this course will have recently completed an introductory *financial accounting* course. **Financial accounting** is concerned with reporting financial information to external parties, such as stockholders, creditors, and regulators. **Managerial accounting** is concerned with providing information to managers for use within the organization. Exhibit 1–1 summarizes seven key differences between financial and managerial accounting. It recognizes that the fundamental difference between financial and managerial accounting is that financial accounting serves the needs of

EXHIBIT 1–1
Comparison of Financial and Managerial Accounting



those *outside* the organization, whereas managerial accounting serves the needs of managers employed *inside* the organization. Because of this fundamental difference in users, financial accounting emphasizes the financial consequences of past activities, objectivity and verifiability, precision, and companywide performance, whereas managerial accounting emphasizes decisions affecting the future, relevance, timeliness, and *segment* performance. A **segment** is a part or activity of an organization about which managers would like cost, revenue, or profit data. Examples of business segments include product lines, customer groups (segmented by age, ethnicity, gender, volume of purchases, etc.), geographic territories, divisions, plants, and departments. Finally, financial accounting is mandatory for external reports and it needs to comply with rules, such as generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS), whereas managerial accounting is not mandatory and it does not need to comply with externally imposed rules.

As mentioned in Exhibit 1–1, managerial accounting helps managers perform three vital activities—*planning, controlling,* and *decision making.* **Planning** involves establishing goals and specifying how to achieve them. **Controlling** involves gathering feedback to ensure that the plan is being properly executed or modified as circumstances change. **Decision making** involves selecting a course of action from competing alternatives. Now let's take a closer look at these three pillars of managerial accounting.

Planning

Assume that you work for Procter & Gamble (P&G) and that you are in charge of the company's campus recruiting for all undergraduate business majors. In this example, your planning process would begin by establishing a goal such as: our goal is to recruit the "best and brightest" college graduates. The next stage of the planning process would require specifying how to achieve this goal by answering numerous questions such as:

- How many students do we need to hire in total and from each major?
- What schools do we plan to include in our recruiting efforts?
- Which of our employees will be involved in each school's recruiting activities?
- When will we conduct our interviews?
- How will we compare students to one another to decide who will be extended job offers?
- What salary will we offer our new hires? Will the salaries differ by major?
- How much money can we spend on our recruiting efforts?

As you can see, there are many questions that need to be answered as part of the planning process. Plans are often accompanied by a *budget.* A **budget** is a detailed plan for the future that is usually expressed in formal quantitative terms. As the head of recruiting at P&G, your budget would include two key components. First, you would have to work with other senior managers inside the company to establish a budgeted amount of total salaries that can be offered to all new hires. Second, you would have to create a budget that quantifies how much you intend to spend on your campus recruiting activities.

Controlling

Once you established and started implementing P&G's recruiting plan, you would transition to the control process. This process would involve gathering, evaluating, and responding to feedback to ensure that this year's recruiting process meets expectations. It would also include evaluating the feedback in search of ways to run a more effective recruiting campaign next year. The control process would involve answering questions such as:

- Did we succeed in hiring the planned number of students within each major and at each school?
- Did we lose too many exceptional candidates to competitors?

- Did each of our employees involved in the recruiting process perform satisfactorily?
- Is our method of comparing students to one another working?
- Did the on-campus and office interviews run smoothly?
- Did we stay within our budget in terms of total salary commitments to new hires?
- Did we stay within our budget regarding spending on recruiting activities?

As you can see, there are many questions that need to be answered as part of the control process. When answering these questions your goal would be to go beyond simple yes or no answers in search of the underlying reasons why performance exceeded or failed to meet expectations. Part of the control process includes preparing *performance reports*. A **performance report** compares budgeted data to actual data in an effort to identify and learn from excellent performance and to identify and eliminate sources of unsatisfactory performance. Performance reports can also be used as one of many inputs to help evaluate and reward employees.

Although this example focused on P&G's campus recruiting efforts, we could have described how planning enables FedEx to deliver packages across the globe overnight, or how it helped Apple develop and market the iPad. We could have discussed how the control process helps Pfizer, Eli Lilly, and Abbott Laboratories ensure that their pharmaceutical drugs are produced in conformance with rigorous quality standards, or how Kroger relies on the control process to keep its grocery shelves stocked. We also could have looked at planning and control failures such as BP's massive oil spill in the Gulf of Mexico. In short, all managers (and that probably includes you someday) perform planning and controlling activities.

Decision Making

Perhaps the most basic managerial skill is the ability to make intelligent, data-driven decisions. Broadly speaking, many of those decisions revolve around the following three questions. *What* should we be selling? *Who* should we be serving? *How* should we execute? Exhibit 1–2 provides examples of decisions pertaining to each of these three categories.

The left-hand column of Exhibit 1–2 suggests that every company must make decisions related to the products and services that it sells. For example, each year Procter & Gamble must decide how to allocate its marketing budget across 23 brands that each generates over $1 billion in sales as well as other brands that have promising growth potential. Mattel must decide what new toys to introduce to the market. Southwest Airlines must decide what ticket prices to establish for each of its thousands

EXHIBIT 1–2
Examples of Decisions

What should we be selling?	Who should we be serving?	How should we execute?
What products and services should be the focus of our marketing efforts?	Who should be the focus of our marketing efforts?	How should we supply our parts and services?
What new products and services should we offer?	Who should we start serving?	How should we expand our capacity?
What prices should we charge for our products and services?	Who should pay price premiums or receive price discounts?	How should we reduce our capacity?
What products and services should we discontinue?	Who should we stop serving?	How should we improve our efficiency and effectiveness?

of flights per day. General Motors must decide whether to discontinue certain models of automobiles.

The middle column of Exhibit 1–2 indicates that all companies must make decisions related to the customers that they serve. For example, Sears must decide how to allocate its marketing budget between products that tend to appeal to male versus female customers. FedEx must decide whether to expand its services into new markets across the globe. Hewlett-Packard must decide what price discounts to offer corporate clients that purchase large volumes of its products. A bank must decide whether to discontinue customers that may be unprofitable.

The right-hand column of Exhibit 1–2 shows that companies also make decisions related to how they execute. For example, Boeing must decide whether to rely on outside vendors such as Goodrich, Saab, and Rolls-Royce to manufacture many of the parts used to make its airplanes. Cintas must decide whether to expand its laundering and cleaning capacity in a given geographic region by adding square footage to an existing facility or by constructing an entirely new facility. In an economic downturn, a manufacturer might have to decide whether to eliminate one 8-hour shift at three plants or to close one plant. Finally, all companies have to decide among competing improvement opportunities. For example, a company may have to decide whether to implement a new software system, to upgrade a piece of equipment, or to provide extra training to its employees.

This portion of the chapter has explained that the three pillars of managerial accounting are planning, controlling, and decision making. This book helps prepare you to become an effective manager by explaining how to make intelligent data-driven decisions, how to create financial plans for the future, and how to continually make progress toward achieving goals by obtaining, evaluating, and responding to feedback.

Why Does Managerial Accounting Matter to Your Career?

Many students feel anxious about choosing a major because they are unsure if it will provide a fulfilling career. To reduce these anxieties, we recommend deemphasizing what you cannot control about the future; instead focusing on what you can control right now. More specifically, concentrate on answering the following question: What can you do now to prepare for success in an unknown future career? The best answer is to learn skills that will make it easier for you to adapt to an uncertain future. You need to become adaptable!

Whether you end up working in the United States or abroad, for a large corporation, a small entrepreneurial company, a nonprofit organization, or a governmental entity, you'll need to know how to plan for the future, how to make progress toward achieving goals, and how to make intelligent decisions. In other words, managerial accounting skills are useful in just about any career, organization, and industry. If you commit energy to this course, you'll be making a smart investment in your future—even though you cannot clearly envision it. Next, we will elaborate on this point by explaining how managerial accounting relates to the future careers of business majors and accounting majors.

Business Majors

Exhibit 1–3 provides examples of how planning, controlling, and decision making affect three majors other than accounting—marketing, operations management, and human resource management.

The left-hand column of Exhibit 1–3 describes some planning, controlling, and decision-making applications in the marketing profession. For example, marketing managers make planning decisions related to allocating advertising dollars across various communication mediums and to staffing new sales territories. From a control standpoint, they may closely track sales data to see if a budgeted price cut is generating an anticipated increase in unit

EXHIBIT 1–3
Relating Managerial Accounting to Three Business Majors

	Marketing	Operations Management	Human Resource Management
Planning	How much should we budget for TV, print, and Internet advertising?	How many units should we plan to produce next period?	How much should we plan to spend for occupational safety training?
	How many salespeople should we plan to hire to serve a new territory?	How much should we budget for next period's utility expense?	How much should we plan to spend on employee recruitment advertising?
Controlling	Is the budgeted price cut increasing unit sales as expected?	Did we spend more or less than expected for the units we actually produced?	Is our employee retention rate exceeding our goals?
	Are we accumulating too much inventory during the holiday shopping season?	Are we achieving our goal of reducing the number of defective units produced?	Are we meeting our goal of completing timely performance appraisals?
Decision Making	Should we sell our services as one bundle or sell them separately?	Should we buy a new piece of equipment or upgrade our existing machine?	Should we hire an on-site medical staff to lower our health care costs?
	Should we sell directly to customers or use a distributor?	Should we redesign our manufacturing process to lower inventory levels?	Should we hire temporary workers or full-time employees?

sales, or they may study inventory levels during the holiday shopping season so that they can adjust prices as needed to optimize sales. Marketing managers also make many important decisions such as whether to bundle services together and sell them for one price or to sell each service separately. They may also decide whether to sell products directly to the customer or to sell to a distributor, who then sells to the end consumer.

The middle column of Exhibit 1–3 states that operations managers have to plan how many units to produce to satisfy anticipated customer demand. They also need to budget for operating expenses such as utilities, supplies, and labor costs. In terms of control, they monitor actual spending relative to the budget, and closely watch operational measures such as the number of defects produced relative to the plan. Operations managers make numerous decisions, such as deciding whether to buy a new piece of equipment or upgrade an existing piece of equipment. They also decide whether to invest in redesigning a manufacturing process to reduce inventory levels.

The right-hand column of Exhibit 1–3 explains how human resource managers make a variety of planning decisions, such as budgeting how much to spend on occupational safety training and employee recruitment advertising. They monitor feedback related to numerous management concerns, such as employee retention rates and the timely completion of employee performance appraisals. They also help make many important decisions such as whether to hire on-site medical staff in an effort to lower health care costs, and whether to hire temporary workers or full-time employees in an uncertain economy.

For brevity, Exhibit 1–3 does not include all business majors, such as finance, supply chain management, management information systems, and economics. Can you explain how planning, controlling, and decision-making activities would relate to these majors?

Accounting Majors

Many accounting graduates begin their careers working for public accounting firms that provide a variety of valuable services for their clients. Some of these graduates will build successful and fulfilling careers in the public accounting industry; however, most will leave public accounting at some point to work in other organizations. In fact, the Institute of Management Accountants (IMA) estimates that more than 80% of professional accountants in the United States work in nonpublic accounting environments (www.imanet.org/about_ima/our_mission.aspx).

The public accounting profession has a strong financial accounting orientation. Its most important function is to protect investors and other external parties by assuring them that companies are reporting historical financial results that comply with applicable accounting rules. Managerial accountants also have strong financial accounting skills. For example, they play an important role in helping their organizations design and maintain financial reporting systems that generate reliable financial disclosures. However, the primary role of managerial accountants is to partner with their co-workers within the organization to improve performance.

Given the 80% figure mentioned above, if you are an accounting major there is a very high likelihood that your future will involve working for a nonpublic accounting employer. Your employer will expect you to have strong financial accounting skills, but more importantly, it will expect you to help improve organizational performance by applying the planning, controlling, and decision-making skills that are the foundation of managerial accounting.

IN BUSINESS

A NETWORKING OPPORTUNITY

The Institute of Management Accountants (IMA) is a network of more than 60,000 accounting and finance professionals from more than 120 countries. Its Middle East membership, growing annually by an average of 30%, reached 10,700 members by March 2010. Fifty-seven percent of the membership is concentrated in Egypt, Saudi Arabia, and the United Arab Emirates. There are five IMA chapters in the Middle East with the most recent one launched in Amman, Jordan.

Every year the IMA hosts a student leadership conference that attracts 300 students from over 50 colleges and universities in the US. Guest speakers at past conferences have discussed topics such as leadership, advice for a successful career, how to market yourself in a difficult economy, and excelling in today's multi-generational workforce. One student who attended the conference said, "I liked that I was able to interact with professionals who are in fields that could be potential career paths for me."

For more information on this worthwhile networking opportunity, contact the IMA at (800) 638-4427(USA) or (971) 4 4472501 (Dubai, UAE) or visit the IMA's website at www.imanet.org.

Sources: Conversation with Jodi Ryan, the Institute of Management Accountants' Director of Alliances and Student/Academic Communities.
www.ameinfo.com/227127.html

Professional Certification—A Smart Investment If you plan to become an accounting major, the Certified Management Accountant (CMA) designation is a globally respected credential (sponsored by the IMA) that will increase your credibility, upward mobility, and compensation. Exhibit 1–4 summarizes the topics covered in the two-part CMA exam. For brevity, we are not going to define all the terms included in this exhibit. Its purpose is simply to emphasize that the CMA exam focuses on the planning, controlling, and decision-making skills that are critically important to nonpublic accounting employers. The CMA's internal management orientation is a complement to the highly respected Certified Public Accountant (CPA) exam that focuses on rule-based compliance—assurance standards, financial accounting standards, business law, and the tax code. Information about becoming a CMA is available on the IMA's website (www.imanet.org) or by calling 1-800-638-4427.

EXHIBIT 1–4
CMA Exam Content Specifications

Part 1	*Financial Planning, Performance, and Control*
	Planning, budgeting, and forecasting
	Performance management
	Cost management
	Internal controls
	Professional ethics
Part 2	*Financial Decision Making*
	Financial statement analysis
	Corporate finance
	Decision analysis and risk management
	Investment decisions
	Professional ethics

IN BUSINESS

YOU CAN MORE THAN DOUBLE YOUR INCOME: BECOME A CMA!

A recent salary study conducted by the IMA and a survey sample of 4,436 IMA members (out of whom 21% responded) indicates that accounting and finance professionals in the Middle East earn on average 122% more when they hold CMA certificates as compared to when they do not. This yields an extra income of up to US$2.6 million over the lifetime of a CMA's career. Moreover, the survey yielded similar results in most areas as compared to the survey conducted in the US, such as salary increments for upper management, for instance. It also indicated that master's degrees in the region are awarded a much larger salary premium than in the U.S.A.

Sources: http://www.menafn.com/qn_news_story_s.asp?StoryId=1093374774&src=MOEN

Managerial Accounting: Beyond the Numbers

Exhibit 1–5 summarizes how each chapter of the book teaches measurement skills that managers use on the job every day. For example, Chapter 8 teaches you the measurement skills that managers use to answer the question—how should I create a financial plan for next year? Chapters 9 and 10 teach you the measurement skills that managers use to answer the question—how well am I performing relative to my plan? Chapter 7 teaches you measurement skills related to product, service, and customer profitability. However, it is vitally important that you also understand managerial accounting involves more than just "crunching numbers." To be successful, managers must complement their measurement skills with six business management perspectives that "go beyond the numbers" to enable intelligent planning, control, and decision making.

An Ethics Perspective

Ethical behavior is the lubricant that keeps the economy running. Without that lubricant, the economy would operate much less efficiently—less would be available to consumers, quality would be lower, and prices would be higher. In other words, without

EXHIBIT 1–5
Measurement Skills:
A Manager's Perspective

Chapter Number	The Key Question from a Manager's Perspective
Chapter 2	What cost classifications do I use for different management purposes?
Chapters 3 & 4	What is the value of our ending inventory and cost of goods sold for external reporting purposes?
Chapter 5	How will my profits change if I change my selling price, sales volume, or costs?
Chapter 6	How should the income statement be presented?
Chapter 7	How profitable is each of our products, services, and customers?
Chapter 8	How should I create a financial plan for next year?
Chapters 9 & 10	How well am I performing relative to my plan?
Chapter 11	What performance measures should we monitor to ensure that we achieve our strategic goals?
Chapter 12	How do I quantify the profit impact of pursuing one course of action versus another?
Chapter 13	How do I make long-term capital investment decisions?
Chapter 14	What cash inflows and outflows explain the change in our cash balance?
Chapter 15	How can we analyze our financial statements to better understand our performance?

fundamental trust in the integrity of business, the economy would operate much less efficiently. Thus, for the good of everyone—including profit-making companies—it is vitally important that business be conducted within an ethical framework that builds and sustains trust.

Code of Conduct for Management Accountants The Institute of Management Accountants (IMA) of the United States has adopted an ethical code called the *Statement of Ethical Professional Practice* that describes in some detail the ethical responsibilities of management accountants. Even though the standards were developed specifically for management accountants, they have much broader application. The standards consist of two parts that are presented in full in Exhibit 1–6 (page 10). The first part provides general guidelines for ethical behavior. In a nutshell, a management accountant has ethical responsibilities in four broad areas: first, to maintain a high level of professional competence; second, to treat sensitive matters with confidentiality; third, to maintain personal integrity; and fourth, to disclose information in a credible fashion. The second part of the standards specifies what should be done if an individual finds evidence of ethical misconduct.

The ethical standards provide sound, practical advice for management accountants and managers. Most of the rules in the ethical standards are motivated by a very practical consideration—if these rules were not generally followed in business, then the economy and all of us would suffer. Consider the following specific examples of the consequences of not abiding by the standards:

- Suppose employees could not be trusted with confidential information. Then top managers would be reluctant to distribute such information within the company and, as a result, decisions would be based on incomplete information and operations would deteriorate.

EXHIBIT 1–6

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.

IN BUSINESS

TOYOTA ENCOUNTERS MAJOR PROBLEMS

When Toyota Motor Corporation failed to meet its profit targets, the company set an aggressive goal of reducing the cost of its auto parts by 30%. The quality and safety of the company's automobiles eventually suffered mightily resulting in recalls, litigation, incentive campaigns, and marketing efforts that analysts estimate will cost the company more than $5 billion. The car maker's president, Akio Toyoda, blamed his company's massive quality lapses on an excessive focus on profits and market share. Similarly, Jim Press, Toyota's former top U.S. executive, said the problems were caused by "financially-oriented pirates who didn't have the character to maintain a customer-first focus."

Sources: Yoshio Takahashi, "Toyota Accelerates Its Cost-Cutting Efforts," *The Wall Street Journal,* December 23, 2009, p. B4; Mariko Sanchanta and Yoshio Takahashi, "Toyota's Recall May Top $5 Billion," *The Wall Street Journal,* March 10, 2010, p. B2; and Norihiko Shirouzu, "Toyoda Rues Excessive Profit Focus," *The Wall Street Journal,* March 2, 2010, p. B3.

- Suppose employees accepted bribes from suppliers. Then contracts would tend to go to the suppliers who pay the highest bribes rather than to the most competent suppliers. Would you like to fly in aircraft whose wings were made by the subcontractor who paid the highest bribe? Would you fly as often? What would happen to the airline industry if its safety record deteriorated due to shoddy workmanship on contracted parts and subassemblies?
- Suppose the presidents of companies routinely lied in their annual reports and financial statements. If investors could not rely on the basic integrity of a company's financial statements, they would have little basis for making informed decisions. Suspecting the worst, rational investors would pay less for securities issued by companies and may not be willing to invest at all. As a consequence, companies would have less money for productive investments—leading to slower economic growth, fewer goods and services, and higher prices.

Not only is ethical behavior the lubricant for our economy, it is the foundation of managerial accounting. The numbers that managers rely on for planning, control, and decision making are meaningless unless they have been competently, objectively, and honestly gathered, analyzed, and reported. As your career unfolds, you will inevitably face decisions with ethical implications. Before making such decisions, consider performing the following steps. First, define your alternative courses of action. Second, identify all of the parties that will be affected by your decision. Third, define how each course of action will favorably or unfavorably impact each affected party. Once you have a complete understanding of the decision context, seek guidance from external sources such as the IMA Statement of Ethical Professional Practice, the IMA Ethics Helpline at (800) 245-1383, or a trusted confidant. Before executing your decision ask yourself one final question—would I be comfortable disclosing my chosen course of action on the front page of *The Wall Street Journal*?

A Strategic Management Perspective

Companies do not succeed by sheer luck; instead, they need to develop a *strategy* that defines how they intend to succeed in the marketplace. 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. A company can only succeed if it creates a reason for its target customers to choose it over a competitor. These reasons, or what are more formally called *customer value propositions,* are the essence of strategy.

Customer value propositions tend to fall into three broad categories—*customer intimacy, operational excellence,* and *product leadership.* Companies that adopt a *customer intimacy* strategy are in essence saying to their customers, "You should choose us because we can customize our products and services to meet your individual needs better than our competitors." Ritz-Carlton, Nordstrom, and Virtuoso (a premium service travel agency) rely primarily on a customer intimacy value proposition for their success. Companies that pursue the second customer value proposition, called *operational excellence,* are saying to their target customers, "You should choose us because we deliver products and services faster, more conveniently, and at a lower price than our competitors." Southwest Airlines, Walmart, and Google are examples of companies that succeed first and foremost because of their operational excellence. Companies pursuing the third customer value proposition, called *product leadership,* are saying to their target customers, "You should choose us because we offer higher quality products than our competitors." Apple, Cisco Systems, and W.L. Gore (the creator of GORE-TEX® fabrics) are examples of companies that succeed because of their product leadership.[1]

The plans managers set forth, the variables they seek to control, and the decisions they make are all influenced by their company's strategy. For example, Walmart would not make plans to build ultra-expensive clothing boutiques because these plans would conflict with the company's strategy of operational excellence and "everyday low prices." Apple would not seek to control its operations by selecting performance measures that focus solely on cost-cutting because those measures would conflict with its product leadership customer value proposition. Finally, it is unlikely that Rolex would decide to implement drastic price reductions for its watches even if a financial analysis indicated that establishing a lower price might boost short-run profits. Rolex would oppose this course of action because it would diminish the luxury brand that forms the foundation of the company's product leadership customer value proposition.

IN BUSINESS

A FOUR-YEAR WAITING LIST AT VANILLA BICYCLES

Sacha White started Vanilla Bicycles in Portland, Oregon, in 2001. After eight years in business, he had a four-year backlog of customer orders. He limits his annual production to 40–50 bikes per year that sell for an average of $7,000 each. He uses a silver alloy that costs 20 times as much as brass (which is the industry standard) to join titanium tubes together to form a bike frame. White spends three hours taking a buyer's measurements to determine the exact dimensions of the bike frame. He has resisted expanding production because it would undermine his strategy based on product leadership and customer intimacy. As White said, "If I ended up sacrificing what made Vanilla special just to make more bikes, that wouldn't be worth it to me."

Source: Christopher Steiner, "Heaven on Wheels," *Forbes,* April 13, 2009, p. 75.

An Enterprise Risk Management Perspective

Every strategy, plan, and decision involves risks. **Enterprise risk management** is a process used by a company to identify those risks and develop responses to them that enable it to be reasonably assured of meeting its goals. The left-hand column of Exhibit 1–7 provides 12 examples of the types of business risks that companies face. They range from risks that relate to the weather to risks associated with computer hackers, complying with the law, employee theft, and products harming customers. The right-hand column of Exhibit 1–7 provides an example of a control that could be implemented to

[1] These three customer value propositions were defined by Michael Treacy and Fred Wiersema in "Customer Intimacy and Other Value Disciplines," *Harvard Business Review,* Volume 71 Issue 1, pp. 84–93.

EXHIBIT 1–7
Identifying and Controlling Business Risks

Examples of Business Risks	Examples of Controls to Reduce Business Risks
• Intellectual assets being stolen from computer files	• Create firewalls that prohibit computer hackers from corrupting or stealing intellectual property
• Products harming customers	• Develop a formal and rigorous new product testing program
• Losing market share due to the unforeseen actions of competitors	• Develop an approach for legally gathering information about competitors' plans and practices
• Poor weather conditions shutting down operations	• Develop contingency plans for overcoming weather-related disruptions
• A website malfunctioning	• Thoroughly test the website before going "live" on the Internet
• A supplier strike halting the flow of raw materials	• Establish a relationship with two companies capable of providing needed raw materials
• A poorly designed incentive compensation system causing employees to make bad decisions	• Create a balanced set of performance measures that motivates the desired behavior
• Financial statements inaccurately reporting the value of inventory	• Count the physical inventory on hand to make sure that it agrees with the accounting records
• An employee stealing assets	• Segregate duties so that the same employee does not have physical custody of an asset and the responsibility of accounting for it
• An employee accessing unauthorized information	• Create password-protected barriers that prohibit employees from obtaining information not needed to do their jobs
• Inaccurate budget estimates causing excessive or insufficient production	• Implement a rigorous budget review process
• Failing to comply with equal employment opportunity laws	• Create a report that tracks key metrics related to compliance with the laws

help reduce each of the risks mentioned in the left-hand column of the exhibit.[2] Although these types of controls cannot completely eliminate risks, they enable companies to proactively manage their risks rather than passively reacting to unfortunate events that have already occurred.

In managerial accounting, companies use controls to reduce the risk that their plans will not be achieved. For example, if a company plans to build a new manufacturing facility within a predefined budget and time frame, it will establish and monitor control measures to ensure that the project is concluded on time and within the budget. Risk management is also a critically important aspect of decision making. For example, when a company quantifies the labor cost savings that it can realize by sending jobs overseas, it should complement its financial analysis with a prudent assessment of the accompanying

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[2] Besides using controls to reduce risks, companies can also chose other risk responses, such as accepting or avoiding a risk.

IN BUSINESS

MANAGING THE RISK OF A GAS LEAK

On October 17, 2012, oil and gas leaked from well no. 136 in Al Rawdhatain oilfield in Kuwait. This was considered to be the biggest and most dangerous spill in the history of the Kuwait Petroleum Company (KPC). For an economy where crude oil production accounts for over 94% of revenue, such an incident is—to say the least–costly: production was stopped, workers were evacuated, and to contain the hazardous hydrogen sulphide gas leak, the oil well was actually burned! Of course this is besides the more significant fact that 230 people were treated at the Jahra Hospital after they inhaled the gas that had leaked.

It is incidents like these that highlight the importance of ERM, a dynamic tool that is sharpened with time and learning as suggested by the journey of KPC's Risk Management function. It evolved from acquiring standard energy insurance policies in 2002 to what is now referred to as the ERM 2030 Strategy where strategic directives are identified along with their risks and related strategic initiatives to address those same risks. As it turns out, KPC recognized operational risks leading to unplanned shutdowns or other supply chain disruptions among the top10 risks that it faces. The next step is to identify and implement specific controls to address them. Although the risk of a gas leak occurring again can never be completely eliminated, perhaps it could be reduced. And, in the event it does happen again, KPC will be better prepared for it.

Sources: "Kuwait gas leak puts 4 in hospital", Arab Times, October 17, 2012, http://www.arabtimesonline.com/; "Our Subsidiaries", http://www.kpc.com.kw, March 9, 2013; Toxic gas leak from oil well sparks Kuwait alert, The Daily Star, October 17, 2012, http://www.dailystar.com.lb; Slow response to gas leak slammed, Kuwait Times, October 18, 2012, http://news.kuwaittimes.net; "Enterprise Risk Management—KPC ERM Journey—2002–2012", PPT presented at 1st Kuwait ERM Conference, 26–28 November 2012, http://spatialco.com/web/previous-events/kuwait-enterprise-risk-management-conference-2/

risks. Will the overseas manufacturer use child labor? Will the product's quality decline, thereby leading to more warranty repairs, customer complaints, and lawsuits? Will the elapsed time from customer order to delivery dramatically increase? Will terminating domestic employees diminish morale within the company and harm perceptions within the community? These are the types of risks that managers should incorporate into their decision-making processes.

A Corporate Social Responsibility Perspective

Companies are responsible for creating strategies that produce financial results that satisfy stockholders. However, they also have a *corporate social responsibility* to serve other stakeholders—such as customers, employees, suppliers, communities, and environmental and human rights advocates—whose interests are tied to the company's performance. **Corporate social responsibility** (CSR) is a concept whereby organizations consider the needs of all stakeholders when making decisions. CSR extends beyond legal compliance to include voluntary actions that satisfy stakeholder expectations. Numerous companies, such as Procter & Gamble, 3M, Eli Lilly and Company, Starbucks, Microsoft, Genentech, Johnson & Johnson, Baxter International, Abbott Laboratories, KPMG, PNC Bank, Deloitte, Southwest Airlines, and Caterpillar, prominently describe their corporate social performance on their websites.

Exhibit 1–8 presents examples of corporate social responsibilities that are of interest to six stakeholder groups.[3] If a company fails to meet the needs of these six stakeholder

[3] Many of the examples in Exhibit 1–8 were drawn from Terry Leap and Misty L. Loughry, "The Stakeholder-Friendly Firm," *Business Horizons,* March/April 2004, pp. 27–32.

EXHIBIT 1–8
Examples of Corporate Social Responsibilities

Companies should provide *customers* with:
- Safe, high-quality products that are fairly priced.
- Competent, courteous, and rapid delivery of products and services.
- Full disclosure of product-related risks.
- Easy-to-use information systems for shopping and tracking orders.

Companies should provide *suppliers* with:
- Fair contract terms and prompt payments.
- Reasonable time to prepare orders.
- Hassle-free acceptance of timely and complete deliveries.
- Cooperative rather than unilateral actions.

Companies should provide *stockholders* with:
- Competent management.
- Easy access to complete and accurate financial information.
- Full disclosure of enterprise risks.
- Honest answers to knowledgeable questions.

Companies and their suppliers should provide *employees* with:
- Safe and humane working conditions.
- Nondiscriminatory treatment and the right to organize and file grievances.
- Fair compensation.
- Opportunities for training, promotion, and personal development.

Companies should provide *communities* with:
- Payment of fair taxes.
- Honest information about plans such as plant closings.
- Resources that support charities, schools, and civic activities.
- Reasonable access to media sources.

Companies should provide *environmental and human rights advocates* with:
- Greenhouse gas emissions data.
- Recycling and resource conservation data.
- Child labor transparency.
- Full disclosure of suppliers located in developing countries.

groups it can adversely affect its financial performance. For example, if a company pollutes the environment or fails to provide safe and humane working conditions for its employees, the negative publicity from environmental and human rights activists could cause the company's customers to defect and its "best and brightest" job candidates to apply elsewhere—both of which are likely to eventually harm financial performance. This explains why in managerial accounting a manager must establish plans, implement controls, and make decisions that consider impacts on all stakeholders.

A Process Management Perspective

Most companies organize themselves by functional departments, such as the Marketing Department, the Research and Development Department, and the Accounting Department. These departments tend to have a clearly defined "chain of command" that specifies superior and subordinate relationships. However, effective managers understand that *business processes,* more so than functional departments, serve the needs of a company's most important stakeholders—its customers. A **business process** is a series of steps that are followed in order to carry out some task in a business. These steps often span departmental boundaries, thereby requiring managers to cooperate across functional departments. The term *value chain* is often used to describe how an organization's functional departments interact with one another to form business processes. A **value chain**, as shown in Exhibit 1–9, consists of the major business functions that add value to a company's products and services.

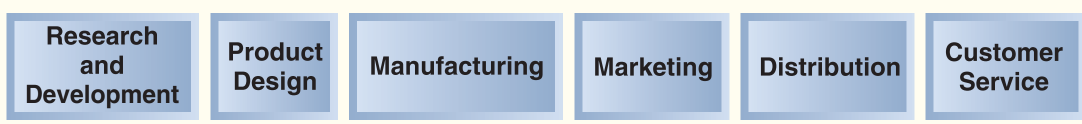
IN BUSINESS

GREENPEACE LEVERAGES THE POWER OF SOCIAL MEDIA

When Nestlé purchased palm oil from an Indonesian supplier to manufacture Kit-Kat candy bars Greenpeace International used social media to express its disapproval. Greenpeace claimed that the Indonesian company destroyed rainforest to create its palm oil plantation; therefore, Nestlé's actions were contributing to global warming and endangering orangutans. Greenpeace posted YouTube videos, added comments to Nestlé's Facebook page, and sent Twitter Tweets to communicate its message to supporters. At one point, the number of fans on Nestlé's Facebook page grew to 95,000, most of them being protesters. Nestlé terminated its relationship with the supplier, which provided 1.25% of Nestlé's palm oil needs. A Nestlé spokesperson says the difficulty in responding to social media is to "show that we are listening, which we obviously are, while not getting involved in a shouting match."

Source: Emily Steel, "Nestlé Takes a Beating on Social-Media Sites," *The Wall Street Journal,* March 29, 2010, p. B5.

EXHIBIT 1–9
Business Functions Making Up the Value Chain



Managers need to understand the value chain to be effective in terms of planning, control, and decision making. For example, if a company's engineers plan to design a new product, they must communicate with the Manufacturing Department to ensure that the product can actually be produced, the Marketing Department to ensure that customers will buy the product, the Distribution Department to ensure that large volumes of the product can be cost-effectively transported to customers, and the Accounting Department to ensure that the product will increase profits. From a control and decision-making standpoint, managers also need to focus on process excellence instead of functional performance. For example, if the Purchasing Department focuses solely on minimizing the cost of purchased materials, this narrowly focused attempt at cost reduction may lead to greater scrap and rework in the Manufacturing Department, more complaints in the Customer Service Department, and greater challenges in the Marketing Department because dissatisfied customers are turning their attention to competitors.

Managers frequently use a process management method known as *lean thinking,* or what is called *Lean Production* in the manufacturing sector. **Lean Production** is a management approach that organizes resources such as people and machines around the flow of business processes and that only produces units in response to customer orders. It is often called *just-in-time* production (or *JIT*) because products are only manufactured in response to customer orders and they are completed just-in-time to be shipped to customers. Lean thinking differs from traditional manufacturing methods, which organize work departmentally and encourage departments to maximize their output even if it exceeds customer demand and bloats inventories. Because lean thinking only allows production in response to customer orders, the number of units produced tends to equal the number of units sold, thereby resulting in minimal inventory. The lean approach also results in fewer defects, less wasted effort, and quicker customer response times than traditional production methods.

IN BUSINESS

LOUIS VUITTON IMPLEMENTS LEAN PRODUCTION

Louis Vuitton, headquartered in Paris, France, used lean production to increase its manufacturing capacity without having to build a new factory. It created U-shaped work arrangements for teams of 10 workers, thereby freeing up 10% more floor space in its factories. The company was able to hire 300 more workers without adding any square footage. Louis Vuitton also uses robots and computer programs to reduce wasted leather and the time needed to perform certain tasks.

Source: Christina Passariello, "At Vuitton, Growth in Small Batches," *The Wall Street Journal,* June 27, 2011, pp. B1 and B10.

A Leadership Perspective

An organization's employees bring diverse needs, beliefs, and goals to the workplace. Therefore, an important role for organizational leaders is to unite the behaviors of their fellow employees around two common themes—pursuing strategic goals and making optimal decisions. To fulfill this responsibility, leaders need to understand how *intrinsic motivation, extrinsic incentives,* and *cognitive bias* influence human behavior.

Intrinsic Motivation Intrinsic motivation refers to motivation that comes from within us. Stop for a moment and identify the greatest accomplishment of your life. Then ask yourself what motivated you to achieve this goal? In all likelihood, you achieved it because you wanted to, not because someone forced you to do it. In other words, you were intrinsically motivated. Similarly, an organization is more likely to prosper when its employees are intrinsically motivated to pursue its interests. A leader, who employees perceive as *credible* and *respectful* of their value to the organization, can increase the extent to which those employees are intrinsically motivated to pursue strategic goals. As your career evolves, to be perceived as a credible leader you'll need to possess three attributes—technical competence (that spans the value chain), personal integrity (in terms of work ethic and honesty), and strong communication skills (including oral presentation skills and writing skills). To be perceived as a leader who is respectful of your co-workers' value to the organization, you'll need to possess three more attributes—strong mentoring skills (to help others realize their potential), strong listening skills (to learn from your co-workers and be responsive to their needs), and personal humility (in terms of deferring recognition to all employees who contribute to the organization's success). If you possess these six traits, then you'll have the potential to become a leader who inspires others to readily and energetically channel their efforts toward achieving organizational goals.

Extrinsic Incentives Many organizations use *extrinsic incentives* to highlight important goals and to motivate employees to achieve them. For example, assume a company establishes the goal of reducing the time needed to perform a task by 20%. In addition, assume the company agrees to pay bonus compensation to its employees if they achieve the goal within three months. In this example, the company is using a type of extrinsic incentive known as a bonus to highlight a particular goal and to presumably motivate employees to achieve it.

While proponents of extrinsic incentives rightly assert that these types of rewards can have a powerful influence on employee behavior, many critics warn that they can also produce dysfunctional consequences. For example, suppose the employees mentioned above earned their bonuses by achieving the 20% time reduction goal within three months. However, let's also assume that during those three months the quality of the employees' output plummeted, thereby causing a spike in the company's repair costs, product returns, and customer defections. In this instance, did the extrinsic incentive work properly? The answer is yes and no. The bonus system did motivate employees to attain the time reduction goal; however, it also had the unintended consequences of causing employees to neglect product quality, thereby increasing repair costs, product returns, and customer defections. In other words, what may have seemed like a well-intended extrinsic incentive actually produced dysfunctional results for the company. This example highlights an important leadership challenge that you are likely to face someday—designing financial compensation systems that fairly reward employees for their efforts without inadvertently creating extrinsic incentives that motivate them to take actions that harm the company.

Cognitive Bias Leaders need to be aware that all people (including themselves) possess *cognitive biases,* or distorted thought processes, that can adversely affect planning, controlling, and decision making. To illustrate how cognitive bias works, let's consider the scenario of a television "infomercial" where someone is selling a product with a proclaimed value of $200 for $19.99 if viewers call within the next 30 minutes. Why do you think the seller claims that the product has a $200 value? The seller is relying on a cognitive bias called *anchoring bias* in an effort to convince viewers that a $180 discount is simply too good to pass up. The "anchor" is the false assertion that the product is actually worth $200. If viewers erroneously attach credibility to this contrived piece of information, their distorted analysis of the situation may cause them to spend $19.99 on an item whose true economic value is much less than that amount.

While cognitive biases cannot be eliminated, effective leaders should take two steps to reduce their negative impacts. First, they should acknowledge their own susceptibility to cognitive bias. For example, a leader's judgment might be clouded by optimism bias (being overly optimistic in assessing the likelihood of future outcomes) or self-enhancement bias (overestimating ones strengths and underestimating ones weaknesses relative to others). Second, they should acknowledge the presence of cognitive bias in others and introduce techniques to minimize their adverse consequences. For example, to reduce the risks of confirmation bias (a bias where people pay greater attention to information that confirms their preconceived notions, while devaluing information that contradicts them) or groupthink bias (a bias where some group members support a course of action solely because other group members do), a leader may routinely appoint independent teams of employees to assess the credibility of recommendations set forth by other individuals and groups.

IN BUSINESS

GOOD DEEDS GROW IN POPULARITY

In August 2010, Orange Jordan, a prominent player in the Kingdom's information and communications technology sector, unveiled its corporate social responsibility (CSR) strategy for 2010–2012. The group's strategy, which confirms its commitment to the local communities, consists of two initiatives: Orange Villages and the Orange Internet Fund. While the first focuses on the development of the Rajm Al Shami villages in Mowaggar, the latter aims at bringing the internet closer to all citizens of Jordan regardless of the service provider. The telecom group allotted a budget of JD3.5m for this two-year CSR project that will build internet capacity for 500 schools, provide training to teachers, launch awareness campaigns, and establish football stadiums and libraries for two selected schools.

Why is Orange Jordan willing to pay this amount? Is it to satisfy its shareholders' interests?

A survey of 1,800 people aged 13–25 revealed that 79% intend to seek employment with companies that care about contributing to society. So, as it turns out, CSR can be an employee recruitment and retention tool. Good corporate citizenship also improves reputation, branding, and hence rapport with the community and the various stakeholders—all of which, in turn, facilitate access to resources, market share and opportunities. The bottom line is that CSR is expected to enhance financial performance and sustainability both of which promote shareholders' interests. So hopefully Orange Jordan's good deeds will not go unnoticed!

Source: "Orange Jordan launches large-scale CSR strategy for 2010–2012", August 12, 2010, http://www.ameinfo.com/

Summary

This chapter defined managerial accounting, explained why it is relevant to business and accounting majors, and described various skills that managers need to do their jobs. It also discussed the importance of ethics in business and corporate social responsibility. The most important goal of this chapter was to help you understand that managerial accounting matters to your future career, regardless of your major. Accounting is the language of business and you'll need to speak this language to communicate effectively with and influence fellow managers.

Glossary

Budget A detailed plan for the future that is usually expressed in formal quantitative terms. (p. 3)

Business process A series of steps that are followed in order to carry out some task in a business. (p. 15)

Controlling The process of gathering feedback to ensure that a plan is being properly executed or modified as circumstances change. (p. 3)

Corporate social responsibility A concept whereby organizations consider the needs of all stakeholders when making decisions. (p. 14)

Decision making Selecting a course of action from competing alternatives. (p. 3)

Enterprise risk management A process used by a company to identify its risks and develop responses to them that enable it to be reasonably assured of meeting its goals. (p. 12)

Financial accounting The phase of accounting that is concerned with reporting historical financial information to external parties, such as stockholders, creditors, and regulators. (p. 2)

Lean Production A management approach that organizes resources such as people and machines around the flow of business processes and that only produces units in response to customer orders. (p. 16)

Managerial accounting The phase of accounting that is concerned with providing information to managers for use within the organization. (p. 2)

Performance report A report that compares budgeted data to actual data to highlight instances of excellent and unsatisfactory performance. (p. 4)

Planning The process of establishing goals and specifying how to achieve them. (p. 3)

Segment A part or activity of an organization about which managers would like cost, revenue, or profit data. (p. 3)

Strategy A company's "game plan" for attracting customers by distinguishing itself from competitors. (p. 11)

Value chain The major business functions that add value to a company's products and services, such as research and development, product design, manufacturing, marketing, distribution, and customer service. (p. 15)

Questions

1–1 How does managerial accounting differ from financial accounting?

1–2 Pick any major television network and describe some planning and control activities that its managers would engage in.

1–3 If you had to decide whether to continue making a component part or to begin buying the part from an overseas supplier, what quantitative and qualitative factors would influence your decision?

1–4 Why do companies prepare budgets?

1–5 Why is managerial accounting relevant to business majors and their future careers?

1–6 Why is managerial accounting relevant to accounting majors and their future careers?

1–7 Pick any large company and describe its strategy using the framework in the chapter.

1–8 Why do management accountants need to understand their company's strategy?
1–9 Pick any large company and describe three risks that it faces and how it responds to those risks.
1–10 Provide three examples of how a company's risks can influence its planning, controlling, and decision-making activities.
1–11 Pick any large company and explain three ways that it could segment its companywide performance.
1–12 Locate the website of any company that publishes a corporate social responsibility report (also referred to as a sustainability report). Describe three nonfinancial performance measures included in the report. Why do you think the company publishes this report?
1–13 Why do companies that implement Lean Production tend to have minimal inventories?
1–14 Why are leadership skills important to managers?
1–15 Why is ethics important to business?

Multiple-choice questions are provided on the text website at www.mcgraw-hill.co.uk/textbooks/garrison2e_mea.

Appendix 1A: Corporate Governance

Effective *corporate governance* enhances stockholders' confidence that a company is being run in their best interests rather than in the interests of top managers. **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 interests of the company's owners and it should provide for effective monitoring of performance.[1]

Unfortunately, history has repeatedly shown that unscrupulous top managers, if unchecked, can exploit their power to defraud stockholders. This unpleasant reality became all too clear in 2001 when the fall of Enron kicked off a wave of corporate scandals. These scandals were characterized by financial reporting fraud and misuse of corporate funds at the very highest levels—including CEOs and CFOs. While this was disturbing in itself, it also indicated that the institutions intended to prevent such abuses weren't working, thus raising fundamental questions about the adequacy of the existing corporate governance system. In an attempt to respond to these concerns, the U.S. Congress passed the most important reform of corporate governance in many decades—*The Sarbanes-Oxley Act of 2002.*

The Sarbanes-Oxley Act of 2002

The **Sarbanes-Oxley Act of 2002** was intended to protect the interests of those who invest in publicly traded companies by improving the reliability and accuracy of corporate financial reports and disclosures. We would like to highlight six key aspects of the legislation.[2]

First, the Act requires that both the CEO and CFO certify in writing that their company's financial statements and accompanying disclosures fairly represent the results of operations—with possible jail time if a CEO or CFO certifies results that they know are false. This creates very powerful incentives for the CEO and CFO to ensure that the financial statements contain no misrepresentations.

Second, the Act established the Public Company Accounting Oversight Board to provide additional oversight over the audit profession. The Act authorizes the Board

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[1] This definition of corporate governance was adapted from the 2004 report titled OECD Principles of Corporate Governance published by the Organization for Economic Co-Operation and Development.

[2] A summary of the Sarbanes-Oxley Act of 2002 can be obtained from the American Institute of Certified Public Accountants (AICPA) website http://thecaq.aicpa.org/Resources/Sarbanes+Oxley.

to conduct investigations, to take disciplinary actions against audit firms, and to enact various standards and rules concerning the preparation of audit reports.

Third, the Act places the power to hire, compensate, and terminate the public accounting firm that audits a company's financial reports in the hands of the audit committee of the board of directors. Previously, management often had the power to hire and fire its auditors. Furthermore, the Act specifies that all members of the audit committee must be independent, meaning that they do not have an affiliation with the company they are overseeing, nor do they receive any consulting or advisory compensation from the company.

Fourth, the Act places important restrictions on audit firms. Historically, public accounting firms earned a large part of their profits by providing consulting services to the companies that they audited. This provided the appearance of a lack of independence because a client that was dissatisfied with an auditor's stance on an accounting issue might threaten to stop using the auditor as a consultant. To avoid this possible conflict of interests, the Act prohibits a public accounting firm from providing a wide variety of nonauditing services to an audit client.

Fifth, the Act requires that a company's annual report contain an *internal control report.* Internal controls are put in place by management to provide assurance to investors that financial disclosures are reliable. The report must state that it is management's responsibility to establish and maintain adequate internal controls and it must contain an assessment by management of the effectiveness of its internal control structure. The internal control report is accompanied by an opinion from the company's audit firm as to whether management has maintained effective internal control over its financial reporting process.

Finally, the Act establishes severe penalties of as many as 20 years in prison for altering or destroying any documents that may eventually be used in an official proceeding and as many as 10 years in prison for managers who retaliate against a so-called whistle-blower who goes outside the chain of command to report misconduct. Collectively, these six aspects of the Sarbanes-Oxley Act of 2002 should help reduce the incidence of fraudulent financial reporting.

Internal Control—A Closer Look

Internal control is an important concept for all managers to understand and, although you may not be aware of it, it also plays an important role in your personal life. **Internal control** is a process designed to provide reasonable assurance that objectives are being achieved. For example, one objective for your personal life is to live to a ripe old age. Unfortunately, there are risks that we all encounter that may prohibit us from achieving this objective. For example, we may die prematurely due to a heart attack, a car accident, or a house fire. To reduce the risk of these unfortunate events occurring, we implement controls in our lives. We may exercise regularly and make nutritional food choices to reduce the likelihood of a heart attack. We always wear seat belts and instruct our friends to prohibit us from drinking alcohol and driving a vehicle to reduce the risk of a fatal car crash. We install fire detectors in our homes to reduce the risk of a fatal fire. In short, internal controls are an integral part of our daily lives.

A company uses internal controls to provide reasonable assurance that its financial reports are reliable.[3] Its financial statements may contain intentional or unintentional errors for three reasons. First, the statements may erroneously exclude some transactions. For example, the income statement may fail to include legitimate expenses. Second, the statements may improperly include some transactions. For example, the income statement may include sales revenue that was not earned during the current period. Third, the statements may include transactions that have been recorded erroneously. For example, an expense or sales transaction may be recorded at the wrong amount.

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[3] Companies also use internal controls to achieve efficient and effective operations and to ensure compliance with applicable laws and regulations.

Exhibit 1A–1 describes seven types of internal controls that companies use to reduce the risk that these types of errors will occur. Each item in the exhibit is labeled as a *preventive control* and/or a *detective control*. A **preventive control** deters undesirable events from occurring. A **detective control** detects undesirable events that have already occurred. Requiring authorizations for certain types of transactions is a preventive control. For example, companies frequently require that a specific senior manager sign all checks above a particular dollar amount to reduce the risk of an inappropriate cash disbursement. Reconciliations are a detective control. If you have ever compared a bank statement to your checkbook to resolve any discrepancies, then you have performed a type of reconciliation known as a bank reconciliation. This is a detective control because you are seeking to identify any mistakes already made by the bank or existing mistakes in your own records.

Segregation of duties is a preventive control that separates responsibilities for authorizing transactions, recording transactions, and maintaining custody of the related assets. For example, the same employee should not have the ability to authorize inventory purchases, account for those purchases, and manage the inventory storeroom. Physical safeguards prevent unauthorized employees from having access to assets such as inventories and computer equipment. Performance reviews are a detective control performed by employees in supervisory positions to ensure that actual results are reasonable when compared to relevant benchmarks. If actual results unexpectedly deviate from expectations, then it triggers further analysis to determine the root cause of the deviation. Companies maintain records to provide evidence that supports each transaction. For example, companies use serially numbered checks so that they can readily track all of their cash disbursements. Finally, companies use passwords (a preventive control) and access logs (a detective control) to restrict electronic data access as appropriate.

It is important to understand that internal controls cannot guarantee that objectives will be achieved. For example, a person can regularly exercise and eat healthy foods, but this does not guarantee that they will live to a certain age. Similarly, an effective internal control system can provide reasonable assurance that financial statement disclosures are reliable, but it cannot offer guarantees because even a well-designed internal control system can break down. Furthermore, two or more employees may collude to circumvent the control system. Finally, a company's senior leaders may manipulate financial results by intentionally overriding prescribed policies and procedures. This reality highlights the

EXHIBIT 1A–1
Types of Internal Controls for Financial Reporting

Type of Control	Classification	Description
Authorizations	Preventive	Requiring management to formally approve certain types of transactions.
Reconciliations	Detective	Relating data sets to one another to identify and resolve discrepancies.
Segregation of duties	Preventive	Separating responsibilities related to authorizing transactions, recording transactions, and maintaining custody of the related assets.
Physical safeguards	Preventive	Using cameras, locks, and physical barriers to protect assets.
Performance reviews	Detective	Comparing actual performance to various benchmarks to identify unexpected results.
Maintaining records	Detective	Maintaining written and/or electronic evidence to support transactions.
Information systems security	Preventive/Detective	Using controls such as passwords and access logs to ensure appropriate data restrictions.

importance of having senior leaders (including the chief executive officer, the chief financial officer, and the audit committee of the board of directors) who value the importance of effective internal controls and are committed to creating an ethical "tone at the top" of the organization.

Glossary

Corporate governance The system by which a company is directed and controlled. (p. 20)

Detective control A control that detects undesirable events that have already occurred. (p. 22)

Internal control A process designed to provide reasonable assurance that objectives are being achieved. (p. 21)

Preventive control A control that deters undesirable events from occurring. (p. 22)

Sarbanes-Oxley Act of 2002 A law intended to protect the interests of those who invest in publicly traded companies by improving the reliability and accuracy of corporate financial reports and discloures. (p. 20)

Questions

1A–1 Imagine that you are the head coach of a college sports team. One of your most important objectives is to win as many games as possible. Describe some controls that you would implement to help achieve the objective of winning as many games as possible.

1A–2 Perhaps your most important post-graduation objective is to get a job. Describe some control activities that you would pursue to help achieve this objective.

1A–3 Describe some controls that parents use to keep their homes safe for themselves and their children.