HANDBOOK OF COST MANAGEMENT
SECOND EDITION

ROMAN L. WEIL
MICHAEL W. MAHER

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CONTENTS

Preface xi
About the Editors xiii
Contributors xv

1 Glossary of Cost Management Concepts (Roman L. Weil) 1
This glossary contains hundreds of accounting and management-related terms, including a summary of financial statement ratios and a chart that explains the distinction between cost terms.

2 Economic Concepts of Cost in Managerial Accounting (Gordon Shillinglaw and Roman L. Weil) 157
This chapter defines basic economic terms and explains their application to and interface with management accounting.

3 Different Costs for Different Purposes (Russell A. Taussig and Roman L. Weil) 175
This chapter explains how the purpose of costs affects their definition and measurement. The chapter discusses cost classification, including costs for internal decision making and costs for responsibility accounting.

4 Accounting Magic (Roman L. Weil) 187
This chapter shows how alternative accounting treatments of identical events can lead to reported income figures that differ from each other.

5 Mathematical Concepts in Cost Accounting (Joel S. Demski) 197
This chapter discusses the role of mathematics in management, including probability as a model of uncertainty and decision theory as a model of choice behavior.

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<table>
<thead>
<tr>
<th>Chapter</th>
<th>Title</th>
<th>Authors</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6</td>
<td>Activity-Based Costing and Management</td>
<td>Michael W. Maher</td>
<td>217</td>
</tr>
<tr>
<td></td>
<td>This chapter explains the mechanics of activity-based costing and the value that this tool offers to management, including analysis of unused resources and analysis of activities that add value versus those that do not.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>Target Costing for New Product Development</td>
<td>Robin Cooper and Regine Slagmulder</td>
<td>243</td>
</tr>
<tr>
<td></td>
<td>This chapter shows how companies can use target costing in the design stage of a product. It considers market-driven costing, product-level costing, and component-level costing.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Kaizen Costing for Existing Products</td>
<td>Robin Cooper and Regine Slagmulder</td>
<td>271</td>
</tr>
<tr>
<td></td>
<td>This chapter discusses the mechanics of kaizen costing and how companies can use this process for continuous improvement toward manufacturing efficiency and quality.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Interorganizational Costing</td>
<td>Robin Cooper and Regine Slagmulder</td>
<td>289</td>
</tr>
<tr>
<td></td>
<td>This chapter explains how companies can use interorganizational cost management to manage costs through the cooperative actions of firms in a supplier network.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Costs and Benefits of Quality Improvement</td>
<td>Christopher D. Ittner and David F. Larcker</td>
<td>313</td>
</tr>
<tr>
<td></td>
<td>This chapter discusses some methods to assess the quality improvement projects that offer the highest returns and shows how firms can quantify the financial payback from these investments.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Logistics and Marketing Costs</td>
<td>James M. Reeve</td>
<td>329</td>
</tr>
<tr>
<td></td>
<td>This chapter discusses the logistics of supply chain activities, which include marketing and selling activities. It discusses expense planning and control through activity-based costing and how to calculate the total cost of delivering a product.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Estimating Cost Behavior</td>
<td>Michael W. Maher and M. Laurentius Marais</td>
<td>351</td>
</tr>
<tr>
<td></td>
<td>This chapter explains the distinction among costs, expenses, and expenditures. It also examines the function and methods of cost estimation, from simple costs with a single cost driver to costs with several cost drivers.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
13 Spoilage, Waste, and Scrap, Including Green Accounting (William N. Lanen) 367

This chapter explains the mechanics of cost accounting for spoilage, waste, and scrap. It also considers the implications for management in controlling the generation, handling, and disposal of such material.

14 Job, Process, and Operations Costing (Michael W. Maher) 389

This chapter provides an overview of the basic cost flow model. It also discusses four production systems—just-in-time, job, process, and operation—and their implications for cost measurement and management.

15 Standard Costing Systems (James A. Largay III) 425

This chapter shows the mechanics of variance analysis for costs, including raw material, variable and fixed overhead, and direct labor expenses. It then discusses different methods to investigate such variances.

16 Allocations of Cost and Revenue (Roman L. Weil) 465

This chapter examines more advanced topics related to allocation: that of joint products, byproducts, and common—other than joint—products. It also discusses allocation of revenue. The chapter appendix explains the mechanics of step-down and reciprocal allocation methods.

17 Cost-Volume-Profit Analyses (Nicholas Dopuch and Michael W. Maher) 483

This chapter discusses breakeven analysis that considers changes in prices, costs, and output volume. It also considers the implications for management decisions, such as whether to add or drop a product, and whether to make or buy a unit.

18 Forecasting Pro Forma Financial Statements (James M. Wahlen) 503

This chapter shows the mechanics and uses of pro forma financial statements.

19 Operating Budgets and Budgeting—Benefits and Costs (Michael D. Shields) 539

This chapter discusses management issues related to budgeting: participation, motivation, and evaluation. It considers several budgeting methods and management implications of each.
20 Theory of Constraints *(Eric Noreen)*

This chapter explains how firms can identify, exploit, and focus on a constraint, then relax the constraint. It discusses the implications for efficiency, process reengineering, and pricing.

21 Capital Budgeting: Concepts and Methods *(Roman L. Weil)*

This chapter discusses and evaluates various methods used to compare investment opportunities for companies. It also considers issues related to leasing.

22 Capital Budgeting: Implementation *(Roman L. Weil)*

This chapter offers guidance for investment management, which includes relating investment decisions to strategic plans, evaluating investments by financial and nonfinancial criteria, and assessing risk of investments.

23 Compound Interest: Concepts and Applications *(Roman L. Weil)*

This chapter explains simple and compound interest and how to perform future value calculations. It also discusses annuities and perpetuities and shows calculations for these financial instruments under different scenarios.

24 Performance Evaluation in Decentralized Organizations *(Michael W. Maher)*

This chapter discusses why firms should adopt a decentralized structure, the organizational options for a decentralized structure, and performance measurement in such organizations.

25 The Balanced Scorecard and Nonfinancial Performance Measures *(Michael W. Maher)*

This chapter considers the value of nonfinancial performance measures, different perspectives related to the balanced scorecard, and how firms can measure and improve performance related to nonfinancial goals.

26 Economic Value Added (EVA®) *(James J. Wallace)*

This chapter discusses EVA®, a shareholder value and management concept derived from residual income. It also discusses evidence of EVA®’s success and problems, as well as implementation issues.
27 Transfer Pricing (Michael W. Maher) 683

This chapter explains how transfer pricing affects performance measurements. It also discusses transfer pricing calculations and issues under four scenarios and shows how the buying and selling divisions can negotiate a price or decide to transact with entities outside the firm.

28 A Managerial Accounting Guide for Nonprofit Managers (Leslie G. Eldenburg and Naomi Soderstrom) 697

This chapter discusses cost accounting practices in nonprofit organizations, including hospital and government entities. It also discusses issues related to environmental accounting reports.

29 Introduction to Costs in Litigation (Elizabeth A. Evans) 721

This chapter explains concepts of costs that litigation questions frequently employ. It shows how cost accounting issues apply to questions of both liability and damages.

30 The Historical Development of Management Accounting (Richard Vangermeersch and Henry R. Schwarzbach) 731

This chapter recounts the history and progress of the accounting profession from the first book of accounting (printed in the 1200s) to current writings.

31 Corporate Scandals: The Accounting Underpinnings (Kathleen Fitzgerald and Roman L. Weil) 759

This chapter surveys the current financial reporting environment, discusses management incentives to report fraudulent earnings, and explains specific methods used to manipulate financial reports.

Appendix: Compound Interest, Present Value, and Annuity Tables 809

Index 819
As the structure and size of companies have changed, so, too, have the practice of and implications for cost management. Global competition forces firms to study the cost management methods of others. Companies have adopted organizational structures that can move cash flow and resources across divisions, partnerships, and oceans. Moreover, as technology changes the type and amount of data, managers have more flexibility and capability to control resource use, measure performance, and make timely decisions. These changes, and others, prompted us to revise the first edition of *Handbook of Cost Accounting*, which included many timeless concepts, but needed an update to reflect the last 30 years of changes in the business world.

We target this book (renamed to *Handbook of Cost Management*) to a readership of consultants, financial managers who want an update on cost management, and nonfinancial managers who want to learn about the management implications of cost measurement and control. We hope that readers will use this as a reference to answer questions, explain concepts, and give guidance.

We cannot allow the readers to progress another paragraph into this book without acknowledging Debbie Asakawa, who made it all possible. She single-handedly brought this book to fruition when the Herculean task of producing this book lay before us and we had already committed our time to other endeavors. She chased down the missing exhibits, the errant passive verbs, and the home addresses of retired professors. She kept us all on task with unfailing good humor from the deck of her home through the summer heat as well as the dark and cold of night. We could never thank you enough, Debbie, so we will just stop here. We thank Judy Howarth, Rose T. Sullivan and John DeRemigis, our liaisons at John Wiley & Sons. Finally, Sidney Davidson. What can we say? The first edition of this book, 30 years ago, originated with him. He has taught us and guided us for more than three decades. Thank you.

Roman L. Weil  
Michael W. Maher  
March 2005
ABOUT THE EDITORS

ROMAN L. WEIL, PhD, CMA, CPA, is V. Duane Rath Professor of Accounting at the Graduate School of Business of the University of Chicago. He is co-director of the Chicago/Wharton/Stanford Law School Directors’ Consortium.

He received his BA in Economics and Mathematics from Yale University in 1962. He received his MS in Industrial Administration in 1965 and PhD in Economics in 1966, both from Carnegie-Mellon University. He joined the faculty at the University of Chicago in 1965, where he has held positions in Mathematical Economics, Management and Information Sciences, Accounting, and in the Law School. He directs the University’s Directors’ College, which trains corporate board members to do their jobs better; his own specialty in that training focuses on financial literacy. He co-founded The Directors’ Consortium, a joint venture of Chicago, Stanford Law School, and The Wharton School.

He has been a CPA in Illinois since 1973 and a CMA since 1974. He has served on the faculties of the Georgia Institute of Technology, New York University Law School, and Stanford University in its Graduate School of Business, Economics Department, and Law School. At Stanford, he has, since its inception, organized the sessions at Directors’ College on Audit Committee duties. He has served on the Board of Academic Advisors of the U.S. Business School in Prague and has taught there. He has served on the accrediting committee of the American Association of Collegiate Schools of Business. He has designed and implemented continuing education programs for partners at the accounting firms of Andersen and PriceWaterhouseCoopers, as well as for employees at Goldman Sachs, Montgomery Ward, Merck, and William Blair, and for business executives in Great Britain and Singapore.


He has co-edited four professional reference books for McGraw-Hill, Simon Schuster, Prentice-Hall, and John Wiley & Sons. He has co-authored more than a dozen textbooks for Holt, Rinehart, and Winston, The Dryden Press, Harcourt, Brace & Jovanovich, and Thomson Learning. He is the senior editor of, and contributor to, the Litigation Services Handbook, now in its third edition. His articles have appeared in Barron's and The Wall Street Journal. He has published more than 80 articles in academic and professional journals. He has served as the principal investigator on various research projects of the National Science Foundation.

He served on the Securities and Exchange Commission Advisory Committee on Replacement Cost Accounting. At the Financial Accounting Standards Board, he has served on two task forces—one on consolidations and the other on interest methods—and on the Financial Accounting Standards Advisory Council.

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Maher has co-authored or co-edited 11 books and more than 50 other academic and professional publications. He won the AAA Competitive Manuscript Award and the AICPA/AAA Notable Contribution to the Literature Award for his research on the effects of anti-bribery regulation on internal controls in U.S. corporations. He also won a national award for research in taxation, and five awards for teaching and service from students of the Graduate School of Management at UC Davis. His current research programs are (1) corporate accountability and (2) cost-effectiveness. He teaches cost management, incentives and controls, and business ethics.

Maher has two children, Krista and Andrea.
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Glossary of Cost Management Concepts*  

Roman L. Weil, PhD, CPA, CMA, Editor  
University of Chicago

The definitions of many words and phrases in the glossary use other glossary terms. In a given definition, we italicize terms that themselves (or variants thereof) appear elsewhere under their own listings. The cross-references generally take one of two forms:

1. absorption costing. See full absorption costing.
2. ABC. Activity-based costing.

Form (1) refers you to another term for discussion of this bold-faced term. Form (2) tells you that this bold-faced term is synonymous with the italicized term, which you can consult for discussion if necessary.

A

AAA. American Accounting Association.

Abacus. A scholarly journal containing articles on theoretical aspects of accounting, published by Basil Blackwell for the Accounting Foundation of the University of Sydney.

abatement. A complete or partial cancellation of a levy imposed by a government unit.

ABC. Activity-based costing.

abnormal spoilage. Actual spoilage exceeding that expected when operations are normally efficient. Usual practice treats this cost as an expense of the period rather than as a product cost. Contrast with normal spoilage.

aboriginal cost. In public utility accounting, the acquisition cost of an asset incurred by the first entity devoting that asset to public use; the cost basis for most public utility regulation. If regulators used a different cost basis, then public utilities could exchange assets among themselves at ever-increasing prices in order to raise the rate base and, then, prices based on them.

* I have developed this glossary over the last 30 years with the help of named co-authors Sidney Davidson, Michael Maher, Patricia O’Brien, James Schindler, and Clyde Stickney. In addition, Katherine Schipper and Steven Zeff have provided much helpful input. My thanks to all of you. RLW
absorbed overhead. Overhead costs allocated to individual products at some overhead rate; also called applied overhead.

absorption costing. See full absorption costing.

Abstracts of the EITF. See Emerging Issues Task Force.

accelerated cost recovery System (ACRS). A form of accelerated depreciation that Congress enacted in 1981 and amended in 1986, so that now most writers refer to it as MACRS, or Modified Accelerated Cost Recovery System. The system provides percentages of the asset’s cost that a firm depreciates each year for tax purposes. The percentages derive, roughly, from 150-percent declining-balance depreciation methods. ACRS ignores salvage value. We do not generally use these amounts for financial accounting.

accelerated depreciation. In calculating depreciation charges, any method in which the charges become progressively smaller each period. Examples are double declining-balance depreciation and sum-of-the-years’-digits depreciation methods.

acceptance. A written promise to pay; equivalent to a promissory note.

account. A device for representing the amount (balance) for any line (or a part of a line) in the balance sheet or income statement. Because income statement accounts explain the changes in the balance sheet account Retained Earnings, the definition does not require the last three words of the preceding sentence. An account is any device for accumulating additions and subtractions relating to a single asset, liability, or owners’ equity item, including revenues and expenses.

account analysis method. A method of separating fixed costs from variable costs based on the analyst’s judgment of whether the cost is fixed or variable. Based on their names alone, the analyst might classify direct labor (materials) costs as variable and depreciation on a factory building as fixed. In our experience, this method results in too many fixed costs and not enough variable costs—that is, analysts have insufficient information to judge management’s ability to reduce costs that appear to be fixed.

account form. The form of balance sheet in which assets appear on the left and equities appear on the right. Contrast with report form. See T-account.

accountability center. Responsibility center.

accountancy. The British word for accounting. In the United States, it means the theory and practice of accounting.

accountant’s comments. Canada: a written communication issued by a public accountant at the conclusion of a review engagement. It consists of a description of the work performed and a statement that, under the terms of the engagement, the accountant has not performed an audit and consequently expresses no opinion. (Compare auditor’s report; denial of opinion.)

accountant’s opinion. Auditor’s report.

accountant’s report. Auditor’s report.

accounting. A system conveying information about a specific entity. The information is in financial terms and will appear in accounting statements only if the accountant can measure it with reasonable precision. The AICPA defines accounting as a service activity whose “function is to provide quantitative information, primarily financial in nature, about economic entities that is intended to be useful in making economic decisions.”

accounting adjustments. Prior-period adjustments, changes in accounting principles accounted for on a cumulative basis, and corrections of errors. See accounting changes. The FASB indicates that it will tend to call these items “accounting adjustments,” not
“accounting changes,” when it requires the reporting of comprehensive income.

**Accounting and Tax Index.** A publication that indexes, in detail, the accounting literature of the period. Published by UMI, a subsidiary of Bell & Howell.

**accounting changes.** As defined by APB Opinion No. 20, a change in (1) an accounting principle (such as a switch from FIFO to LIFO or from sum-of-the-years'-digits depreciation to straight-line depreciation), (2) an accounting estimate (such as estimated useful lives or salvage value of depreciable assets and estimates of warranty costs or uncollectible accounts), or (3) the reporting entity. The firm should disclose changes of type (1). It should include in reported earnings for the period of change the cumulative effect of the change on retained earnings at the start of the period during which it made the change. The firm should treat changes of type (2) as affecting only the period of change and, if necessary, future periods. The firm should disclose reasons for changes of type (3) in statements reporting on operations of the period of the change, and it should show the effect of the change on all other periods, for comparative purposes. In some cases (such as a change from LIFO to other inventory flow assumptions or a change in the method of accounting for long-term construction contracts), GAAP treat changes of type (1) like changes of type (3). That is, for these changes the firm should restate all statements shown for prior periods to show the effect of adopting the change for those periods as well. See all-inclusive (income) concept and accounting errors.

**accounting conventions.** Methods or procedures used in accounting. Writers tend to use this term when the method or procedure has not yet received official authoritative sanction by a pronouncement of a group such as the APB, EITF, FASB, or SEC. Contrast with accounting principles.

**accounting cycle.** The sequence of accounting procedures starting with journal entries for various transactions and events and ending with the financial statements or, perhaps, the post-closing trial balance.

**accounting deficiency.** Canada: a failure to adhere to generally accepted accounting principles or to disclose essential information in financial statements.

**accounting entity.** See entity.

**accounting equation.** Assets = Equities; Assets = Liabilities + Owners’ equity.

**accounting errors.** Arithmetic errors and misapplications of accounting principles in previously published financial statements. The firm corrects these during the current period with direct debits or credits to retained earnings. In this regard, the firm treats them like prior-period adjustments, but technically APB Opinion No. 9 does not classify them as prior-period adjustments. See accounting changes, and contrast with changes in accounting estimates as described there.

**accounting event.** Any occurrence that is recorded in the accounting records.

**Accounting Horizons.** A quarterly journal of the American Accounting Association.

**accounting methods.** Accounting principles; procedures for carrying out accounting principles.

**accounting period.** The time period between consecutive balance sheets; the time period for which the firm prepares financial statements that measure flows, such as the income statement and the statement of cash flows. See interim statements.

**accounting policies.** Accounting principles adopted by a specific entity.

**accounting principles.** The methods or procedures used in accounting for events reported in the financial statements. We tend to use this term when the method or procedure has
received official authoritative sanction from a pronouncement of a group such as the APB, EITF, FASB, or SEC. Contrast with accounting conventions and conceptual framework.

**Accounting Principles Board.** See APB.

**accounting procedures.** See accounting principles. However, this term usually refers to the methods for implementing accounting principles.

**accounting rate of return.** Income for a period divided by average investment during the period; based on income, rather than discounted cash flows, and hence a poor decision-making aid or tool. See ratio.

**Accounting Research Bulletin (ARB).** The name of the official pronouncements of the former Committee on Accounting Procedure (CAP) of the AICPA. The committee issued 51 bulletins between 1939 and 1959. ARB No. 43 restated and codified the parts of the first 42 bulletins not dealing solely with definitions.

**Accounting Research Study (ARS).** One of a series of studies published by the Director of Accounting Research of the AICPA and “designed to provide professional accountants and others interested in the development of accounting with a discussion and documentation of accounting problems.” The AICPA published 15 such studies in the period 1961–1973.

**Accounting Review.** A journal of the American Accounting Association.

**Accounting Series Release (ASR).** See SEC.

**accounting standards.** Accounting principles.

**Accounting Standards Executive Committee (AcSEC).** The senior technical committee of the AICPA authorized to speak for the AICPA in the areas of financial accounting and reporting as well as cost accounting.

**accounting system.** The procedures for collecting and summarizing financial data in a firm.

**Accounting Terminology Bulletin (ATB).** One of four releases of the Committee on Terminology of the AICPA issued in the period 1953–57.

**Accounting Trends and Techniques.** An annual AICPA publication that surveys the reporting practices of 600 large corporations. It presents tabulations of specific practices, terminology, and disclosures along with illustrations taken from individual annual reports.

**accounts payable.** A liability representing an amount owed to a creditor; usually arising from the purchase of merchandise or materials and supplies, not necessarily due or past due; normally, a current liability.

**accounts receivable.** Claims against a debtor; usually arising from sales or services rendered, not necessarily due or past due; normally, a current asset.

**accounts receivable turnover.** Net sales on account divided by average accounts receivable. See ratio.

**accretion.** Occurs when a book value grows over time, such as a bond originally issued at a discount; the correct technical term is “accretion,” not “amortization.” This term also refers to an increase in economic worth through physical change caused by natural growth, usually said of a natural resource such as timber. Contrast with appreciation. See amortization.

**accrual.** Recognition of an expense (or revenue) and the related liability (or asset) resulting from an accounting event, frequently from the passage of time but not signaled by an explicit cash transaction; for example, the recognition of interest expense or revenue (or wages, salaries, or rent) at the end of a period even though the firm makes no explicit cash transaction at that time. Cash flow follows accounting recognition; contrast with deferral.
accrual basis of accounting. The method of recognizing revenues as a firm sells goods (or delivers them) and as it renders services, independent of the time when it receives cash. This system recognizes expenses in the period when it recognizes the related revenue, independent of the time when it pays cash. SFAC No. 1 says,

Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for the enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise.

Contrast with the cash basis of accounting. See accrual and deferral. We could more correctly call this “accrual/deferral” accounting.

accrue. See accrued, and contrast with incur.

accrued. Said of a revenue (expense) that the firm has earned (recognized) even though the related receivable (payable) has a future due date. We prefer not to use this adjective as part of an account title. Thus, we prefer to use Interest Receivable (Payable) as the account title rather than Accrued Interest Receivable (Payable). See matching convention and accrual. Contrast with incur.

accrued depreciation. An incorrect term for accumulated depreciation. Acquiring an asset with cash, capitalizing it, and then amortizing its cost over periods of use is a process of deferral and allocation, not of accrual.

accrued payable. A payable usually resulting from the passage of time. For example, salaries and interest accrue as time passes. See accrued.

accrued receivable. A receivable usually resulting from the passage of time. See accrued.

accumulated benefit obligation. See projected benefit obligation for definition and contrast.

accumulated depreciation. A preferred title for the asset contra account that shows the sum of depreciation charges on an asset since the time the firm acquired it. Other account titles are allowance for depreciation (acceptable term) and reserve for depreciation (unacceptable term).

accumulated other comprehensive income. Balance sheet amount in owners’ equity showing the total of all other comprehensive income amounts from all prior periods.

accurate presentation. The qualitative accounting objective suggesting that information reported in financial statements should correspond as precisely as possible with the economic effects underlying transactions and events. See fair presentation and full disclosure.

acid test ratio. Quick ratio.

acquisition cost. Of an asset, the net invoice price plus all expenditures to place and ready the asset for its intended use. The other expenditures might include legal fees, transportation charges, and installation costs.

ACRS. Accelerated Cost Recovery System.

AcSEC. Accounting Standards Executive Committee of the AICPA.


activity-based costing (ABC). Method of assigning indirect costs, including nonmanufacturing overhead costs, to products and services. ABC assumes that almost all overhead costs associate with activities within the firm and vary with respect to the drivers of those activities. Some practitioners suggest that ABC attempts to find the drivers for all indirect costs; these people note that in the long run, all costs are variable, so fixed indirect costs do not occur. This method first assigns costs to activities and then to products based on the products’ usage of the activities.
activity-based depreciation. Production method (depreciation).

activity-based management (ABM). Analysis and management of activities required to make a product or to produce a service. ABM focuses attention to enhance activities that add value to the customer and to reduce activities that do not. Its goal is to satisfy customer needs while making smaller demands on costly resources. Some refer to this as “activity management.”

activity basis. Costs are variable or fixed (incremental or unavoidable) with respect to some activity, such as production of units (or the undertaking of some new project). Usage calls this activity the “activity basis.”

activity center. Unit of the organization that performs a set of tasks.

activity variance. Sales volume variance.

actual cost (basis). Acquisition or historical cost. Also contrast with standard cost.

actual costing (system). Method of allocating costs to products using actual direct materials, actual direct labor, and actual factory overhead. Contrast with normal costing and standard costing.

actuarial. An adjective describing computations or analyses that involve both compound interest and probabilities, such as the computation of the present value of a life-contingent annuity. Some writers use the word even for computations involving only one of the two.

actuarial accrued liability. A 1981 report of the Joint Committee on Pension Terminology (of various actuarial societies) agreed to use this term rather than prior service cost.

ad valorem. A method of levying a tax or duty on goods by using their estimated value as the tax base.

additional paid-in capital. An alternative acceptable title for the capital contributed in excess of par (or stated) value account.

additional processing cost. Costs incurred in processing joint products after the split-off point.

adequate disclosure. An auditing standard that, to achieve fair presentation of financial statements, requires disclosure of material items. This auditing standard does not, however, require publicizing all information detrimental to a company. For example, the company may face a lawsuit, and disclosure might require a debit to a loss account and a credit to an estimated liability. But the court might view the making of this entry as an admission of liability, which could adversely affect the outcome of the suit. The firm should debit expense or loss for the expected loss, as required by SFAS No. 5, but need not use such accurate account titles that the court can spot an admission of liability.

adjunct account. An account that accumulates additions to another account. For example, Premium on Bonds Payable is adjunct to the liability Bonds Payable; the effective liability is the sum of the two account balances at a given date. Contrast with contra account.

adjusted acquisition (historical) cost. Sometimes said of the book value of a plant asset, that is, acquisition cost less accumulated depreciation. Also, cost adjusted to a constant-dollar amount to reflect general price-level changes.

adjusted bank balance of cash. The balance shown on the statement from the bank plus or minus amounts, such as for unrecorded deposits or outstanding checks, to reconcile the bank’s balance with the correct cash balance. See adjusted book balance of cash.

adjusted basis. The basis used to compute gain or loss on the disposition of an asset for tax purposes. See also book value.

adjusted book balance of cash. The balance shown in the firm’s account for cash in bank plus or minus amounts, such as for notes
collected by the bank or bank service charges, to reconcile the account balance with the correct cash balance. See adjusted bank balance of cash.

**adjusted trial balance.** Trial balance taken after adjusting entries but before closing entries. Contrast with pre- and post-closing trial balances. See unadjusted trial balance and post-closing trial balance. See also work sheet.

**adjusting entry.** An entry made at the end of an accounting period to record a transaction or other accounting event that the firm has not yet recorded or has improperly recorded during the accounting period; an entry to update the accounts. See work sheet.

**adjustment.** An account change produced by an adjusting entry. Sometimes accountants use the term to refer to the process of restating financial statement amounts to constant dollars.

**administrative costs (expenses).** Costs (expenses) incurred for the firm as a whole, in contrast with specific functions such as manufacturing or selling; includes items such as salaries of top executives, general office rent, legal fees, and auditing fees.

**admission of partner.** Occurs when a new partner joins a partnership. Legally, the old partnership dissolves, and a new one comes into being. In practice, however, the firm may keep the old accounting records in use, and the accounting entries reflect the manner in which the new partner joined the firm. If the new partner merely purchases the interest of another partner, the accounting changes the name for one capital account. If the new partner contributes assets and liabilities to the partnership, then the firm must recognize them. See bonus method.

**ADR.** See asset depreciation range.

**advances from (by) customers.** A preferred title for the liability account representing receipts of cash in advance of delivering the goods or rendering the service. After the firm delivers the goods or services, it will recognize revenue. Some refer to this as “deferred revenue” or “deferred income,” terms likely to confuse the unwary because the item is not yet revenue or income.

**advances to affiliates.** Loans by a parent company to a subsidiary; frequently combined with “investment in subsidiary” as “investments and advances to subsidiary” and shown as a noncurrent asset on the parent’s balance sheet. The consolidation process eliminates these advances in consolidated financial statements.

**advances to suppliers.** A preferred term for the asset account representing disbursements of cash in advance of receiving assets or services.

**adverse opinion.** An auditor’s report stating that the financial statements are not fair or are not in accord with GAAP.

**affiliated company.** A company controlling or controlled by another company.

**after closing.** Post-closing; a trial balance at the end of the period.

**after cost.** Expenditures to be made after revenue recognition. For example, expenditures for repairs under warranty are after cost. Proper recognition of after cost involves a debit to expense at the time of the sale and a credit to an estimated liability. When the firm discharges the liability, it debits the estimated liability and credits the assets consumed.

**AG (Aktiengesellschaft).** Germany: the form of a German company whose shares can trade on the stock exchange.

**agency cost.** The cost to the principal caused by agents pursuing their own interests instead of the principal’s interests. Includes both the costs incurred by principals to control agents’ actions and the cost to the principals if agents
pursue their own interests that are not in the interest of the principals.

**agency fund.** An account for assets received by governmental units in the capacity of trustee or agent.

**agency theory.** A branch of economics relating the behavior of principals (such as owner nonmanagers or bosses) and that of their agents (such as nonowner managers or subordinates). The principal assigns responsibility and authority to the agent, but the agent’s own risks and preferences differ from those of the principal. The principal cannot observe all activities of the agent. Both the principal and the agent must consider the differing risks and preferences in designing incentive contracts.

**agent.** One authorized to transact business, including executing contracts, for another.

**aging accounts receivable.** The process of classifying accounts receivable by the time elapsed since the claim came into existence for the purpose of estimating the amount of uncollectible accounts receivable as of a given date. See sales contra, estimated uncollectibles, and allowance for uncollectibles.

**aging schedule.** A listing of accounts receivable, classified by age, used in aging accounts receivable.

**AICPA (American Institute of Certified Public Accountants).** The national organization that represents CPAs. See AcSEC. It oversees the writing and grading of the Uniform CPA Examination. Each state sets its own requirements for becoming a CPA in that state. See certified public accountant. Web Site: http://www.aicpa.org. Although the AICPA sets many auditing and professional standards for public accountants, the PCAOB regulates auditing of public companies and the profession.

**all-capital earnings rate.** Rate of return on assets.

**all-current method.** Foreign currency translation in which all financial statement items are translated at the current exchange rate.

**all-inclusive (income) concept.** A concept that does not distinguish between operating and nonoperating revenues and expenses. Thus, the only entries to retained earnings are for net income and dividends. Under this concept, the income statement reports all income, gains, and losses; thus, net income includes events usually reported as prior-period adjustments and as corrections of errors. GAAP do not include this concept in its pure form, but APB Opinions No. 9 and No. 30 move far in this direction. They do permit retained earnings entries for prior-period adjustments and correction of errors.

**allocate.** To divide or spread a cost from one account into several accounts, to several products or activities, or to several periods.

**allocation base.** The systematic method that assigns joint costs to cost objectives. For example, a firm might assign the cost of a truck to periods based on miles driven during the period; the allocation base is miles. Or the firm might assign the cost of a factory supervisor to a product based on direct labor hours; the allocation base is direct labor hours.

**allocation of income taxes.** See deferred income tax.

**allowance.** A balance sheet contra account generally used for receivables and depreciable assets. See sales (or purchase) allowance for another use of this term.

**allowance for funds used during construction.** In accounting for public utilities, a revenue account credited for implicit interest earnings on shareholders’ equity balances. One principle of public utility regulation and rate setting requires that customers should pay the full costs
of producing the services (e.g., electricity) that they use, nothing more and nothing less. Thus, an electric utility must capitalize into an asset account the full costs, but no more, of producing a new electric power-generating plant. One of the costs of building a new plant is the interest cost on cash tied up during construction. If funds are explicitly borrowed by an ordinary business, the journal entry for interest of $1,000 is typically:

<table>
<thead>
<tr>
<th>Interest Expense</th>
<th>1,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Payable</td>
<td>1,000</td>
</tr>
<tr>
<td>Interest expense for the period.</td>
<td></td>
</tr>
</tbody>
</table>

If the firm is constructing a new plant, then another entry would be made, capitalizing interest into the plant-under-construction account:

<table>
<thead>
<tr>
<th>Construction Work-in-Progress</th>
<th>750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest Expense</td>
<td>750</td>
</tr>
<tr>
<td>Capitalize relevant portion of interest relating to construction work in progress into the asset account.</td>
<td></td>
</tr>
</tbody>
</table>

The cost of the plant asset increases; when the firm uses the plant, it charges depreciation. The interest will become an expense through the depreciation process in the later periods of use, not currently as the firm pays for interest. Thus, the firm reports the full cost of the electricity generated during a given period as expense in that period. But suppose, as is common, that the electric utility does not explicitly borrow the funds but uses some of its own funds, including funds raised from equity issues as well as from debt. Even though the firm incurs no explicit interest expense or other explicit expense for capital, the funds have an opportunity cost. Put another way, the plant under construction will not have lower economic cost just because the firm used its own cash rather than borrowing. The public utility using its own funds, on which it would have to pay $750 of interest if it had explicitly borrowed the funds, will make the following entry:

<table>
<thead>
<tr>
<th>Construction Work-in-Progress</th>
<th>750</th>
</tr>
</thead>
<tbody>
<tr>
<td>Allowance for Funds Used during Construction</td>
<td>750</td>
</tr>
<tr>
<td>Recognition of interest, an opportunity cost, on own funds used.</td>
<td></td>
</tr>
</tbody>
</table>

The allowance account is a form of revenue, to appear on the income statement, and the firm will close it to Retained Earnings, increasing it. On the statement of cash flows it is an income or revenue item not producing funds, and so the firm must subtract it from net income in deriving cash provided by operations. SFAS No. 34 specifically prohibits nonutility companies from capitalizing, into plant under construction, the opportunity cost (interest) on their own funds used.

allowance for uncollectibles (accounts receivable). A contra account that shows the estimated accounts receivable amount that the firm expects not to collect. When the firm uses such an allowance, the actual write-off of specific accounts receivable (debit allowance, credit specific customer’s account) does not affect revenue or expense at the time of the write-off. The firm reduces revenue when it debits bad debt expense (or, our preference, a revenue contra account) and credits the allowance; the firm can base the amount of the credit to the allowance on a percentage of sales on account for a period of time or compute it from aging accounts receivable. This contra account enables the firm to show an estimated receivables amount that it expects to collect without identifying specific uncollectible accounts. See allowance method.

allowance method. A method of attempting to match all expenses of a transaction with their associated revenues; usually involves a debit to expense and a credit to an estimated liability, such as for estimated warranty
expenditures, or a debit to a revenue (contra) account and a credit to an asset (contra) account, such as in some firms’ accounting for uncollectible accounts. See allowance for uncollectibles for further explanation. When the firm uses the allowance method for sales discounts, the firm records sales at gross invoice prices (not reduced by the amounts of discounts made available). The firm debits an estimate of the amount of discounts to be taken to a revenue contra account and credits an allowance account, shown contra to accounts receivable.

**American Accounting Association (AAA).** An organization primarily for academic accountants but open to all interested in accounting. It publishes the *Accounting Review* and several other journals.

**American Institute of Certified Public Accountants.** See AICPA.

**American Stock Exchange (AMEX) (ASE).** A public market where various corporate securities are traded.

**AMEX.** *American Stock Exchange.*

**amortization.** Strictly speaking, the process of liquidating or extinguishing (“bringing to death”) a debt with a series of payments to the creditor (or to a sinking fund). From that usage has evolved a related use involving the accounting for the payments themselves: “amortization schedule” for a mortgage, which is a table showing the allocation between interest and principal. The term has come to mean writing off (“liquidating”) the cost of an asset. In this context it means the general process of allocating the acquisition cost of an asset either to the periods of benefit as an expense or to inventory accounts as a product cost. This is called depreciation for plant assets, depletion for wasting assets (natural resources), and “amortization” for intangibles. SFAC No. 6 refers to amortization as “the accounting process of reducing an amount by periodic payments or write-downs.” The expressions “unamortized debt discount or premium” and “to amortize debt discount or premium” relate to accruals, not to deferrals. The expressions “amortization of long-term assets” and “to amortize long-term assets” refer to deferrals, not accruals. Contrast with accretion.

**amortized cost.** A measure required by SFAS No. 115 for held-to-maturity securities. This amount results from applying the method described at effective interest method. The firm records the security at its initial cost and computes the effective interest rate for the security. Whenever the firm receives cash from the issuer of the security or whenever the firm reaches the end of one of its own accounting periods (that is, reaches the time for its own adjusting entries), it takes the following steps. It multiplies the amount currently recorded on the books by the effective interest rate (which remains constant over the time the firm holds the security). It debits that amount to the Debt Security account and credits the amount to Interest Revenue. If the firm receives cash, it debits Cash and credits the debt security account. The firm recomputes the book value of the Debt Security as the book value before these entries plus the increase for the interest revenue less the decrease for the cash received. The resulting amount is the amortized cost for the end of that period.

**analysis of variances.** See variance analysis.

**annual report.** A report prepared once a year for shareholders and other interested parties. It includes a balance sheet, an income statement, a statement of cash flows, a reconciliation of changes in owners’ equity accounts, a summary of significant accounting principles, other explanatory notes, the auditor’s report, and comments from management about the year’s events. See 10-K and financial statements.

**annuitant.** One who receives an annuity.
annuity. A series of payments of equal amount, usually made at equally spaced time intervals.

annuity certain. An annuity payable for a definite number of periods. Contrast with contingent annuity.

annuity due. An annuity whose first payment occurs at the start of period 1 (or at the end of period 0). Contrast with annuity in arrears.

annuity in advance. An annuity due.

annuity in arrears. An ordinary annuity whose first payment occurs at the end of the first period.

annuity method of depreciation. See compound interest depreciation.

appraisal. In valuing an asset or liability, a process that involves expert opinion rather than evaluation of explicit market transactions.

appraisal costs. Costs incurred to detect individual units of products that do not conform to specifications, including end-process sampling and field-testing. Also called “detection costs.”

approximate net realizable value method. A method of assigning joint costs to joint products based on revenues minus additional processing costs of the end products.
**ARB.** Accounting Research Bulletin.

**arbitrage.** Strictly speaking, the simultaneous purchase in one market and sale in another of a security or commodity in hope of making a profit on price differences in the different markets. Often, writers use this term loosely when a trader sells an item that is somewhat different from the item purchased; for example, the sale of shares of common stock and the simultaneous purchase of a convertible bond that is convertible into identical common shares. The trader hopes that the market will soon see that the similarities of the items should make them have equal market values. When the market values converge, the trader closes the positions and profits from the original difference in prices, less trading costs.

**arbitrary.** Having no causation basis. Accounting theorists and practitioners often, properly, say, “Some cost allocations are arbitrary.” In that sense, the accountant does not mean that the allocations are capricious or haphazard but does mean that theory suggests no unique solution to the allocation problem at hand. Accountants require that arbitrary allocations be systematic, rational, and consistently followed over time.

**arm’s length.** A transaction negotiated by unrelated parties, both acting in their own self-interests; the basis for a fair market value estimation or computation.

**arrears.** Cumulative dividends that the firm has not yet declared. See annuity in arrears for another context.

**ARS.** Accounting Research Study.

**articles of incorporation.** Document filed with state authorities by persons forming a corporation. When the state returns the document with a certificate of incorporation, the document becomes the corporation’s charter.

**articulate.** The relation between any operating statement (for example, income statement or statement of cash flows) and comparative balance sheets, where the operating statement explains (or reconciles) the change in some major balance sheet category (for example, retained earnings or working capital).

**ASE.** American Stock Exchange.

**ASR.** Accounting Series Release.

**assess.** To value property for the purpose of property taxation; to levy a charge on the owner of property for improvements thereto, such as for sewers or sidewalks. The taxing authority computes the assessment.

**assessed valuation.** For real estate or other property, a dollar amount that a government uses as a basis for levying taxes. The amount need not have some relation to market value.

**asset.** SFAC No. 6 defines assets as “probable future economic benefits obtained or controlled by a particular entity as a result of past transactions. . . . An asset has three essential characteristics: (a) it embodies a probable future benefit that involves a capacity, singly or in combination with other assets, to contribute directly or indirectly to future net cash inflows, (b) a particular entity can obtain the benefit and control others’ access to it, and (c) the transaction or other event giving rise to the entity’s right to or control of the benefit has already occurred.” A footnote points out that “probable” means that which we can reasonably expect or believe but that is not certain or proved. You may understand condition (c) better if you think of it as requiring that a future benefit cannot be an asset if it arises from an executory contract, a mere exchange of promises. Receiving a purchase order from a customer provides a future benefit, but it is an executory contract, so the order cannot be an asset. An asset may be tangible or intangible, short-term (current) or long-term (noncurrent).

**asset depreciation range (ADR).** The range of depreciable lives allowed by the Internal