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Ch 1: *BMGIT 221*
Preiffer

9/2

Introduction to Managerial Accounting

Obj 1. Managers' 4 Primary Responsibilities

- ① Decision Making: making decisions while they plan, direct, and controlling operations
 - ex. price setting or product offerings
 - renovations of facilities, operations openings or closings
- ② Planning: setting goals and objectives and how to achieve them
 - ex. more sales by opening more stores
 - reduce labor costs by reducing store hours
- ③ Directing: overseeing day-to-day operations
 - ex. using sales to adjust marketing strategies
 - using product cost reports to adjust raw material usage
- ④ Controlling: evaluating results of operations
 - ex. comparing budgeted sales with actual sales to take corrective actions
 - comparing budgeted product costs against actual product costs to take corrective actions

Budgets

Obj 2 Managerial vs. Financial Accounting

Issue	Managerial	Financial
primary users	internal (managers)	external (creditors, stockholders)
purpose of information	plan, direct, control, decide	users make investing and funding decisions
primary accounting product	internal reports to management	general purpose financial statements
what is included?	defined by management	determined by GAAP
underlying basis of info	internal and external transactions, focus on future	based on historical transactions with external parties
emphasis	data must be relevant	data must be reliable and objective

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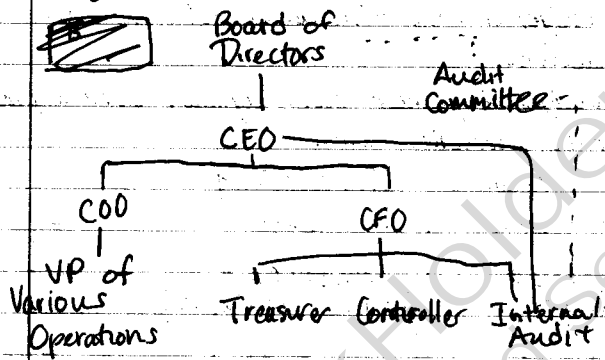
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	Issue	Managerial Managerial segments of the business	Financial Company as a whole
Business Unit			
preparation		depends on management needs	annually and quarterly
Verification		internal audit	external audit
information requirements		no requirement	SEC requires publicly traded companies to issue audited financial statements
Impact on Employee Behavior		careful consideration	adequacy of disclosure

Organizational Structure



- Board of Directors - elected by shareholders, ~~not~~ ~~oversee~~
- Internal and External audit report to audit committee

Changing Roles of Management Accountants

- impact of technology
- ensuring accurate financial records
- planning, analyzing, and interpreting accounting data
- providing decision support

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Required Skills

- knowledge of financial and managerial accounting
- analytical skills (critical thinking)
- knowledge of business functions
- ability to work on a team
- oral and written communication skills

Institute of Management Accountants (IMA)

- professional association for management accountants

IMA's functions

- Certification (CMA)
- Practice Development
- Networking
- Ethical Standards
- Public Education

Summary of IMA ethical standards

- Competence
- Confidentiality
- Integrity
- Credibility

Read in Book

Ethical Behavior

Ex 1 Unethical

- ① allowing reimbursement of false expense report
- ② manipulating income
- ③ performing tasks not qualified to perform

How to Resolve These Dilemmas

Ex 1 If not resolved

- ① discuss w/ immediate supervisor
- ② discuss w/ objective advisor
- ③ consult an attorney

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Unethical vs Illegal

• Not all unethical behavior is illegal, but all illegal behavior is unethical.

• ~~Not unethical~~

• ~~Definitely~~

• Regulatory and Business Issue

- Sarbanes - Oxley Act of 2002 (SOX)
 - restoring trust in publicly traded corporations, management, financial statements, and auditors
 - CEO/CFO requirements: had to sign off
 - financial statements
 - internal control structure
 - annual assessment
 - independent audit committee
 - increases white collar crime penalties

Chapter 1 Booknotes

- Managerial accountants translate plans into budgets - quantitative expression of a budget
- Stockholders elect board of directors who hires CEO.
- COO is responsible for company's operations, ~~and~~ research & development, production, and distribution
- CFO does financial concerns
- Treasure and Controller — Treasurer raises capital (through issuing stocks and bonds) and investing funds
 - Controller: general financial acc, managerial acc, and tax reporting

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- NY Stock exchange requires ^{listed} companies have an internal audit function, ensure companies' internal controls and risk management policies are functioning properly
 - ↳ reports to subcommittee of B.O.D. called Audit Committee which oversee the internal audit function as well as the annual audit of the financial statements by independent CPA's
- Internal Audit Comm. and CPA's report to Audit Comm. to ensure the management will not intimidate or bias their work
- A lot of managerial accountants use to report to controller but now work on cross functional teams; consists of employees representing various functions of the company, such as R&D, production, marketing, distribution, and customer service
- Institute of Management Accountants (IMA)
 - professional association for management accountants
 - mission: to provide a dynamic forum
 - IMA wants to educate society about the role of MA's play in organizations
 - 85% of accountants work in organizations performing roles from earlier
 - IMA publishes monthly journal called strategic finance
 - IMA issues CMA (certified MA)
 - pass exam and continue professional edu
 - MA topics, business & ~~fin~~ economics
 - higher salaries and job positions if you have

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Ethics

- discuss unethical sit. w/ supervisor unless supervisor is involved. If so, notify supervisor of next level, if the immediate supervisor is involved then notify audit committee or B.O.D.
- or discuss w/ objective advisor, such as IMA ethics counselor.

Sarbanes Oxley Act of 2002 - b/c of fraudulent transactions

- purpose: restore trust in publicly traded corporations, their management, their financial statements, and their auditors
- requires CEO and CFO responsibility for financial statements and disclosures
- increases penalties for white collar crime

Independent audit committee

International Financial Reporting Standards (IFRS)

- result of globalization
- SEC considering whether to require all publicly traded companies to ~~adopt~~ adopt IFRS
- expensive and time consuming, long run it'll save
- Several financial statements to 1 financial statement

SEC studying IFRS reporting standards needed worldwide

Extensive Business Reporting Language (XBRL)

- enables companies to release financial and business information in a format that can be easily accessed, sorted, and analyzed on the internet
- efficiency
- SEC requiring all public trading companies begin using XBRL for financial reports

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- Shifting ~~Responsibility~~ Economy
 - ~~not~~ shifting from manufacturing toward service
 - managerial acc has shifted to ~~products~~ as well, expanding towards meeting the needs of service and merchandising firms as well as manufacturers
- Competing in Today's Global Marketplace
 - Cost-benefit analysis - weighs the expected costs of taking an action against the expected benefits of the action. *more accurate and timely info needed*
 - Sustainability - ability to meet the needs of the present w/o compromising the ability of future generations to meet their own needs.
 - to move towards ~~economic~~ environmental sustain...
 - companies introduce "green initiative" doing business w/o negative consequences on Earth
 - Social Responsibility - ~~can~~ considering how their business affects employees, consumers, local citizens
 - "give back" to community
 - ~~not only~~ builds gives their business opportunities for innovation and business development.
- Advanced Information Systems
 - Enterprise Resource Planning (ERP) - large companies turning to this to integrate companies worldwide functions, departments and data. *ex: SAP, Oracle, PeopleSoft*
- B2E Commerce
 - an important means of supply chain management; where companies exchange information w/ suppliers to reduce cost, improve quality, and speed delivery of goods and services from suppliers to the company itself.
 - need to survive in global economy

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ex) Dell's suppliers can check their inventory so it lets them know size of next day shipment

Lean Production

Def; philosophy and business strategy to reduce of manufacturing w/o waste

lowers cost
increases competitive decision

- more waste eliminated, lower company's costs will
- One primary goal of Lean Production - eliminate waste of time and money that accompanies large inventories

- Just in Time (JIT) manufacturing product

reduces raw material and finished good inventory

JIT to fill customers order, and no sooner

- reduces storage costs and handling costs
- Throughput Time - time between buying raw material and selling finished products

Total Quality Management (TQM)

- give good quality

ISO 9001:2008 (International Organization of Standardization)

- may become certified by complying with quality management standards set forth by ISO and undergoing extensive audits of their quality management process

- certification gives competitive advantage in market place

global

- CPA was 1st pro membership organization to earn ISO 9001 certification in US

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inventory = finished good inventory

• Enterprise Resource Planning (ERP)

- system that integrates a company's functions, departments, and data, explorable and peoplesoft

- Advantages

- ~~streamline~~ streamline operations
- respond quickly to decisions
- replace ~~software~~ separate software systems

- disadvantage - expensive

Ch 2:

• 3 Types of Companies

① Service

- only provide a service, no inventory
ex accountant, banks, doctors, lawyers

② Merchandisers

- resell products purchased from sellers

- one inventory account
ex Amazon.com, J.C. Penney, Sears

purchase exclusively from wholesaler

- Retailer vs. Wholesaler - buy finished goods from manufacturer then sell to retailer

③ Manufacturers

- Use labor and other inputs to convert raw materials into finished products

Ex Crayola Crayons, Dell Comp., Craftsman Tools

- 3 Inventory Accounts

- 1.) Raw Materials - not ~~started~~ started product
- 2.) Work in Process - partially completed product
- 3.) Finished Goods - fully finished product

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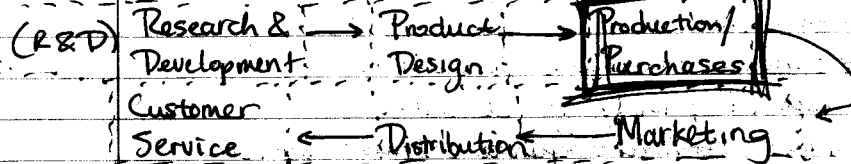
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Value Chain

Activities that add value to products and services that ~~add~~ ~~value~~ and cost & money



Current asset Production/Purchases - product costs: initially reflect in inventory as an asset on balance sheet.
Others - period costs - expenses on balance sheet

R&D expenditures will appear as expenses

Period Costs

- R&D
- Design
- Customer Service
- Distribution
- Marketing

Product Costs

- Production/Purchases

Marketing - product is now available for sale, advertise for product, etc.

Distribution - product is now being sold, distributing it out now

Customer Service - after the sale, dealing w/ defects, technical support, product coming back to you (redistribution)

Cost Object

- anything for which managers want a separate measurement of cost
 - Direct Cost
 - Indirect Cost

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- Direct Cost: you can trace to the cost object, there is no (no ambiguity to the association)
- Indirect Cost: cannot trace to the cost object (allocated to the association)

Direct

Indirect

- costs for activities/services that benefit specific projects
- ex) project staff, consultants, project supplies, travel, training
- benefit more than one project
- ex) utilities, rent, and legal, equipment rental

Both

telephone charges, computer use, project clerical personnel, postage and printing miscellaneous office supplies

Two definitions of Product Cost

- Total Costs: used internally only, must recover 100% of all costs in value chain, to make revenue, revenue must exceed costs of period and product costs
- Inventoriable Product Costs: used for external reporting (costs incurred during production or purchase)
 - inventoriable product costs takes place of product design in value chain
 - merchandiser: (Wholesaler or Resaler)
 - * purchase price from supplier
 - * cost to get ready for sale
 - * freight-in
 - * Import Duties or Tariffs
 - manufacturer
 - * direct materials and direct labor (direct costs)
 - * manufacturing overhead (indirect costs)

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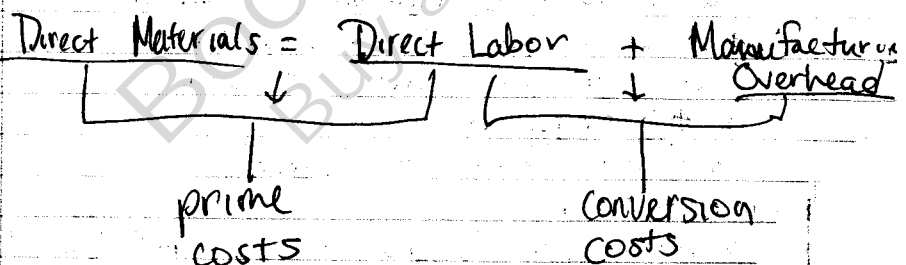
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Manufacturing Overhead

indirect costs related to manufacturing that aren't direct materials or direct labor

- indirect material: materials used in the plant that aren't easily traced to individual units
- indirect labor: cost of all employees in the plant other than those converting raw mat. to ^{prod}
- other indirect manufacturing overhead

- ① cost of milk purchased from farmers
Product, direct material
- ② lubricants used in bottling machines.
Product, ~~direct materials~~ Indirect Overhead
- ③ Depreciation on refrigerated trucks to collect raw milk
Product, direct material
- ④ Property Tax on processing plant
Product, Indirect manufacture
- ⑤ Depreciation on ~~plant~~ comp of mark. dep.
Period associated w/ marketing activity
- ⑥ Wages and Salaries to plant employees
Product, indirect overhead
- ⑦ R&D on improving milk past. process
Period



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Direct and Indirect Labor Costs

- salaries & wages
- fringe benefits
- payroll taxes

Income Statement: Service Company

- simplest income statements
- all costs are period costs
- Service revenues
 - operating expenses and income

* Income Statement: Merchandiser

- + sales
- costs of goods sold
- = ~~operating expenses~~ gross profit
- operating expenses
- = operating income

* Costs of Good Sold Calculations: Merchandiser

- + Beginning Inventory
- + Purchases
- + Import duties or tariffs
- + freight in
- = costs of goods sold available for sale
- ending inventory
- = costs of goods sold

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* Income Statement : Manufacturer

+ sales

- ~~cost~~ C.O.G.S.

= gross profit

- oper. exp.

= op. inc.

* C.O.G.S. : Manufacturer

+ Beginning finished goods inventory

+ C.O.G. manufactured

= C.O.G. available for sale

- Ending finished goods inventory

= C.O.G.S.

* G. COG Manufactured : ~~Manufacturer~~ Manufacturer

+ Beg. work in process inv.

+ Direct materials used

+ direct labor

+ manufacturing overhead

= total manufacturing costs to account for

- ending work in process inventory

= costs of good manufactured

* Direct Materials Used : Manufacturer

+ Beg. raw materials inv.

+ purchases of raw materials

+ freight in

= materials available for use

- ending raw materials inventory

= direct materials used

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Reading for Ch 2

- **Total Costs**: costs of all resources used throughout the value chain
ex) prius total cost of R&D, manufacture, etc.
- **Product Costs**: initially recorded as inventory (asset)
- **Period**: always recorded as expense
- **Prime Costs** = Direct Materials + Direct Labor
- **Conversion Costs** = ~~Manufacturing~~ Manufacturing Overhead + Direct Labor

Rest of Ch 2

- **Controllable Cost**: management can influence or change cost
- **Uncontrollable**: management cannot change or influence cost in short run
ex) Cont: turn a/c off to reduce utilities
Un: can't change rent
- **Sunk Cost**: cost that has been incurred
- cost of cell phone, change phones your previous one is a sunk cost
- **Variable**: change in total cost in direct proportion to changes in volume
ex) cost of transportation for commuters
- **Fixed**: stay constant in total cost over a wide range of time
ex) insurance
- **Total Cost** = fixed costs + (variable cost per unit x number of units)
- **Average Cost** = total cost ÷ number of units
- **Marginal Cost** = cost of making one more unit
ex) you don't have texting for every text so the marginal cost is \$0.20 per text

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Ch 3: Job Costing

• Process Costing - large amounts of homogeneous products

- Mass Production

- similar items

- total costs are averaged over all units

↳ ex) paint manufacturers

* oil refineries

* cereal manufacturers

• Job Costing

- unique, custom products or small products or small batches

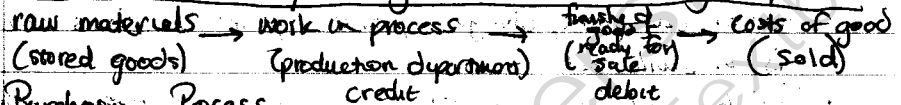
- total costs are accumulated by job

ex) hospitals

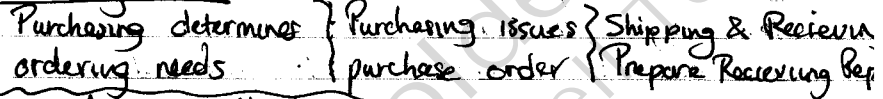
* custom home builders

* advertising agencies

• Flow of Inventory Through a Manufacturing System



• Purchasing Process



• Materials Requisition

materials to complete product

• Raw materials for each Material Requisition

• Direct Labor Costs traced to individual jobs

• Direct Labor and Materials Posted to Job Cost Record

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Calculating Predetermined Manufacturing Overhead Weight

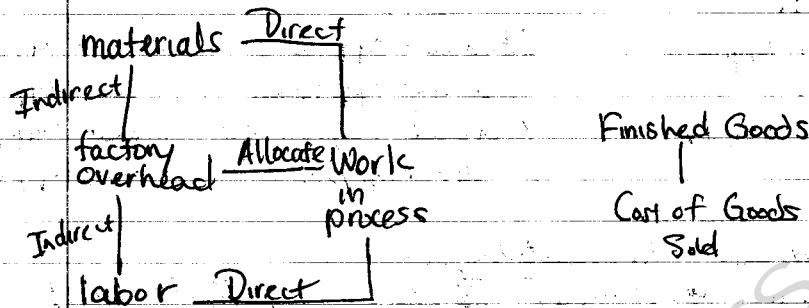
$$POHR = \frac{\text{total estimated mfg overhead costs}}{\text{total estimated amount of allocation base}}$$

Allocating Manufacturing Overhead (MOH) to Individual Jobs

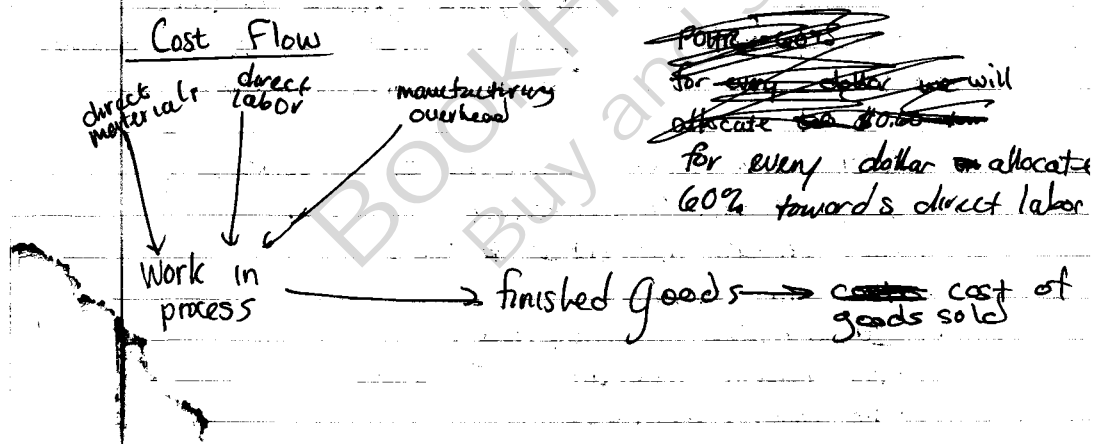
$$\text{Allocated (Applied) MOH} =$$

$$POHR \times \text{Amount of cost Allocation activity use}$$

When is manufacturing Overhead Allocated?



Overhead	
Actual under applied	Applied over applied



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Reasons why Management Needs Product Cost

- ① Control Costs
- ② Assess profitability of products
- ③ Pricing Decisions
- ④ Discounts on high volume sales
- ⑤ Bids on contracts
- ⑥ Financial Statement Preparation

OH			
Actual	Applied	Actual > applied	actual > applied
		underapplied	underapplied
under	over	Actual < applied	actual < applied
		overapplied	overapplied

Overhead Application Ex

- Actual man overhead \$190,000, 11,000 DLH
- using pre man OH of \$20 DLH, how much overhead allocated during year

MOH allocated: 220,000

OH		
190	220	Overapplied
G.O. 30		\$30,000 credit balance
		How to clear it a 0 balance
		Debit overhead account

What do when actual ≠ allocated?

- Underallocated (undercosted)
 - not enough allocated to jobs
 - too little expense
- Overallocated (overcosting)
 - too much allocated to jobs
 - too much expense

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Reasons why

Why/How?

- Estimated manufacturing overhead costs were higher or lower than actual
- used more or less of the estimated allocation base than projected

2 Solutions

- Adjust ~~C~~ C.O.G.S.
- prorate between C.O.G.S., wip inventory, finished goods inventory

• Underapplied - unfavorable variance

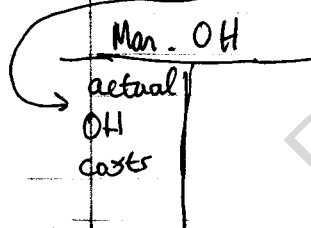
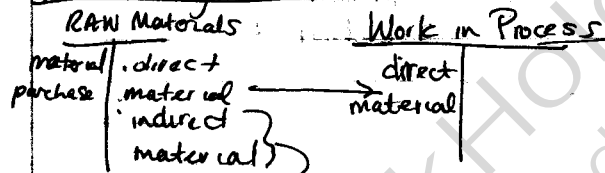
• Overapplied - favorable variance

How do manufacturers treat non-manufacturing costs?

- GAAP: only inventoriable product costs added to the ~~cost~~ cost of assets (inventory)

- Internal Decision Making: management wants to know the total cost of the product across the value chain

Accounting for Materials



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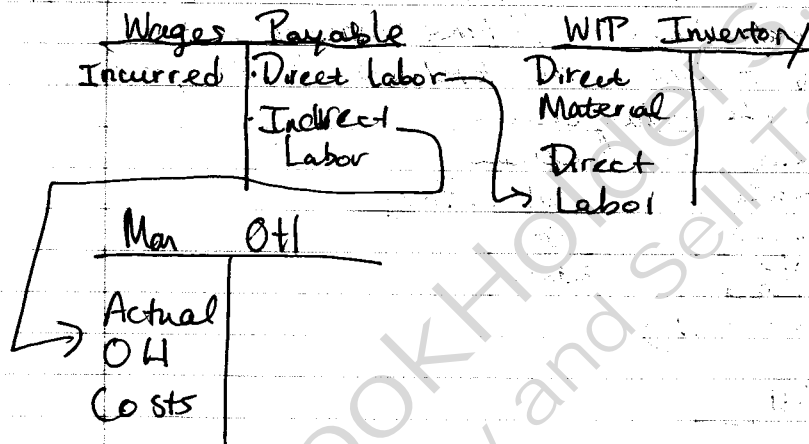
Raw Materials	
beg. bal	35,680
purchases	71,100
	63,280
	requisitioned
ending bal	

$$\text{Beg Bal} + \text{Purchases} - \text{Used} = \text{Ending}$$

$$35,680 + 71,100 - 63,280$$

Direct labor - debit to w.i.p. inventory
+ credit to wages payable
~~Man O/H - debit to~~

Accounting for Labor



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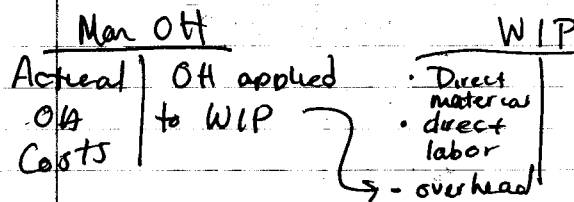
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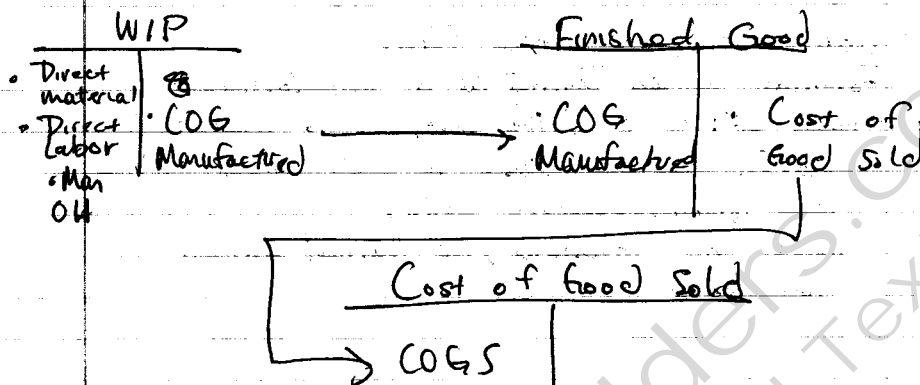
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Accounting for Man OH



Accounting for Finished Goods



Man OH Analysis

Man OH		Man OH	
20,000	18,000	18,000	20,000
2000 overhead was under applied - COGS is understated	COGS	Overhead was over applied - COGS overstated	2,000

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Closing Manufacturing OH

Underallocated
Man OH

over allocated

20,000	18,000	18,000	
2,000	2,000	2,000	2,000

COGS

2,000

COGS

2,000

Job Costing at Service Firm

- similar to job costing at a manufacturer
- main difference is the company is allocated indirect period costs to each client rather than manufacturing costs
- since no inventory, no journal entries necessary

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3

Ch 48 Reading

Process Costing - used by companies that produce large numbers of identical units through a series of uniform production steps or processes

- each identical unit bears the same cost
ex) oil refining, food and beverages

Job Costing - used by companies that manufacture produce unique, custom ordered products, or small batches of different products

each product or unit is considered a separate job

· direct materials, direct labor, man OH

· service providers use it for cost of serving each client

Raw Materials Inventory → WIP Inventory → FG Inventory

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Ch 4

Why and how do Companies Refine their Cost Allocation Systems?

- Why Refine?

- Mismatching Resources
- Cost distortion

- Who can Refine?

- Manufacturing Operations
- Service Companies and Governmental Agencies

Plant-wide Overhead Rate

- Using one predetermined manufacturing overhead cost rate for all operations

Department Overhead Rates

- Separate Predetermined manufacturing overhead rates for each department
- When to use
 - departments incur different amounts and types of MOH
 - different jobs or products use the department resources to a different extent

Over or under?

Plantwide: \$200 per machine hour

Departmental Rate:

Potato Chips = \$160.00 Overcosted

Corn Chips = \$289.86 Undercosted

Cheese Puffs = \$250.00 Undercosted

Activity Based Costing

- Allocates indirect costs to production
- focuses on activities and costs of activities
- Separate Allocation rate for each activity

Manufacturing Activities

Machine Set up

Materials Handling

Fabricating Parts

Supervising Assembly

Inspecting Products

Packaging Products

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Cost Hierarchy

Facility level
Product Level
BATCH Level
UNIT LEVEL ↓

• Activity Base Management

- Using ABC information to make decisions
 - * pricing and product mix
 - * cost cutting
 - * planning and control

• Pricing and Product Mix Decisions

- Changes the prices for products after identifying the different total cost
- decide to market the higher profitability product
- shift the product mix away from less profitable products

• Cutting Costs

- analyze costs in value chain
- value engineering

• Planning and Controlling Decisions

- uses the costs of activities to create products
- compare w/ actual activities to see if goals are being met

• Using ABC Outside of Manufacturing

- Merchandising & service: find the most profitable product or service

- Manufacturers: allocate operating activities

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Cost Benefit Test

Benefits are higher when in competitive markets:

188

- accurate product cost information
- opportunities for cost savings results in an increase in profits
- Benefits are higher when risk of cost distortion is high
- many different products, many different types/amounts of resources
- high indirect costs
- high and low volume products

Costs of Adopting ABC

- Generally lower with accounting the information system expertise to develop the
 - information technology
- Are Companies glad they adopted ABC?
 - 89% of the companies say that it was worth the cost
 - on the rise
 - not a cure-all, helps managers understand costs better

Signs the Old System may be Distorting Costs

- Costs system may need repair when:
 - managers don't understand costs and profits
 - ~~cost~~ cost system is outdated

Traditional Production Systems

- often described as push systems
- keep large inventories on hand
- Problems
 - storage cost, ~~high quality~~ hide quality, bottle neck and obsolete part
- Solution: Lean Production Systems

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~~Functional~~

Lean Production System

- philosophy and a business strategy
 - primary goal is to eliminate waste and cost
 - Focus on JIT
 - purchase raw materials & JIT for production
 - finished goods JIT for delivery
- (JIT) ~~is~~ "Just-In-Time"
- not [unclear] production occurs in self contained cells

broad employee roles

Drawbacks to Lean Production System

- vulnerable when problems strike suppliers or distributors
- Examples:
 - delays in delivery
 - personnel problems - union strikes
 - shortage of parts due to recalled products
 - weather related issues

Total Quality Management

- Goal: provide customers w/ superior products and services
- continuous improvement
- more investment up front to generate savings in the back end of the value chain

4 Types of Quality Costs

- ① Prevention Costs: avoid poor quality goods
- ② Appraisal Costs: detect poor quality goods or services
- ③ Internal Failure Costs: avoid poor quality goods or services before delivery to consumers
- ④ External Failure Costs: incurred after defective product is delivered

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Non Manufacturing

Cost of Quality Reports

- identifies, categorizes and quantifies all of the costs it incurs relating to quality
- calculate the % of total costs of quality that are incurred in each cost category
- use of frameworks for decisions

↑ Prevention Costs + Appraisal Costs

↓ Internal Failure Costs + External Failure Costs

- Prevention + Appraisal Costs = Total Costs of Adopting New Program

Costs of Not Adopting New Quality Program

Appraisal Costs + IF Costs + EF Costs = Total Costs of Not Adopting

Ch 4: Book Notes

Cost Distortion: some products overcosted while others are undercosted by the cost allocation system

plantwide overhead rate = $\frac{\text{predetermined}}{\text{MOH}}$

Departmental overhead rate - separating manufacturing overhead rate, re/ machining and assembly department

Activity Based Costing

ABC reduces cost distortion more than Departmental Costing
↳ focuses on activities, rather than departments, as the fundamental cost objects

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- ABC is more accurate than ^{Departmental} ~~Plantwide~~ which is more accurate than plantwide
- cost distortion is solely a result of the way the company allocates its indirect costs

Facility Level
Product Level
Batch Level
Unit Level ↓
Hierarchy

① Unit Level: activities and costs incurred for every unit

ex) inspecting and packaging each unit

② Batch Level: activities and costs incurred for every batch, regardless of # of units in the batch
ex) could be a batch of 1, 10, 100 units

③ Product Level: activities and costs incurred for a particular product, regardless of # of unit or batches
of the product produced

ex) cost to research, develop, and design market new models

④ Facility Level: Activities and costs incurred now matter how many, units, batches, or products are produced in the plant

ex) facility upkeep; cost of depreciation, insurance, property tax, and maintenance on the entire production plant

• (ABM) Activity Based Management: using activity based cost information to make decisions that increase profits while satisfying customers needs

ABM can look at the ABC and determine which activity costs they can cut

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Ch 6: Cost Behavior

Cost Behavior

Cost Behavior: how costs change as volume change

- 3 ~~types~~ common cost behaviors

- Variable costs - over plan minutes, certain price per ^{minute} ~~month~~
- Fixed costs - cell phone up to certain # of minutes
- Mixed costs

Fixed Costs

-

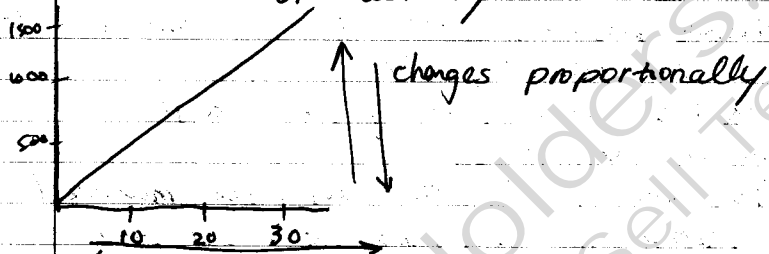
Variable Cost

- changes in direct proportion to changes in volume
- variable cost per unit remains constant
- slope:

$$\text{Total variable cost (y)} = vx$$

V = variable cost per unit of activity

X = volume of activity



Fixed Costs

- total fixed costs stay constant over relevant range
- fixed costs per unit of activity vary inversely w/ changes in volume
- don't ~~change~~ change

2000

\$40000

go outside \$40,000 the new fixed costs might go up or down or stay same

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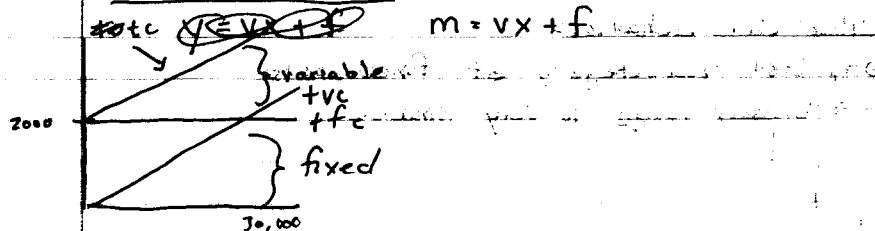
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Mixed Costs

- total mixed costs increase as volume increases
- total mixed costs can be expressed as a combination of the variable and fixed cost equations
- total mixed cost = total variable cost + total fixed cost



Cost Equation

- mathematical equation for a straight line product total cost
- Total Cost = total variable cost + total fixed costs

$$y = mx + b$$

Cost Graphs

- X-axis shows volume
- Y-axis shows total costs

Costs and Decisions

- Committed Fixed Costs: ~~are~~ in the short term we can't avoid these fixed costs
- Discretionary Fixed Costs: are avoidable, even in the short term, advertise for hotel, just b/c you built hotel doesn't mean you have to advertise for it.
 - ~~Are~~ Avoidable and under management control

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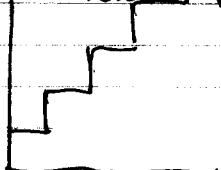
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• Relevant Range

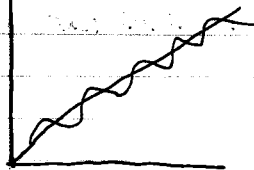
- band of volume where total fixed costs remain constant at certain level
- variable costs per unit remain constant at a certain level

• Other Cost Behavior

Step Cost - subcategory of fixed costs
↳ relevant range is very small



Curvilinear Costs



Ex

- fixed cost/garment would change depending on # of garments
- variable cost/garment same regardless of # of garments
- total predicted costs = avg of fixed and variable x volume

Actual Costs 8,500
Total Predicted (4,300)
(2.15×200)
underestimated 4,200

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E6-24A

Total Cost - Total Fixed Costs = Total Variable Costs

$\frac{\text{Total Variable Costs}}{\text{number of units}}$ = variable cost per unit

$$y = mx + b$$

↑ variable cost per unit ↑ total fixed costs

Cost Behavior Analysis

- 3 Methods to analyze cost behavior:

- ① Scatter Plots
- ② High Low Method
- ③ Regression Analysis

Account Analysis

- use of judgement to classify each general ledger account as variable, fixed, or mixed

- subjective

Scatter Plots

- use historical data to determine a cost's behavior
- graph of historical data on the y-axis and volume data on the x-axis
- helps determine how strong the relationship is between cost and the volume of the chosen activity base
- where slope intercepts y-axis is fixed cost

High Low Method

- Step 1: find variable cost per unit (slope) of cost line
- Step 2: find fixed costs (vertical intercept)
- Step 3: create cost equation

- Disadvantage: only uses 2 data points

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• Step 1

- change in cost ($y_2 - y_1$) / change in volume ($x_2 - x_1$)

• Step 2:

- Fixed Cost = Total Mixed Cost - Total Variable Cost

$y = m(x) + b$
Variable
high vol. price

• Step 3:

- create and use an equation to show the behavior of a mixed cost

$$y = mx + b$$

↑ slope ↑ fixed cost

$$x = 0.25 \quad b = 2,000$$

predicted cost → Predicted operating cost at 15,000 miles
 $y = 0.25(15,000) + 2,000$

• Regression Analysis

- Statistical procedure to find line of best fit data (cost equation)

- Uses all data points

- R-square, intercept, X variable 1

• R-square Value

• 0-1 shows how strong relationship is

• "Goodness of fit"

• Predicting Costs and Data Concerns

- Data Concerns

① Only valid w/ relevant range

② Seasonal Variations

③ Inflation

④ Outliers - abnormal data points

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• Traditional Income Statement

Sales
(Cost of Goods Sold)
Gross Margin
(Selling, General & Administrative Costs)
Operating Income

• Contribution Margin Income Statement

Sales
(Variable Costs)
Contribution Margin
(Fixed Costs)
Operating Income

• Variable Costing

- assigns only variable manufacturing costs to products (DM, DL, Variable MOH), inventoriable product costs.
- fixed ~~MOH~~ MOH = period cost, ~~not~~
- for internal management decisions.

• Absorption Costing

- required by GAAP for external reporting.
- all MOH costs to products (inventoriable product cost).
- traditional income statement.

• Absorption Costing and Manager Incentives

- inventories ↑, absorption costing income is higher than variable costing income.
- inventories ↓, absorption cost income is lower than variable costing income.

~~managers~~ Therefore managers may ↑ production to build up inventory to maximize income and ~~earn~~ therefore their own bonus

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Ch 7: Cost-Volume-Profit Analysis

★ LO 1: Calculate unit contribution margin and contribution margin ratio

• Cost-Volume-Profit (CVP) Analysis

- helps managers make important business decisions
- relationship among costs, volume, and profit or loss
- determines how much the company must sell each month just to cover costs or break even
- helps managers decide how sales volume would need to change to achieve the same profit level

• Components of CVP Analysis

• Relies on interdependency of 5 components or pieces of information

① Sales price per unit -

② Volume Sold

③ Variable Costs per Unit

④ Fixed Costs

⑤ Operating Income

- have 4 of 5, you can figure out the 5th

• CVP Assumptions

① Only changes in volume affect costs

② Managers can classify costs as variable or fixed

- costs are linear throughout relevant range

③ Revenues are linear throughout relevant range

④ Inventory levels will not change

⑤ Sales mix of products will not change

• CVP Example: Kay's Poster

• posters \$25, price - they're sold out

• variable cost \$21

• Fixed Costs = \$7000

• Selling 550 posters

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Contribution Margin Income Statement

- Sales Revenue (550 x 35)	\$ 19,250
- Less: Variable Exp (550 x 21)	(11,500)
- Contribution Margin	7,700
- Less: Fixed Expenses	(7,000)
- Operating Income	<u>\$ 700</u>

Unit Contribution Margin

- Sales Price Per Unit	\$ 35	
- Variable Costs per Unit	(21)	7000/14 = 5000
- Contribution Margin Per Unit	<u>\$ 14</u>	needs to sell 500 posters to break even

Assume sales are 650 posters

- Contribution Margin (650 x 14)	\$ 9,100
- Fixed Cost	(7,000)
- Operating Income	<u>\$ 2,100</u>

Contribution Margin Ratios

- % of each sales dollar that is available for covering fixed expenses and generating a profit.

- CMR = $\frac{\text{unit contribution margin}}{\text{sales price per unit}} = \frac{14}{35} = 40\%$

- CHR = $\frac{\text{contribution margin}}{\text{sales revenue}} = \frac{\$ 2,100}{\$ 19,250} = 40\%$

same answer



LO #2:

CVP Analysis to Find Breakeven Points and Target Profit Volumes.

Breakeven Point

- sales level at which operating income at 0
- * sales above breakeven, profit
- * sales below breakeven, loss
- Fixed Expenses = total contribution margin
- Total Sales = total expenses

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Calculating Break-even Point

- ① Income Statement
- ② Shortcut approach using unit cont. margin
- ③ Shortcut using cont. margin ratio

Income Statement

Sales	35x	14x = 7000 = 0
- Variable Exp	- 21x	14x = 7000
Cont. Marg.	14x	x = 500
- Fixed Expenses	- 7000	
<u>Operating Income</u>	<u>0</u>	

↑
units sold from posters earlier slide

Shortcut Calculating Break-even Unit Cont. Marg

$$\text{Units Sold} = \frac{\text{Fixed Expenses} + \text{Operating Income}}{\text{Contribution Margin Per Unit}}$$

$$\text{Units Sold} = \frac{7000 + 0}{14} = \boxed{500}$$

Shortcut Unit Contribution Margin Ratio

$$\text{Sales in \$} = \frac{\text{Fixed Expenses} + \text{Op. Inc.}}{\text{Cont. Marg. Rat.}}$$

$$= \frac{\$7,000 + 0}{0.40} = \boxed{\$17,500}$$

Finding Volume Needed for Target Profit

$$\text{Units Sold} = \frac{\text{Fixed Exp.} + \text{Op. Inc.}}{\text{Cont. Marg. Unit}}$$

$$\frac{\$7,000 + 4,900}{14} = \frac{\$11,900}{14} = 850$$

850 posters

$$850 \text{ posters} \times \$35 = \$29,750$$

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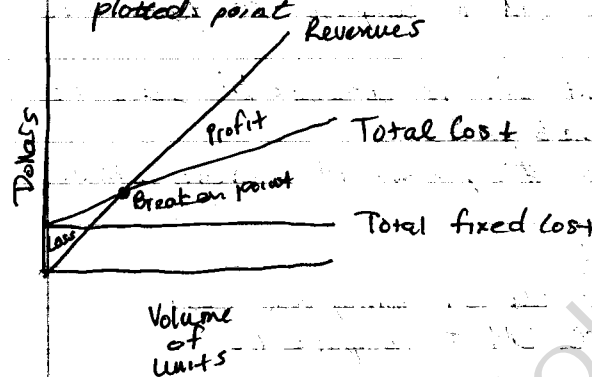
Finding Volume Needed for a Target Profit using Ratio

$$\begin{aligned} \text{Sales Revenue} &= \text{Fixed Exp} + \text{Target Op. Inc.} \\ &\quad \text{Cont. Marg. Ratio} \\ &= \frac{\$7,000 + \$4,900}{0.40} = \frac{\$11,900}{0.40} \\ &= \boxed{\$29,750} \end{aligned}$$

Graphing CVP Relationships

Step 1:

- choose a sales ~~volume~~ volume (units + revenue)
- plot point for total sales revenue
- draw the sales revenue line from origin through the plotted point



~~Break even~~ Break even point: can be units or \$

LO #3

Perform Sensitivity Analysis in Response to Changing Business ~~Conditions~~ Conditions

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Sensitivity Analysis

Managers need to be prepared for increasing costs, pricing pressure from competitors, and other changing business conditions

Sensitivity Analysis

Conducts "what if" analysis

① What if sales price changes?

② " " costs change?

③ " " sales mix " ?

Sales Price Changes ?

- calculate new CM using new sales price
- using New Unit CM to compute BE ~~per~~ sales in units
- Use New Unit CM to compute BE sales to maintain target profit
- Using new BE #'s, decide if change should be made

Costs Change?

- calculate new ~~to~~ CM using new cost
- using new ~~to~~ CM to compute BE

Fixed Costs Change?

- Changes in FC don't affect CM !!!
- BE changes b/c FC change
- Use new unit CM to compute BE sales to maintain target profit

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• LO #4

Find BE and target profit volumes for multiproduct companies

• BE in Sales Rev: Multiproduct Firms

- Total Expected CM

Reg Posters (500 x \$14)	\$7,000
Large " " (300 x 30)	\$9,000
Total Exp. CM	\$16,000

- Divided by Exp. Sales Rev

Reg Posters (500 x \$35)	\$17,500
Large Posters (300 x 70)	21,000
Tot Exp. Sales	\$38,500

CMR = 41.558%

• BE in Sales Rev: Multiproduct Firm

$$\text{Units Sold} = \frac{\text{FE} \times \text{Op. Inv.}}{\text{CMR}} = \frac{\$7,000 + 0}{0.41588} = \$16,814$$

• Information Technology and Sensitivity Analysis

- Allows managers to perform a wide array of sensitivity analysis before committing to decisions

- uses excel spreadsheets to perform analysis

• LO #5

• Determine a Firm's Margin of Safety and Operating leverage

• Common Indicators of Risk

- Margin of Safety:

* excess of expected sales over breakeven sales

- Operating Leverage

* Relative amount of fixed and variable costs that make up a company's total cost

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Margin of Safety

- excess of expected sales over breakeven sales
- drop in sales that the company can absorb before incurring a loss
- used to evaluate the risk of current operations as well as the risk of new plans

$$\text{MOS in units} = \text{Exp Sales in Units} - \text{BE Sales in units}$$

$$450 \text{ units} = 950 - 500$$

$$\text{MOS \$} = \text{Exp Sales \$} - \text{BE Sales \$}$$

$$15,750 = 33,250 - 17,500$$

$$\text{MOS \%} = \frac{\text{MOS in Units}}{\text{Exp. Sales Units}} = \frac{450}{950} = 47.4\%$$

$$\text{MOS \%} = \frac{\text{MOS \$}}{\text{Exp. Sales \$}} = \frac{15,750}{33,250} = 47.4\%$$

Operating Leverage Factor

- How responsive a company's OI is to changes in volume
- * lowest possible value for this factor is 1, if the company has no fixed costs

$$\text{OLF} = \frac{\text{CM}}{\text{OI}}$$

$$= \frac{13,360}{6,300} = 2.11$$

High Operating Leverage

- High OL companies have:
 - * higher level of fixed costs and lower levels of variable cost
 - * higher CM ratios
- For High OL companies, changes in volume significantly affect OI, so they face higher risks and higher potential for reward

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- ex| golf courses, hotels, rental car agencies, theme parks, airlines, cruise lines
- Low Operating Leverage
 - have: higher level of variable costs and lower levels of fixed costs, and lower contribution margin ratios
 - changes in volume do NOT have as significant an effect on OI, so they face lower risks and lower potential for reward
 - ex| merchandising companies

CH 8 SHORT TERM BUSINESS DECISIONS

LO # 1

- Describe and identify information relevant to short-term business decisions

How Managers Make Decisions

- define business goals
- identify alternative courses of action
- Gather and analyze relevant information
- Choose best alternative
- Implement Decision
- Follow-Up: compare actual with anticipated results

Relevant and Irrelevant Information

- Relevant

- * expected future (cost and revenue) data
- * differs among alternative courses of action
- * both qualitative and quantitative

- Irrelevant

- * Costs that ~~are~~ do not differ between alternatives
- * Sunk costs

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Relevant Nonfinancial Information

- Nonfinancial, or qualitative factors, also play a role in manager's ~~the~~ decisions

* laying off employees

* outsourcing, reduced control over delivery time and product quality

* discounted prices to select customers

- managers who ignore qualitative factors can make serious mistakes

6 Short-Term Special Decisions

① ~~Special~~ Special Sales Orders

② Pricing

③ Dropping products, departments, and territories

④ Product Mix

⑤ Outsourcing (make or buy)

⑥ Selling as is or processing further

Keys to Making Short-Term Special Decisions

- Decision Approach

* Relevant Information approach or Incremental Analysis Approach

- Two Keys in analyzing short-term special business decisions

* focus on relevant revenues, costs, and profits

* use CM approach that separates variable costs from fixed costs

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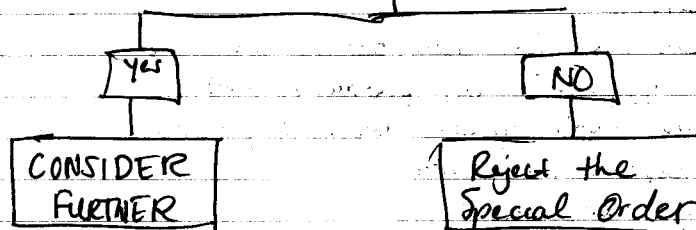
LO #2 Make Special Order Decisions

Special Order Considerations

- A customer requests a special one-time order at a reduced price, often for a large quantity.

Decision Rule:

Do we have excess Capacity Available to fill this order?



Fixed Cost is not relevant in ~~special~~ special decisions

LO #3 Making Pricing ~~Price~~ Decisions.

Considerations

- Target Profit?
- How much will customers pay?
- Are we a price-taker or a price-setter for this product?

Price-Taker vs. Price Setter

~~Price-taker~~ automobiles

Price-Taker	Price-Setter
Product Lacks Uniqueness	Product is Unique
Heavy Competition	Less Competition
Price Approach	Price Approach
Emphasizes Target Costing	Emphasizes Cost-Plus pricing
Hyundai vs Toyota Honda	Lamborghini

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Advantage

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Target Costing

$\text{Market Price} - \text{Desired Profit} = \text{Target Cost}$

- Target Cost Includes

* Development Cost

* Design "

* Production

* Marketing

* Service

- actual cost less than target total cost

* okay, proceed w/ product cost

- actual cost greater than target total cost

* accept a lower profit

* cut fixed costs

* cut variable costs

* Use other strategies

• increase sales volume

• change or adding to its product mix

• differentiate its products

Other Strategies

- Increase Sales

- Change or add to its product mix

- differentiate its products (make it more unique)

Cost-Plus Pricing

- Opposite of Target-Pricing Approach

- Starts w/ company's full cost

- adds desired profit to determine a cost-plus price

Total Cost

+ Desired Profit

Cost Plus Price

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Calculating Cost Plus

Current VC
+ Current FC
~~Desired~~ Current TC
+ Desired Profit
Target Revenue
÷ # of units
Cost-Plus Price per unit 3.20
Current price ~~3.00~~ \$3.00, you can charge \$3.20

Price-taker - target costing approach
Price Setter - cost plus pricing

LO #4 Make dropping a product, department, or territory decisions

• Other Short-Term Business Decisions

- When to drop a product, department, or territory

- when to outsource
- which products to emphasize
- when to sell as is or process further

• Consideration for Dropping Product

- will dropping affect sales of company's other products?

Product A and B are complements

- What can be done w/ freed capacity

• If lost revenues from dropping a product, department, or territory exceed cost savings from dropping

DO NOT DROP PRODUCT

• If total cost savings > lost revenues from dropping

DROP

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LO #5 Make Product Mix Decisions

Product Mix

- Which Product to Emphasize?
 - Products with highest CM per unit of constraint \leftarrow machine hours

LO #6

Make Outsourcing (Make or Buy Decisions)

- to buy a product or service or produce it in house
- the heart of the decisions: how best to use available resources

Should the Company Outsource

- If incremental costs of making exceed incremental costs of outsourcing \Rightarrow Outsource
- Inc. Costs of making $<$ inc costs of outsourcing \Rightarrow DON'T OUTSOURCE

LO #7 Make sell as is or process further decision

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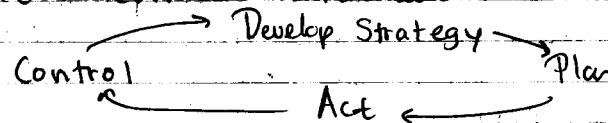
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Exam 3

CH 9: MASTER BUDGET AND RESPONSIBILITY ACCOUNTING LO #1 Describe how and why Managers Use Budgets

• Budgeting

- A plan for a specific period of time;
- helps management determine how to use resources.
- used to estimate future costs and revenues.



• Rolling (or continuous) Budget

- continually ~~budgets~~ updated budget so that next 12 months of operations are always budgeted

• Participative Budgeting

- involves many levels of management
- benefits
- disadvantages

• Starting Point for Developing Budgets

- Prior years budgeted figures or actual ~~budget~~ result

or

- Zero-Based Budgeting

• Benefits of Budgeting

- forces managers to plan
- promotes coordination and communication
- provides a benchmark

• Master Budget

- comprehensive planning document for the ^{entire} organization
- consists of all supporting budgets

• Operating Budget

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~~Operating Budget~~
Sales Budget

Sales Budget

- plan for sales revenues in future periods
- # of units sold x sales price per unit = total sales Revenue

Production Budget

purchase

- + Units Needed For Sales (Costs of Goods Sold)
- + Desired Ending Inventory -
- = Total Units ~~Produced~~ Needed

COGS

- Units in Beginning Inventory -
- = Units to Produce E.G.I

Accounts Receivable (Current Asset)

Beg Sales	Cash Receipt
END	

Beg + Sales - CR ⇒ End

Inventory (Current Asset)

Beg Purchases	COGS
END	

Beg + Purchases - COGS = END

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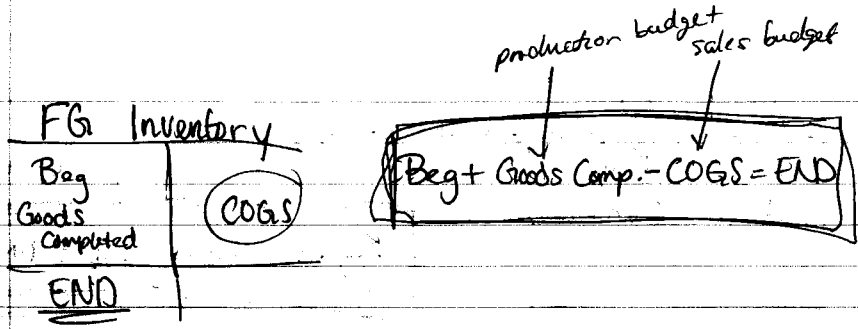
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Financial Budget Component

- Capital Expenditures Budget
- Cash Collections Budget
- Cash payments Budget
- Combined Cash Budget
- Budgeted Balance Sheet

What if? asks what a result

CH 10 Flexible Budgets

AND

STANDARD COSTS

LO #1 Prepare a flexible budget for planning purposes

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- Budgets

- Static Budget: prepared for one level of sales volume
- Flexible Budget: prepared for different levels of budgets
- Variance: difference between actual results and the budget

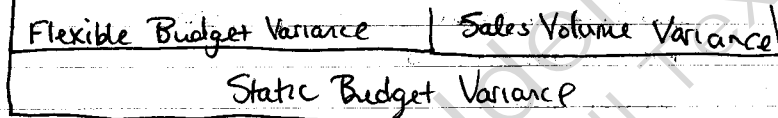
- Flexible Budget

- summarized budgets prepared for different levels of volume
- flexible budgets can help managers answer questions

- ~~Flexible Budget for Evaluating Performance~~

~~LO/ # Pa~~
~~used sales~~

	Flexible Budget	Static budget
Actual Results	based on actual # of outputs	based on expect # of outputs



Sales Volume Variance

static budget (for # of units expected to be sold) — flexible budgets (for # of units sold)

Flexible Budget Variance

Flexible Budget (# of units sold) — Actual Results

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- Interpreting the Variance

- Favorable variances increase operating income
 - * Higher Sales
 - * Lower Expenses
- Unfavorable variances decreasing operating income
 - * lower sales
 - * higher expenses

LO #3

Identify the benefits of standard costs and learn how to set standards.

Standard Costs

- Budget for a single unit
- Quantity Standard
- Price Standard

Quantity Standard Components

- Direct materials
- Direct Labor
- Manufacturing Overhead

Price Standard Components

- Direct Materials $\$$: purchase price (after early pay discount) + freight in + receiving costs
- Direct Labor: basic pay rates + payroll taxes + fringe benefits

Man Overhead

- determine standard MOH rates
 - FOH
 - VOH

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$$\text{Standard total OH rate} = \text{standard variable OH rate} + \text{Standard fixed OH rate}$$

$$\text{Standard MOH rate (fixed or variable)} = \frac{\text{estimated total OH cost}}{\text{estimated total allocation base}}$$

- Each variance has
- unfavorable-debit
 - favorable-credit

CH 11 PERFORMANCE EVALUATION AND THE BALANCED SCOREBOARD

LO #1 Why and How Companies Decentralize

Responsibility Center	Manager Responsible for	Ex
Cost center	controlling costs	production line at Dell Comp
Revenue Center	Generating Sales Revenue	Midwest sales @ pace foods
Profit Center	producing profit through generating sales and controlling costs	product line @ Anheuser Busch
Investment Center	producing profit and managing the decisions invested capital	company divisions such as Walt Disney World Resorts

① RC ② RC ③ IC ④ CC ⑤ IC ⑥ CC

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QPC

LO #2

Explain why companies use performance evaluation systems

Goals of Performance Evaluations Systems

- Promoting goal congruence and coordination
- communicating expectations
- motivating unit managers
- providing feedback
- benchmarking

Limitations of Financial Performance Measures

- Management needs both:
 - * lag indicators
 - * lead indicators
- Tendency to focus on short-term achievements

LO #3 Describe the balanced scorecard and identify key performance indicators for each perspective

Balanced Scorecard

- measure companies activities in terms of its visions and strategies
- financial and operational performance measures are considered
- link company goals to key performance indicators

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Company Goals

Critical Factors

(customer satisfaction, operation efficiency, employee excellence, financial profitability)

Key Performance Indicators (KPI's)

(market share, yield rate, employee training hours, revenue growth)

Four Perspectives - comprise the balanced scorecard

- Financial Perspective: How do we look ~~we~~ to shareholders?
- Customer Perspective: How do Customers see us?
- Internal Business Perspective: At what business processes must we excel to satisfy customer and financial objective (deliver)
- Learning and Growth Perspective: Can we continue to improve and create value

LO #4

Use performance reports to evaluate cost, revenue, and profit centers

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Performance Reports

- Report financial performance of responsibility centers
 - cost center: focus on flexible budget variance
 - revenue center: focus on flexible budget ~~center~~ variance and sales volume variance
 - profit center: focus on flexible budget variance
- includes allocated charges from service departments

LO #5

Use ROI, RI, and EVA to evaluate investment centers

- Investment Centers
- Financial Evaluation must measure

- income generated
- effective use of current assets

- Performance Measures

- Return on Investment (ROI)
- Residual Income (RI)
- Economic Value Added (EVA)

- Return on Investment (ROI)

$\frac{\text{Operating Income}}{\text{Total Assets}}$

or

$\frac{\text{Operating Income}}{\text{Sales}} \times \frac{\text{Sales}}{\text{Total Assets}}$

Sales Margin

Capital Turnover

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ROI Cont'd

- Advantages:

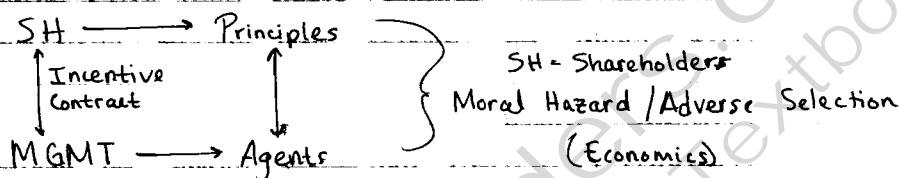
- expanded equation provides additional information
- can be used to compare across divisions w/ other companies
- useful for resource allocation

- ~~Disadvantages~~

- Drawback

- provides an incentive to select projects that are expected to increase ROI

$$\text{ROI} = \frac{\text{Operating Income}}{\text{Total Assets}}$$



Company → ROI: 20%

Your Division → ROI: 30%

New Product Line → ROI: 25%

Moral Hazard: maximizes your wealth

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Example: ~~Residential~~ ~~Profit~~ company's division

	Professional	Residential
(Profit) ROI	44%	31%
(Profit) Sales Margin	16%	10%
(Asset) Capital Turnover	2.75	3.1

60% greater (huge difference) most likely reason why ROI is higher

more efficient

- b/c of profitability differential the more efficient Residential division can't catch up with the Professional division's ROI
- Expanded ROI formula shows why one division's ROI might be greater than another division's

Residual Income

- Compare division's operating income w/ minimum operating income expected, given the size of the division's assets. Complete Solution to moral hazard problem in ROI
- Positive: income exceeds target rate of return
- Negative: income doesn't meet target rate of return

$$RI = OI - \text{Minimum Acceptable Income}$$

$$RI = OI - (\text{Target Rate of Return} \times \text{Total Assets})$$

Economic Value Added

- looks at a division's ~~RI~~ RI through the eyes of the company's primary stakeholders: investors and long term competitors
- $$EVA = \text{After tax operating income} - [(\text{Total Assets} - CL) \times WACC]$$

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RI vs EVA

- Both calculate whether the division created any income above and beyond expectations

Differences

- EVA uses after tax OI
- TA is reduced by CL
- WACC replace's mgmt's TR of Return

p652

Example	Professional	Residential
RI	\$71,250	\$12,250
EVA	\$81,750	\$24,200

ROI was 44% Prof and 31% for Res, that and the higher OI of Prof is why their RI is greater than Res.

Limitations of Financial Performance Measures

- Measurement Issues
 - TA ~~at~~ BOY or EOY
 - All assets or excludable nonproductive assets
 - use gross book value vs. net book value
- Short-term focus
 - time frame of one year or less

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CH 12 CAPITAL INVESTMENT DECISIONS AND THE TIME OF MONEY

LO #1

Describe the importance of capital investments and the capital budgeting process

Capital Budgeting

- Acquisition of assets used for a long period of time and which require large sums of money

4 Popular Methods of Capital Budgeting Analysis

Method	Advantage/Disadvantage
Payback Period	quick & easy to calculate,
Accounting Rate of Return (ARR)	used for shorter life span investments
Net Present Value (NPV)	more difficult to calculate, used
Internal Rate of Return (IRR)	for longer life span investments considers time of money

Cash Basis vs Accrual Basis

- Cash vs Accrual Basis
 - accrual basis required by GAAP
 - capital budgeting focuses on cash flow
 - only ARR method uses accrual based accounting income

Cash Flows

- Cash Flows
 - future cash revenue
 - any future savings in ongoing cash operating costs
 - any future residual value of the asset

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Capital Budgeting Process

- Identify potential investments
- project the net cash inflows
- analyze the investments
- choose among alternatives capital investments
- Capital rationing
- post-audit - ~~evaluation~~

LO #2

Use the payback and accounting rate of return methods to make capital investment decisions.

LO #3

Using time value of money to compute the present and future values of an annuity of single lump sums and annuities

Time Value of Money Factors

- ~~Invested~~ Principal Amount (p)
 - single lump sum
 - Annuity: equal cash received @ equal time intervals
- Number of periods (n)
- Interest Rate (i)
 - simple interest applied to only principle
 - compound interest applied to accumulated interest and principle
- Annuities: could be at the beginning or end of period
only dealing with ordinary annuities assuming the payment is due at the end

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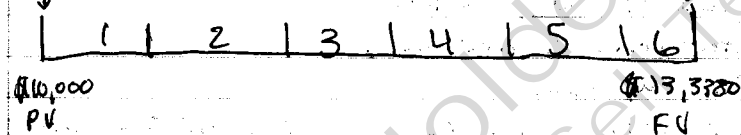
Simple interest

Year	int. calc.	S.I.
1	$\$10,000 \times 6\%$	600
2	↓	600
3		600
4		600
5		600

Compounded Interest

Year	int. calc.	present value	single sum
1	$\$10,000 \times 6\%$	600	600
2	$(\$10,000 + 600) \times 6\%$	636	636
3	$(\$10,000 + 600 + 636) \times 6\%$	675	675
4	↓	↓	↓
5			

Present Value + Interest Earned = Future Value



Ex

- f.v. of annuity ① Save \$3,000 a year starting now for 30 yrs or
 f.v. of annuity ② Wait until your 40 to start saving
 and then save \$7,500 per year for 12
 years
 - 10% interest

Which to choose?

- ① invest \$90,000 over 30 yrs
 ② invest \$90,000 over 12 yrs

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~~How much~~

$$\textcircled{1} FV = \text{Payment} \times (\text{Annuity FV factor } 10\% \times 30\text{yrs})$$

$$= 3000 \times 164.94$$

$$= \$493,482$$

$$\textcircled{2} = 7,500 \times (\text{Annuity FV factor } i=10\%, 12\text{yrs})$$

$$= 7,500 \times 21.384$$

$$= \$160,380$$

$$\frac{1,000,000}{165} = ? \times \frac{165}{165} \quad \begin{matrix} 30\text{yrs} & 10\% \\ & 165 \end{matrix}$$

$$\frac{1,000,000}{165} = x$$

Say you need 10 more years of work
Future value of \$1 = $PV \times \text{table factor}$

$$\textcircled{1} \quad \$493,482 \times 2.594$$

$$= \$1,280,092$$

$$\textcircled{2} \quad \$160,380 \times 2.594$$

$$= \$416,026$$

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