Glossary

Absorption costing A method whereby a product's inventoriable cost includes direct manufacturing costs, such as materials and direct labor, as well as indirect manufacturing costs such as machine depreciation and factory. Generally Accepted Accounting Principles (GAAP) requires absorption costing.

Account classification method A cost estimation technique that involves systematically classifying a company's list of cost accounts into fixed and variable categories.

Accounting rate of return (ARR) The average annual income from a project divided by the average annual investment in the project.

Activity The basic element of any business process.

Activity-based Costing (ABC) An allocation methodology used to estimate the controllable cost of capacity resources.

Activity-based management (ABM) Using information from ABC systems to improve profitability by managing products, customers, and resources.

Allocation basis Same as "cost driver."

Allocation rate The cost pool divided by the allocation volume.

Allocation rate Equals the costs in the cost pool divided by the allocation (denominator) volume.

Allocation volume The sum of the cost driver amounts across all cost objects.

Allowable cost The cost target we must meet to achieve profit targets.

Annuity A stream of cash flow with the property that the cash flows per period.

Applied overhead The amount of overhead allocated to products using a predetermined overhead rate.

Avoidable fixed costs Costs that need not be incurred if an option is not chosen. Same as controllable fixed costs.

Balanced scorecard (BSC) A tool for systematically choosing performance measures linked with the firm's overall strategy.

Batch-level activities Activities that pertain to a group of units.

Batch-level cost A cost that varies in proportion to the number of batches of units made (used synonymously with step cost).

Benchmarking Systematic evaluation of various activities and business processes relative to the best practices.

Bottom-up budgeting A process by which lower-level employees actively participate in setting budgets.

Breakeven revenues The sales volume in revenues at which profit equals zero.

Breakeven volume The sales volume in units at which profit equals zero.

Budget A plan for using limited resources.

Budget reconciliation report A report that uses variances to reconcile the difference between master budget profit and actual profit.

Burden Term frequently used to refer to "allocation rate."

Business process Converts a set of organizational inputs into a measurable output.

Capacity The maximum volume of activity that a company can sustain with available resources.

Capacity costs The sum of variable and fixed overhead costs.

Capital budgeting The collective term for the mechanisms and tools used to evaluate expenditures on long-lived resources.

Cash budget A budget that focuses on the inflow and outflow of cash.

Centralized decision making An organizational setting where a few top managers make all the decisions.

Chief executive officer (CEO) The highest ranking executive in an organization. The CEO is responsible for carrying out the policies of the board of directors on a day-to-day basis.

Chief financial officer (CFO) The person in an organization who oversees all accounting and finance functions.

Chief internal auditor (CIA) The person in an organization who oversees the internal audit function.

Contribution margin Revenues less variable costs.

Contribution margin ratio The unit contribution margin divided by the unit price. The contribution margin ratio represents the portion of each sales dollar that, after covering variable costs, goes toward covering fixed costs and, ultimately, profit.

Contribution margin statement An income statement that groups costs by their variability, reporting variable costs and fixed costs as separate line items.

Control account A temporary holding account for accumulating costs such as direct labor and overhead. We zero out a control account at the end of an accounting period.

Control decisions Decisions related to motivating, monitoring, and evaluating performance.

Controllable cost, controllable benefit A cost or benefit that a decision maker chooses to incur, relative to doing nothing.

Controllable performance measure A performance measure that reflects only the consequences of the actions taken by the decision maker.

Controller The person in an organization who manages the day-to-day accounting and issues guidance concerning corporate accounting policies.

Conversion costs The sum of direct labor and manufacturing overhead costs.

Core competency Skill set and expertise that characterize a firm and its employees.

Cost accounting Accounting systems for calculating the values of ending inventories and the cost of goods sold.

Cost allocation A procedure that distributes a common cost among the items giving rise to the cost.

Cost center Organizational unit that has control over and is accountable for costs incurred in offering products or services.

Cost driver Attributes that we can measure for each cost object that are used to distribute the cost pool among cost objects.

Cost gap The difference between the current cost and the allowable cost.

Cost hierarchy The classification of costs into unit-, batch-, product-, and facility-level.

Cost leadership A strategy of competing on the basis of cost advantages.

Cost objects The items, or entities, to which costs are to be allocated.

Cost of capital The opportunity cost of money in the form of returns from alternate investments.

Cost of goods manufactured (COGM) The cost of items finished and transferred from work in process inventory to finished goods inventory.

Cost of goods sold (COGS) The cost of products sold in a period. The cost of items transferred from finished goods inventory to the income statement.

Cost pool The total costs to be allocated.

Cost structure The proportion of total costs that are fixed and variable.

Critical success factors (CSF) Things that must "go right" for the organization to be successful.

Cross-subsidization Some cost allocation systems allocate systematically lower amounts to some products and higher amounts to allocate other products. In such instances, products receiving higher allocations are said to cross-subsidize products receiving lower allocations.

Current cost The cost of new product as per current configurations and production technologies.

Customer perspective One of the four perspectives in the balanced scorecard. This perspective ensures that the organization considers the customer's viewpoint.

Customer planning The set of decisions to assess the profitability of individual customers and customer segments, including the actions taken to improve their profitability.

Decentralization The practice of delegating authority to lower-level managers.

Decentralized decision making An organizational setting where decision-making authority is dispersed throughout the firm.

Decision Choosing an option from a set of options to achieve a goal.

Decision framework A four-step process that consists of specifying the decision goals, identifying available options, evaluating these options, and then selecting the option that best meets the decision maker's goals.

Denominator volume Same as "allocation volume."

Departmental rates The use of many rates, usually one per department, for allocating capacity (overhead) costs to products.

Direct cost, direct benefit A cost or benefit that is uniquely related to a decision option.

Direct costing Term frequently used to refer to "variable costing."

Direct labor Labor costs than can be traced to individual units of a product in a cost-effective manner.

Direct materials Materials costs than can be traced economically to individual units of a product.

Direct method An allocation procedure that ignores the relationship among support activities and focuses instead on the relationship between support and line activities.

Discount factor The amount by which a future cash flow is multiplied to obtain its present value.

Discount rate The rate of return employed to compute the present value of future cash flows.

Discounting The practice of expressing a future cash flow in terms of its present value.

Discretionary cost center A cost center for which there is no clear relation between inputs and outputs.

Dual-rate allocations A procedure that employs two separate drivers to allocate fixed and variable costs in a cost pool.

DuPont model A method for decomposing ROI into two component parts: profit margin and asset turnover.

Economic value added (EVA) A performance measure similar to residual income. The difference is that EVA has specific guidelines on how to compute income, investment, and the weighted average cost of capital.

Engineered cost centers Cost centers for which there is a clear relation between inputs and outputs.

Excess capacity/Excess supply A condition that obtains when available capacity exceeds realized demand.

Excess demand A condition that obtains when realized demand exceeds available capacity.

Facility-level activities Activities that are required to sustain the business.

Facility-level cost Cost that does not vary at the unit-, batch-, or product-level. Cost required to sustain the organization.

Favorable variance A difference between an actual result and a budgeted amount that leads to an *increase* in profit.

Financial accounting Accounting information system that aims to meet the needs of decision makers outside the organization.

Financial budgets Budgets quantifying the outcomes of operating budgets in summary financial statements.

Financial measures Metrics that rely on data recorded in a firm's accounting system.

Financial perspective One of the four perspectives in the balanced scorecard. This perspective ensures that the organization meets its ultimate goals.

Fixed cost A cost that does not change as the volume of activity changes.

Fixed manufacturing overhead Indirect manufacturing costs that do not vary with production volume.

Fixed overhead Indirect manufacturing costs that do not vary with production volume.

Flexible budget A budget made for the actual level of sales, retaining all other plan assumptions in the master budget.

Flexible budget variance The difference between actual profit and flexible budget profit.

Full costing Term frequently used to refer to "absorption costing."

Goals Objectives that decision makers try to achieve.

Gross margin Revenues less product costs.

High-low method A cost estimation technique that uses two observations pertaining to the highest and lowest activity levels to estimate fixed and variable costs.

Hurdle rate Minimum required rate of return chosen by management. Often exceeds the cost of capital.

Incremental (differential) approach An approach for framing and solving decisions that involves expressing the benefits and costs of the various decision options *relative* to one of the options.

Indirect cost, indirect benefit A cost or benefit that is not unique to a decision option—only a portion relates to a decision option.

Informativeness principle The notion that any metric that provides information about a manager's effort or skill could be a useful performance measure.

Initial outlay All costs connected with purchasing an asset and getting it ready for its intended use.

Innovation and learning perspective One of the four perspectives in the balanced scorecard. This perspective ensures that the organization does not stagnate and has mechanisms that allow it to grow and stay competitive.

Input price variance Profit effect associated with the difference between the budgeted and actual price of an input.

Input quantity variance Profit effect associated with the difference between the budgeted and actual input quantity used.

Internal business perspective One of the four perspectives in the balanced scorecard. This perspective ensures that the organization's processes are aligned with its customer and financial goals.

Internal rate of return (IRR) The discount rate at which a project's net present value is zero.

Inventoriable costs See Product costs.

Investment center Organizational unit that has control over and is accountable for revenues, costs, and long-term investment decisions.

Job shop Setting that involves discrete production of unique products.

Joint cost A cost that is common to two or more products. Costs of a joint process.

Joint product Products that are produced in a joint process. It is not possible to produce one joint product without producing the others as well.

Kaizen Philosophy of continuous improvement.

Labor efficiency variance See Input quantity variance.

Labor rate variance See Input price variance.

Lagging measures Measures that reflect past performance.

Leading measures Measures that capture the drivers of future performance.

Life-cycle analysis A technique that partitions a product's life into discrete stages and thereby guides efforts toward pricing and cost control.

Line activity An activity that is directly related to making and selling the firm's products and services.

Lumpy resource Resources for which it is difficult to match the demand for capacity with the supply.

Managerial accounting Accounting information system that aims to meet the needs of decision makers inside an organization.

Manufacturing firm A firm that uses labor and equipment to transform inputs such as materials and components into outputs.

Manufacturing overhead The sum of all indirect manufacturing costs.

Margin of safety The percentage by which current sales exceed breakeven sales.

Market share variance The profit effect due to differences between the actual and budgeted share of the market for a product.

Market size variance Profit effect due to differences between the actual and budgeted size of the market for a product.

Master budget Comprehensive set of operating and financial budgets.

Master budget The budget as prepared at the start of the accounting period.

Materials efficiency variance See Input quantity variance.

Materials price variance See Input price variance.

Merchandising firm A firm that resells essentially the same product it buys from suppliers.

Mixed cost A cost that contains both fixed and variable components.

Modified payback method/period The length of time it takes to recoup the initial investment using discounted cash flows.

Net present value (NPV) The present value of all of the cash flows associated with a resource.

Nonfinancial measures Measures that employ data not in the firm's accounting system.

Normal costing A product-costing system that uses predetermined overhead rates to apply overhead to products.

Operating budgets Budgets reflecting the collective expression of numerous short-term decisions that conform to the direction set by long-term plans.

Operating leverage The ratio of fixed costs to total costs (total costs = fixed costs plus variable costs).

Operations costing A combination of job costing and process costing.

Opportunity cost The value of the next-best option.

Organization A group of individuals engaged in a collectively beneficial mission.

Organization chart A graphical representation of the hierarchical relations among positions in an organization.

Overapplied overhead The difference between actual overhead and applied overhead. Arises when actual overhead is smaller than applied overhead.

Overhead The costs of capacity resources.

Overhead Same as manufacturing overhead.

Overhead costs Term frequently used to refer to "capacity costs."

Overhead rate Term frequently used to refer to "allocation rate."

Payback method/period The length of time it takes to recoup the initial investment using undiscounted cash flows.

Period costs A financial accounting concept under GAAP. Any cost that is not a product cost. A cost related to the selling of goods and the administration of the organization.

Planning decisions Decisions about acquiring and using resources to deliver products and services to customers.

Plant-wide rate The use of one rate for the entire company when allocating capacity costs (overhead) to products.

Practical capacity A realistic estimate of the maximum possible activity level.

Predetermined overhead rate Overhead rate computed using expected overhead costs and expected activity volumes at the start of a plan period, typically a year.

Present value The value today of a future cash flow.

Prime costs The sum of direct materials and direct labor costs, as these are the primary inputs into the production process.

Process shop Setting that involves continuous production of homogeneous products.

Product costs A financial accounting concept under GAAP. Any cost associated with getting products and services ready for sale.

Product mix The proportion, expressed in units, in which products are expected to be sold.

Product planning The set of decisions about which products to offer and their prices.

Product-/customer-level activities Activities that relate to a specific product or a specific customer.

Product-level cost A cost that varies in proportion to the number of products.

Profit center Organizational unit that has control over and is accountable for both revenues and costs.

Profit margin Contribution margin less allocated capacity costs.

Profit margin Contribution margin less the controllable cost of capacity resources.

Purchase price variance The difference between the budgeted and actual price of materials multiplied by the actual quantity of materials *purchased*.

Real option analysis A collection of mathematical techniques for valuing the flexibility associated with a project.

Reciprocal method An allocation procedure that fully accounts for the relationship among support activities.

Reciprocity in consumption A consumption pattern in which two departments provide services to each other.

Regression analysis A statistical method that uses all available observations to estimate fixed and variable costs.

Relative performance evaluation The practice of measuring a manager's or a division's performance against other managers or divisions.

Relevant cost analysis See Incremental (differential) approach.

Relevant cost, relevant benefit A cost or benefit that differs across decision options.

Relevant range A firm's normal range of operations. Over this range, we expect a stable relation between activity and cost.

Residual income (RI) The income that a division generates over and above the required rate of return on investment.

Resource planning Decisions that pertain to improving the efficiency and effectiveness of organizational processes.

Responsibility accounting Set of concepts pertaining to decision rights and performance evaluation in decentralized organizations.

Responsibility center An organizational subunit.

Responsibility center An organizational subunit with specified decision rights. There are three common forms of responsibility centers: cost centers, profit centers, and investment centers.

Return on investment (ROI) A measure of profit generated per dollar of investment—equals divisional operating income divided by divisional investment.

Sales mix variance Used in multiproduct firms, it captures the effect of changes in the sales mix from the budgeted level.

Sales price variance The difference between actual revenues and flexible budget revenues.

Sales quantity variance Used in multiproduct firms, it captures the effect of an aggregate change in sales quantity, holding the sales mix at the budgeted level.

Sales volume variance The difference in profit between the flexible budget and the master budget.

Salvage value The final one-time costs or benefits associated with disposing of a resource.

Segment (product) margin The contribution margin of a segment (e.g., product, customer, geographical region) less traceable fixed costs.

Self-consumption A support department consuming its own output.

Selling and administration costs Nonmanufacturing costs. A term frequently used to refer to "period costs."

Sequential allocation See Step-down method.

Service firm A firm whose product is neither tangible nor storable.

Shareholder value The long-run expected wealth potential of an organization to its shareholders.

Spending variance The difference between budgeted fixed costs and actual fixed costs.

Split-off point Step in a joint process after which we can identify and process the joint products separately.

Step cost A cost that increases in discrete steps as the volume of activity increases.

Step-down method An allocation procedure that partially accounts for the relationship among support activities.

Strategy Approach for creating and sustaining its value proposition.

Sunk cost A past expenditure that cannot be changed.

Support activity An activity that is not a line activity. These activities help the firm execute the line activity.

Target costing A technique for cost planning during product design and development.

Time value of money Phrase used to denote that a dollar today is worth more than a dollar tomorrow.

Top-down budgeting A process by which top management sets the budgets.

Total manufacturing costs charged to production The sum of materials, labor, and overhead added to the work-in-process account during the period.

Total profit variance The difference between actual profit and master budget profit.

Totals (gross) approach An approach that includes noncontrollable costs and benefits to construct a contribution margin statement for each decision option.

Traceability The degree to which we can directly relate a cost or a revenue to a decision option.

Transfer price A notional price paid for an internal transfer of goods or services.

Treasurer The person in an organization who manages cash flows and serves as the contact point for banks, bondholders, and other creditors.

Two-factor allocation See Dual-rate allocation.

Underapplied overhead The difference between actual overhead and applied overhead. Arises when actual overhead is larger than applied overhead.

Unfavorable variance A difference between an actual result and a budgeted amount that leads to a *decrease* in profit.

Unit contribution margin The contribution margin per unit.

Unit-level activities Activities that are proportional to production volume.

Unit-level cost A cost that increases or decreases in direct proportion to the number of units produced (used synonymously with variable cost).

Value The benefits less the costs of a decision option.

Value chain Set of logically sequenced activities that together execute the chosen business strategy.

Value differentiation A strategy of competing on the basis of providing customer value through innovation and service.

Value proposition The key source of customer value provided by an organization.

Variability The relation between a cost or a benefit and an activity.

Variable cost A cost that is proportional to the volume of activity.

Variable costing A method that separates variable costs from fixed costs. Under this method, the cost of a unit of product in inventory includes only variable manufacturing costs, such as direct materials, direct labor, and variable manufacturing overhead.

Variable overhead Indirect manufacturing costs that vary with production volume.

Variance The difference between an actual result and a budgeted amount.

Variance analysis Technique for determining why actual revenues, costs, and profit differ from their budgeted amounts.

Weighted contribution margin ratio Contribution margin ratio averaged across multiple products, with each product's contribution margin ratio being weighted by its share of revenues (which is a function of both the product mix and prices).

Weighted unit contribution margin Unit contribution margin averaged across multiple products, with each product's unit contribution margin being weighted by the product mix (i.e., its share of total sales in units).

Whale curve A curve that plots customer profitability, after ranking customers in order of their profitability. Has the appearance of a "whale."