

15.514 Summer 2003

Session 19

Managerial Accounting and Financial Reporting

Objectives

1. Understand how internal reporting can affect the incentives of managers
2. Understand how managerial incentives can affect financial reports.

Game Plan & Class Pedagogy

Case discussion

Reading Assignment

CP: Scovill Inc, NuTone Housing Group

Class Preparation Questions

- Can be completed in small groups
- **Problem Set 6** due at the start of class: Hand in answers to questions 1, 2, and 6. You should discuss the remaining questions with your group prior to class discussion.
- Each group member is advised to keep a copy of the group's answers for use during the class discussion.

1. Consider the following events at the NuTone division of Scovill:

In the past year, The NuTone division built 1,000 units of a particular model of paddle fan. The standard (and actual) direct material cost was \$20/unit. The standard cost for a direct labor hour was \$8.00. Standard direct labor hours for this level of production were 1,200; however, actual direct labor hours used were 400. The workers were paid an average hourly rate of \$10 (including incentives) because the average direct labor efficiency rate was 300%. The overhead rate in the plant was 150% of direct labor.

Quarterly sales of this model were 100, 125, 150, and 125 units, respectively, at a constant price of \$60 each, for total annual sales of 500 units. Production volume was steady at 250 units per quarter.

At year-end, a physical inventory count was taken. It revealed 400 units left in inventory; these were determined to have an average cost of \$30 each.

- a. Compute the standard cost/unit that NuTone would use to account for the production and sale of this model over the course of the year.
 - b. Compute revenue, Cost of goods sold, gross profit margin, and ending inventory for each of the first three quarters, using the standard cost you computed above.
 - c. Make the end-of-year adjustment required by the inventory count and valuation assumption. How does this adjustment affect reported income for the 4th quarter and the year?
2. Page 5 of the case describes Incentive Compensation (bonuses) for top management. Suppose the EPS target was \$3.60. How much bonus would a manager receive under each of the following scenarios? (Briefly justify your answers.)
 - a. Actual EPS is \$3.65, and base salary is \$60,000.
 - b. Actual EPS is \$3.00 and base salary is \$80,000.

c. Actual EPS is \$3.51 and base salary is \$100,000.

Comment on the pros and cons of using this type of incentive compensation scheme, i.e., what trade-offs must the Board of Directors evaluate when setting this plan?

3. Summarize and critically evaluate the concerns raised by Bob Hager, Scovill's new treasurer / controller, about NuTone's use of overstated standard costs.
4. Summarize and critically evaluate the justifications given by Jim Rankin, NuTone's executive VP, for continuing the status quo.
5. What, if anything, would you recommend Bob Hager do about the accounting system used in the NuTone division?
6. Suppose you are required to arbitrate the accounting issue between Hager and Rankin and recommend a solution to the Board of Directors. What do you propose NuTone do, if anything? Justify your answer, with sufficient attention paid to countering the key arguments raised by each participant. Your analysis and recommendation should not exceed one page.