

# Management accounting techniques for competitive advantage



Hadika plc

## **A Report: The Use of Management Accounting Techniques for Achievement of Competitive Advantage**

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## **1. Introduction**

The current financial crisis has in the space of one year radically changed the global business environment. Resulting in failures and bankruptcies of international banks and financial institutions, sharp increases in mortgage failures and home repossessions, drastically reduced availability of credit, termination of thousands of job, and increasing unemployment, the crisis is expected to impact the market for cars, Hadika plc's main product, <https://assignbuster.com/management-accounting-techniques-for-competitive-advantage/>

significantly. Demand for cars is already showing signs of reducing, leading to their stockpiling at factories, dealers, and ports. Whilst sales of cheaper cars, which form Hadika's major product range, have not until now experienced worrying drops, future prospects remain uncertain and the market is expected to become far more competitive.

Company managements, especially those of smaller firms, need to become more conscious of costs and efficiencies, and aware of management accounting techniques, in order to improve their operational efficiencies, product costs and internal reporting.

This management report focuses first on (a) the need for operational managers to understand and use management accounting techniques, (b) the similarities and differences between financial and management accounting principles and methods, (c) the roles played by management accountants, (d) the most suitable classification of costs for the company and (e) the application of management accounting techniques in pricing decisions, and thereafter takes up the appropriateness and use of management accounting techniques to maintain and increase the company's market share.

## **2. Management Accounting**

Management accounting (MA) essentially involves the use of financial and accounting tools and techniques by managers of business firms to improve operational efficiencies, control and reduce costs, improve sales volumes and sales mix, and increase productivity, profitability, market share, and competitive advantage. <sup>[1]</sup>

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Whilst based upon similar accounting fundamentals, MA is essentially different from financial accounting.

Financial accounting is primarily a recording method that aims to present a true and fair picture of (a) the revenues, expenses and profits of businesses during specific determined periods, and (b) the value of their assets and liabilities on a specific date, for all users of prepared financial statements. This aim of financial accounting to provide a true and fair picture of the operations and the assets of businesses has resulted in the development of a vast and intricate system of accounting that has been shaped by influences from accountants, auditors, taxation authorities, regulatory bodies, stock exchanges, company managements, and other stakeholders. [2] Whilst financial accounting has evolved in different directions in different regions and countries, globalisation is leading to the convergence of these different methods and to the gradual evolution of a single standardised global financial accounting system. [3]

MA, like financial accounting, helps in providing a picture of the company's operations. Its basic approach is however very different and it serves more as an internal accounting tool that helps managements to improve their costs and cost structures, productivity, operational efficiency, sales performance, and profitability. [4] Based upon the same time tested accounting methods as financial accounting, MA uses more of cost accounting techniques and has essentially evolved and enlarged from the cost accounting methods that were pioneered by John Wedgwood during the great recession. [5]

The use of MA as an internal management tool allows for great flexibility in its usage and scope and encourages its shaping and modification by the needs of operating processes, businesses, and organisations. [6] MA uses accepted costing methods like batch, process, standard and activity based costing. It helps managements to determine unit costs, variable costs, fixed costs, and breakeven points. Processes like marginal costing, Make or Buy and Cost Volume Profit (CVP) analyses help in determination of product profitability and optimisation of sales mix; budgeting techniques aid in optimising operational performance and cash flows through comparison of actual performance against budgets and analysing positive and negative variances. [7]

The company currently determines unit costs by absorbing all costs incurred by the company into individual products and dividing such costs by simple parameters like production or sales numbers. [8] Such a system, whilst in use in many firms, is likely to lead to erroneous costing build-ups, misleading information and inappropriate pricing decisions. [9]

Classification of Hadika's costs into Variable Costs, (those that are dependent upon production volume; like material and direct labour), and Fixed Costs, (those that are incurred irrespective of production volume; like salaries, rents and depreciation), will enable the organisation to ascertain breakeven points at different sales prices and sales volumes and make appropriate pricing decisions, which in turn will help in achieving competitive advantage, market penetration, and profit optimisation. [10]

CVP analyses will allow the firm to determine the effect of various cost, price and volume combinations upon organisational profitability and assist significantly in taking decisions regarding determination of sales mix, introduction of new products and phasing out of unprofitable products or product lines. <sup>[11]</sup> Sensitivity analyses and cost and volume simulations will help Hadika in forecasting the impact of changes in costs and volumes upon profitability. <sup>[12]</sup>

Management accountants are expected to compile records, statements, and forecasts, on the basis of historical and projected figures for sales, costs and other expenses, with the use of current cost and management accounting techniques. <sup>[13]</sup> Their job, whilst being grounded in basic accounting and cost accounting concepts, is essentially interdisciplinary and interdepartmental, needing them to investigate the nature of different costs and revenues and analyse them in a user friendly manner for the use of management, as well as for the sales, and production departments. <sup>[14]</sup>

Whilst management accountants make use of normal computing aids like Excel spreadsheets for their computation and analysis, the development of sophisticated ERP software has empowered them significantly and they are now able to provide far more complex analyses of the impact of developments in various business areas upon organisational productivity, cost efficiency and profitability.

### **3. Application of Management Accounting Methods at Hadika**

With the current financial crisis reducing credit availability, employment, and incomes, across the advanced nations, the market for cars is likely to be affected drastically in the coming months; buyers are expected to increasingly look for products that are cheap, economical to run, and provide value for money.

The crisis is expected to be particularly hard on people in higher income groups, consequent to their wealth evaporating in the face of stock market meltdowns. The market for larger cars is forecasted to shrink much faster than those of smaller compacts and sub-compacts; which are cheaper and more economical to operate and maintain.

Management accounting techniques in this scenario should be employed to examine and analyse costs, sales prices, sales volumes, and sales mixes, in order to empower the company management to take appropriate action for improvement of competitive advantage, and for maintaining and improving market share.

The use of variable costing will enable managers to know the composition and amount of direct costs for each component and each product, as well as the expected contribution from each product. Products with higher unit contributions being more profitable than others, contribution analysis will enable the management to localise more profitable products and determine the thresholds to which prices of these products can be reduced.

Such initiatives will also help the management in investigating and analysing “make or buy” options, and if possible in outsourcing the production of some components from more economical sources; thus driving down the company’s cost of production. Outsourcing of components from more economical producers will in turn lead to the identification of surplus employees, who can then either be deployed effectively in other activities, or let go, both options leading to cost savings and improvements in efficiency.

The segregation of costs into fixed and variable will also bring all fixed costs into focus and provide numerous other opportunities for cost savings through the identification of (a) unutilised or underutilised workforce, rent, or machinery, and (b) excessive costs in administration, travel, entertainment, external consultants, electricity, canteen expenses and legal fees, thus opening up numerous areas in which costs could progressively be reduced without upsetting the working of the company or employee morale.

Comparison of sales forecasts with actual achievements, accompanied by analysis of variances and study of product contribution, could help the company in focussing on poorly performing products, followed by identification of reasons for poor performance, and the possibilities and consequences of introducing price or even, (if the situation so warrants), production cuts.

CVP analysis will allow managers to gain instant access to the results of numerous permutations of sales mix, in terms of individual and composite break even points and profitability, thus allowing them to target on the



optimum sales mix, both from the point of view of the market and of the firm.

Application of MA techniques will help the company to (a) control and reduce costs (b) focus on profitable and unprofitable segments by way of contribution analysis, (c) decide upon price reductions and (d) strategically pass on cost advantages to the customer or dealer to increase competitive advantage and market share.

Analysis and simulation of Cash Flows, another integral component of MA, will help the management to understand the effect of these changes on the cash flows of the company and enable timely corrective action.

#### **4. Conclusion and Recommendations**

Management Accounting methods help managements of firms in improving understanding of costs, control and management of costs, and the effect of changes of costs and volumes on profits and cash flows, and by doing so help in the taking of complex decisions that can significantly affect organisational working.

Whilst the use of MA techniques prove to be helpful at all points of time, they become imperative in times of increased competition or market recession, not just for improvement of competitive advantage but for simple survival. Their use in these critical times is deemed to be essential, as is their knowledge at all decision making levels of the company.

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