

# Sample essay on strategic management accounting

[Business](#), [Company](#)



## **Critical Study of Standard Costing and Variance Analysis**

Standard costing is a method of developing cost standards of the whole or part of business activities so as to set particular cost estimates which can be later compared with the actual costs that have been used. The variations are then investigated and used to identify loop holes within the organization. The standard costs may then be changed periodically depending on current prevailing costs so as to reconcile them with actual costs. The main reason standard costing is used is to approximate the costs that will be used in a period so as to make it easier to draw a budget. The costs may be based on either ideal or expected performance, but the best way to base them is on efficient and attainable performance. Attainable and efficient performance will be the best mark that the company or organization can make if all the activities are carried out efficiently with minimal waste and maximum utilization of the available resources.

Variance analysis is a comparison of actual and standard costs. It is a vital tool in controlling unnecessary costs as it will identify the costs that were not in line with the original plan. It will call for the management to explain how the costs were authorized in their expenses. Variance analysis will also identify ways of improving efficiency and profitability. It is mainly used because it will help establish the efficiency of the system used in the processes and compare the performance with the set standards of performance. If the actual costs are less than the estimated costs, then it means that the conditions were favorable and, on the other hand, if the actual cost was more than the estimated cost, it means that the conditions were unfavorable, and it calls for investigation.

Variance analysis is only useful if the resulting information will be used by the management to improve operations or to lower costs. If the analysis is considered to have a practical application, cost accountant will research on the cause of the variance and present the results to the manager with a proposed course of action.

There may arise two types of variances. The first classification of variance is rate variance; this is the difference in costs between the estimated cost and the actual costs of a product purchased or a service paid. The second type is the volume variance which is the difference between the actual quantity consumed or sold and the quantity that had been budgeted.

Standard cost variance reports are prepared on a monthly basis. They are complex and hence take time to be prepared; as a result they are released days or even weeks after the end of the month. By the time they are released, new estimations are usually already made and hence they are not used for the following month. This untimely preparation is mainly because of the complexity of these reports, the reports usually emphasize on being precise but this makes them delay for longer. People will prefer timely, frequent reports to make their decisions rather than the complex untimely reports which are mostly out of date when they get them.

Most of the jobs that the company will engage in will be under contracts with outsiders. For this reason, the contractor will need to know the actual costs that he or she will spend. Standard costing cannot provide the actual costs to be incurred in case of a situation where one is to be paid according to the amount he or she spends, this makes the method weak and also if one chooses to use the standard costing method; it might result to loss where

the variation is unfavorable.

Standard costing will put unnecessary pressure to the management if they aim to be seen as performers. Managers will like to be seen as good performers all the time, for this reason, they might take unnecessary measures so as to provide favorable variance results. The actions will only have short term positive impacts on the organization. For example, a manager might buy raw material in large quantities so as to improve the purchase price variance, this will be unfavorable in the long term especially if the inventory is perishable. It will be a threat because the company will have to discard it either at a lower cost or may lead to an abnormal increase in the rate business activities leading to over working of the employees. It could also tempt the managers to acquire goods of sub-standard quality or employ low qualified employees so that the cost on the goods, or amounts spent on salaries can be reduced so as to create favorable cost variances.

Although the standard costs consume time before they are set, the environment is dynamic. Estimating costs in a dynamic environment is difficult since they might change at any time. Standard costing assumes that the product cost will not change in the near future. It is, however, not the case as the costs keep changing and varying each month as the quality of the products keeps changing.

On the other hand, standard costing is considered important in budgeting. A budget cannot be prepared without standard costs; the costs must be estimated first so as to establish the estimated values. It is impossible to include the exact costs of the period ahead and hence it is inevitable to have a standard costing when preparing a budget.

If the standard costs are utilized properly, they will enhance efficiency in calculating the cost of goods produced and sold. Goods produced will have different costs attached to them; it will be tedious to calculate the actual cost of these products and hence, it becomes important to assign each component of the cost to the products. If a perfect cost allocation is made, it will ensure that the managers will have a better budgeting and price setting in the products or future jobs.

Managers of organizations that practice standard costing and variance analysis will be more responsible for their work. The top managers will prepare standard costs with the help of the implementing managers. For this reason, the implementing managers will be expected to explain any unfavorable variance on their project. That makes the managers more accountable and transparent in their activities. The pressure that will be mounted on different managers on different departments of an organization will seek to ensure that they remain on the check with their activities. The immediate head of a certain department is the one that will be held responsible for the activities of his or her department and will be expected to explain in case of an unfavorable variance.

Variance analysis will help managers identify the resources that are underutilized. Since the standards and the level of production or service utilization will be set at its optimum point, it will be used to identify the departments that produce output at a notable lower rate than their potential is. Manager will investigate the cause of this underutilization and establish measures for increased rate of production or make sure there is a reduced expense if the amount spent is unfavorable.

Budget costing will help the management prepare profit and loss account for short periods. The reason behind the management wish to make short term profit and loss account is to determine the trend of business. Managers will be concerned to know whether their business has upward or downward trend in its operations and hence they will prepare estimated revenues against the estimated costs. It will help the management to take corrective measures in case there are chances of making a loss that can be avoided by increasing operations or carrying out various desirable activities.

If the apportionment of various overhead costs is necessary, recording actual costs of every single unit will be tedious. It, therefore, calls for less complex way of handling the recording for easier and faster calculation of the cost of goods. Standard costing will help on this issue by providing a pre-determined cost estimate of each unit that has been produced. It will also be a simpler way of valuing stock since it already has a pre-determined value which is the approximate value of a single unit. Determining the value of stock will be easier as it will involve multiplication with the total number of units in the stock records.

### **Decision whether to Shut Down or keep a Business running**

Managers are faced with problems in an organization on a regular basis.

They will have to choose between different alternatives that will be available and in choosing among these alternatives he or she will need all the relevant information that is needed concerning the available options. Many factors will influence the decision the manager make; these factors will be both quantitative factors and qualitative factors. Quantitative factors are

measurable in value especially in monetary terms while qualitative factors are the factors that cannot be measured, but they still play a role in the decision making process.

For a firm to decide whether to shut down or continue operating, the first thing they will consider is the value of the loss they are experiencing. If a company temporarily stops its operations, it means that the maximum loss it will suffer while not in operation will be the fixed costs. This is because the company must continue paying its fixed costs regardless of whether they are in production or not. For this reason, the maximum amount of loss that a company can accept is the fixed costs. Any loss beyond fixed costs will mean that the company cannot sustain itself and hence it has to shut down permanently. The firm should shut down if the losses from shutdown are less than the loss from continued operation,

**It should close if  $R - VC - FC \geq - FC$  which is also  $R \geq VC$**

Where: R- Revenue

VC- Variable Costs

FC- Fixed Costs

If a company is experiencing loss in its operations, it will not close down until total revenue is less than its variable costs. Fixed costs are irrelevant in an operating firm because no matter the level that the firm is operating, it will have to cover its fixed costs. However, this is only in the short run, and the firm manager will opt to close the firm if total revenue is less than variable costs.

Managers will also consider the price of the product before settling on

shutting down the firm. If the price of a firm product is less than Average variable cost, the company will not be able to sustain its operations. For this reason, it is advisable for a firm that it stops its production and close down completely.

### **Total revenue < variable cost**

$$(P * Q) < VC$$

### **P < AVC**

Where: P- price

Q- Quantity

AVC- Average Variable Costs

#### Qualitative factors Considered when Shutting a Business Down

The firm should also consider its external reputation. Before the firm closing down, it should consider its external reputation. There might be investors who are willing to invest on business or rebrand it. If the company has a good reputation, it will mean that its products will have more customers and hence there might be some hope left (Lloyd, 2011). A company with a good reputation might choose to increase the price of its products and still maintain its loyal customers.

### **Decision on Pricing**

Although many factors will determine the success of a product, fixing the right price of the firm product is one of the major factors that will contribute to its success.

The major cost to determine in fixing the price of a product is the cost of



production. The price of the product in a profit maximizing firm should be above its total production cost. Fixing the price over the product cost of production will be necessary to ensure that the firm will be ensured of its profits. The firm should also add its expected profits over that particular product and come up with the most appropriate price.

The selling costs should also be factored in when determining the cost of the product. Selling cost will be one of the important costs that will be put on the product. The product should be able to cover for all its costs including the selling costs; which include all amount paid to both the sales people and advertisement.

Government regulations will also play a role in determining the price of a commodity. Tax imposed on a product and excise duty will determine the amount charged on a product, the higher the amount of the tax duties, the higher the price that will be charged.

### **Qualitative factors in Pricing**

Demand of the product will help the manager fix his product price. Demand of the product will set its ceiling price. If the market is highly elastic, the company will apply penetrating pricing. On this policy, the price<sup>3</sup> will be fixed below the competitive level in order to obtain a large share of the market . However, new products are likely to be highly inelastic due to lack of close substitutes, for this reason the prices are usually set higher than on the elastic markets.

## **Product Mix and Limiting Factor Analysis**

Product mix is a major decision that firms offering many products have to make; they have to decide what to make for the different kinds of customers that they have. Many entrepreneurs will tend to be swayed by new products and wish to offer more range of products. Various types of products offered by a company will mean that there will be diffusion of effort and, as a result increase the firm expenses which will result to reduced profits. For this reason, it is important for managers to determine the right product mix to offer so as to ensure they get the optimum profits.

A company will consider and prioritize its cash cow. The company should put more emphasis on the products with low production cost but high returns. The company will need to produce more cash cow products and reduce on the products that are costly to produce but have low profit margins.

The manager should determine the variable costs of each product and compare it to the revenue it generates. Only the variable cost should be considered since the fixed cost will be the same regardless of the project that is undertaken. All the costs should be accounted for ranging from the material costs to the labor costs.

## **Qualitative factors of Product Mix and Limiting Factor Analysis**

Besides the cost of production, the firm has to consider its manufacturing capacity. A firm might not have production capacity that is big enough to vary in the range of products it produces. If a firm has lower production capacity, it should focus on producing fewer amounts of goods and, as a result it should not focus on producing a wide range of products.

A manager should consider the availability of labor and material in his firm. A firm will only be able to produce a wide range of products if it has the required labor and materials. If a firm has enough labor and material, it can focus on producing more products than a firm that has lean resources.

### **Make or Buy decisions.**

Managers will be faced with the task of determining whether they should purchase some components of their products or whether they should make them. The main concern of such a business is to determine which option will provide maximum returns in terms of profits.

Marketing is a major factor to consider while determining whether to make or buy a product. The level of marketing that is required to get a product to be acceptable to customers is a great thing to consider. If making a product gives the customers more sense of security and will require less vigorous marketing, then it is cheaper to produce it since it will also be less expensive to market it. On the other hand, products from famous brands that will require less marketing are more economical to buy than to produce them. The manager must determine the cost that the firm needs to pay in order to create security with the customers.

Cost of production will also determine whether a company buys or makes its product. If a product cost of production is lower than the cost of acquiring it, managers should consider producing it. If the cost of acquiring it is lower than the cost of producing it, then the company should purchase it. In determining the cost of production of goods, all costs should be included

including the additional fixed costs that will come with the additional unit of production.

### **Qualitative factors of Make or Buy Decisions**

The firm plant capacity should be considered. If the firm has enough facilities for production, it means that it has the potential to produce a product and hence it should go ahead and evaluate the other factors to determine whether it is economical to produce a product.

The quantity of the products required will also determine whether a firm should make or buy the product. Some products might be uneconomical to produce in low quantities due to diseconomies of scale, it will be better to purchase them rather than produce them.

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