

# Strategic management accounting essay

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



## **Introduction**

I agree that Standard Costing and Variance Analysis are vital and crucial for any kind of business. I will support this position by showing the importance of standard costing and variance analysis for businesses. In light of this statement, I will also show that standard costing and variance analysis are as important to small businesses as they are to large organizations. Variance analysis is the comparison of standard costs and actual costs hence it is important for any type of organization. This is because controlling costs helps in identifying ways in which costs can be controlled thus enhancing efficiency and ensuring increased profitability. Moreover, the report will also address the qualitative factors that influence the decisions made by SMA.

### **Part a.**

“ Standard Costing and Variance Analysis are appropriate to any type and size of organization.” Critically evaluate this statement, indicating whether you agree with the statement or not.

Standard costs are related to manufacturing overheads, direct labor, and the direct material of a company. Manufacturing companies prefer to assign standard or expected costs to their overheads, direct material, and direct labor as opposed to stating the actual costs incurred in the production of goods. The first reason why standard costing is necessary is because it assists businesses to regulate their costs (Quinn 2011, p. 133). Management accountants can investigate the cause of a variance between the actual and expected costs. For instance, during the start of a year a manufacturing firm estimated that the direct labor costs would be \$2 for every unit. Usually, this

standard is set by analyzing the historical trend of the company's costs. After a while, a firm can conduct an evaluation to establish whether it has successfully controlled costs. If the actual costs is discovered to be \$4 per unit there is need to investigate the cause of the variance because a difference of \$2 is significant and unfavorable. This will prove to be beneficial for an organization, as corrective measures will be taken to avoid further losses. As such, regardless of whether an organization is big or small they will be able to improve its profitability by making use of variance analysis. If the actual costs exceed the expected or standard costs then this means that there is an unfavorable variance and corrective measures need to be taken. On the other hand, when the standard cost is more than the actual cost there is a favorable variance and hence it is important to make inquiries and sustain the trend. In this regard, businesses will be able to monitor their production costs thereby minimizing or preventing losses.

Secondly, standard costing is appropriate for all kinds of businesses because it allows them to carry out budgetary control. Preparation of budgets is often important as it enables businesses to strategize on how to achieve their goals. Rather than wait to record the actual costs incurred, standard costs are usually recorded at the beginning of a financial year. As, such the management are able to determine their costs prior to making any expenditures. Evidently, this is beneficial for any business enterprise because it increases their ability to monitor their expenditure. Moreover, this will give businesses an opportunity to divert some of their resources on capital expenditure. Prior knowledge to the estimated expenditure using standard costing enables organizations to control their costs. For instance, if

the cost of direct material as stated in the budget is \$5 per unit then expenditure can be regulated if actual costs go beyond standard costs. Costs may go beyond what is stated in the budget due to factors like increase in prices. As such, an organization may control costs by reduce the quantity demanded of the material. Furthermore, the organization may identify the adverse variance between budget expectations and actual expenditure. The management will have control of their budget as they will incorporate the price changes in the materials in subsequent financial years. Generally, standard costing and variance analysis ensure regulation of budgets with a greater degree of accuracy.

Thirdly, standard cost and variance analysis allows businesses to make informed decisions. In most cases, businesses tend to have so many expenses and yet they experience a constraint on their budgets. Using standard costing, an organization can choose the best alternative early enough so reduce the potential burden of costs. The other decision that can be made by managers is related to the department where costs can be assigned. Using standard costing, firms are able to come up with cost centers and consequently charge them with responsibilities. This decision is vital for every business entity as it promotes efficiency in their operations. Since supervisors are not always around to overlook the activities of employees, standard costing improves the effectiveness of delegation. Therefore, employees will feel a greater sense of responsibility in ensuring that there are little or no variances in the costs of materials charged to their departments. In fact, all levels of management will get involved in promoting a cost effective attitude to decisions in the organizations. Additionally,

standard costing and variance analysis influence the top management to make decisions that will have a positive impact for the entire organization. For example, strategic managers can conduct reappraisal of techniques, materials and the methods that are likely to cause an organization to experience unfavorable variances.

Another reason why standard costing and variance analysis is appropriate for various organizations is because it encourages effective utilization of resources. When a company does not establish standard costs, it will amount to misuse of resources. Consequently, an organization will have wasted its working capital. This is evident from the example given below.

### **Item Actual Cost**

Material X \$40, 000

Material Y \$30, 000

Material Z \$20, 000

Given that an organization has not established the standard quantity and price, it may purchase the raw materials at a cost that is more than the current costs. Another supplier was offering the same raw materials at cheaper costs.

### **Item Actual Cost**

Material X \$35, 000

Material Y \$20, 000

Material Z \$15, 000

Such a company will incur a total loss of \$20, 000 for not making budgetary allocations using standard costing. Standard costing normally allows

companies to conduct research so that they can come up with standard costs that are reliable. Consequently, businesses will utilize their resources effectively.

Finally, the standard costing can be used as a yardstick through which the performance of businesses can be evaluated (Quinn 2011, p. 25)).

Businesses often establish standard costs that are attainable and this motivates employees to work towards meeting those standards. This is especially because workers in an organization are aware that in case of errors in the form of adverse variances the same will be investigated by the management and thus they are encouraged to perform their work efficiently. Consequently, managers will be able to assess the performance of departments to determine whether they are in line with the gauge that has been provided to the employees. In this regard, every person in the organization will become cost-conscious because of the standard costs and variance analysis, which monitor operations within the organization. Therefore, standard costing and variance analysis is crucial for the success of all kinds of businesses because when employees are cost conscious incidences of wastage are avoided.

## **Part b**

### 1. Shutting down or Keeping Open part of the business

a) It is difficult for managers to determine whether to keep or maintain one segment of the business. However, managers can consider common costs in such a situation. According to Drury (2007, p. 56) common costs are those that are likely to make a given segment of a business look unprofitable. Interestingly, shutting down the segment may cause an organization to

experience an overall decline in its net operating income. Therefore, allocated common costs are relevant because they are crucial to the decision of whether to keep a segment of the business or shut it down completely. Secondly, it is important to draw comparison on fixed costs and contribution margins. A part of the business can only remain in operation when the total contribution margin outweighs the fixed cost. Otherwise if the total contribution margin is lower than the fixed costs or it decreases more than the fixed costs then there is need to shut down the segment. Finally, incomes are also relevant given that a comparison between the available alternatives helps in decision-making. The total net income when a segment is in operation should be compared with the one that will be obtained when the segment is closed (Drury 2007, p. 67). From the differing costs it is necessary to choose the one that gives the highest income. Therefore, incomes are relevant to managers as it assists them to make an appropriate decision.

b) Before shutting down a segment of the business, it is important to consider qualitative factors such as the image of the company. In most cases, the good image of a company is what attracts customers to a business (Quinn 2011, p. 132). Therefore, if closing down will affect the image of a company negatively then the decision is not worthwhile. This is because if the part of the business that has been left in operation will be adversely affected and this may eventually cause the business to incur losses. Secondly, the profitability of a business in the long-run is important. It is possible that a few of the products from the part that is shut down is what is responsible for the overall success of a business. Consequently, firms will

make losses in the long-run especially because the part they abandoned has been taken over by competitors who end up performing well. Additionally the morale of employees and the existent relationships with customers will be destroyed. When only a part of a business is open, employees will feel insecure and demotivated. They will constantly have the fear that just like their colleagues they too may be dismissed. Consequently, the low morale will compromise the quality of service delivery. Furthermore, suppliers will lose confidence in the operations of a firm that has been partly shut down because they will be of the view that it is performing poorly. In fact, such a company may not obtain credit facilities from creditors because of their lack of confidence.

## 2. Pricing Products or Services

a) Cash costs are important when pricing both products and services. This is evident from the costs incurred in making the products and providing services. For instance, in the case of output, the costs that will be considered include the costs of raw materials, overheads and that of the labor involved in production. In this case, absorption costs involving variable and fixed costs will be considered. However, the relevant costs will be the variable costs because they affect the pricing of products and services. A manager will need to add the marginal costs to the expected profit in order to establish the price of a service or product. Secondly, future costs are relevant in assisting an SMA to come up with pricing decisions. A good example can be seen in a situation where there is an expected increase of taxes on a given commodity. This will definitely cause an increase in the price of any unit of output so that the excess tax can be borne by the final consumers. A similar



scenario will be experienced when there is a foreseen increase in taxes on a certain service provider. These future costs have to be integrated into the price in order to ensure that producers earn a profit.

Attributable fixed costs are another set of relevant costs that affect the pricing of a product. Even though fixed costs are considered irrelevant, there are exceptional situations when they become relevant. Some fixed costs arise in the direct production of a particular output. For instance, if an organization had to incur extra cost such as that of hiring a supervisor to ensure that a special order is delivered then the salary paid to the extra personnel will be channeled charged to the products in that department. In this way, pricing will ensure that all the production costs are charged to a good or service and even the expected income, which is the profit per unit of output, is covered in the pricing.

b) Government regulations is a factor that can influence pricing. Although manufacturers can determine the price of their products using costs incurred as their benchmark, they may also have to adhere to government policies (Berger 2011, p. 80). In cases where the government has established a price ceiling, it would be inappropriate to set prices that go against this regulation. The other factor is the market price of a product. In a market where there is perfect competition, manufactures are mostly price takers because the demand and supply forces in the market determine the prices. Therefore, regardless of costs incurred when prices are set too high, the products will not sell and this will amount to losses.

### 3. Product Mix and Limiting factor Analysis

a) Marginal costs are relevant when a certain factor is limited. Various

factors such as labor hours or even the raw materials that are required to facilitate production may be limited. In this regard, a firm will strive to maximize its output subject to the limiting factor (Bhattacharyya 2011, p. 110). Therefore, variable costs are essential in where there are limiting factors and in this product, mix thus cannot be ignored. Moreover, opportunity cost is another relevant cost that is associated with limiting. For instance, if a firm wants to make two products that is King and Ace, opportunity cost will be involved. A strategic manager may prefer to produce King as opposed to Ace even though it has a lower contribution in comparison to ace. This may be the situation because there is insufficient labor supply and hence by making King a manufacturing company will be able to cater for the full sales demand of consumers and forego the production of Ace. Alternatively, the management may decide to engage in a production mix where the remaining labor hours will be utilized in the manufacturing Ace. Even so, the firm will still have foregone the cost of producing Ace in large quantities because of a limitation in labor supply. Therefore, opportunity cost will be a cost that will have been undertaken by a manager while making his decision.

b) The quality of output is important in situations where there are limiting factors. For example, production of a particular product in order to maximize contribution despite the available limitations may compromise the quality of output. Businesses should consider the long-term benefits of their decisions. As such, managers can make the decision to manufacture products that will benefit them in the long term despite the presence of limiting factors. Moreover, they can engage in a product mix that despite not giving them the

maximum contribution they will be able to maintain the high quality of their products.

#### 4. Make or Buy Decision

a) This decision also known as an outsourcing decision requires management to make a judgment on whether they should manufacture a product or buy the same from outside. As such, quantitative factors like relevant costs and incomes will be put into consideration. Incremental costs are the first factor that will be considered. An incremental cost is the difference that arises between manufacturing a product and outsourcing it. Incremental costs are very vital as they play a major role in influencing the management's decision to buy or make a product. The validity of this position can be deduced from the example provided in the appendix.

Marginal costs are relevant in determining whether a firm should make or buy a particular output. Variable costs involve direct labor, direct material, and the variable overheads. Once the variable costs are determined, it will be easier for the managers to identify the profitability of a product. This can be achieved by subtracting the unit variable costs from selling price of per item. This will give the contribution of an item, which can be multiplied by the number of items to obtain the overall amount. Thereafter the fixed costs will be deducted from the contribution to get the profits that a firm is likely to earn if they manufacture a product. It is this income in terms of profits that will inform the decision of the management. If there are little or no profits then a company will make a purchase decision.

Finally, opportunity costs are very important in enabling the SMAs to make an appropriate decision. Opportunity costs are extremely relevant in decision

making because selecting one alternative will automatically hinder a firm from exploring another option. Therefore, in most cases a firm will go for an option that will give the highest contribution. As such, making the decision to make a product will mean that the management has foregone the opportunity to explore another alternative. The incomes that will be considered in this case are the profits, which influence the management's decision to make or outsource a product.

b) Besides, quantitative factors, there are a number of qualitative factors that will influence a firm's decision to outsource a product. To begin with, managers may consider the business relationship they have with their suppliers. It may be cheaper to outsource a certain product but Strategic Management Accounts (SMAs) may opt to manufacture the product instead so that they can remain loyal to their suppliers in a bid to maintain the good relationship an organization has with its suppliers (Hensinger, 2008). Secondly, SMAs may give priority to the quality of a product rather than to its price. As such, managers may be reluctant to buy a product because they are not too sure about the quality of a product. They would rather make the product and retain their customers because in the long run this will prove to be cheaper than losing their customers.

Another qualitative factor that can be put into consideration is the company's production capacity. If a business has the requisite production capacity then the management will prefer to make the product rather than let this capacity remain idle. On the other hand, a product may be purchased from outside if the capacity to produce the output in-house is inadequate. Additionally, it is important for a business to observe timelines when making

the crucial buy or make decision. Buying may appear to be the best alternative in situations when customers require a product within a short duration of time. Meeting consumer requirements at the right time and place is the goal of every business. As such, the decision to buy is appropriate to cater for consumer needs within a limited timeframe. However, when time is not a limiting factor then SMAs can make the decision to manufacture a product.

## **Conclusion**

Standard costing and variance analysis are important for business enterprises regardless of their size or products being manufactured. This is because the success of any business enterprise greatly relies on its ability to regulate its costs in a manner that is efficient and cost effective. Besides the quantitative factors that influence the decisions made by managers, qualitative factors also play an important role in such decisions. Some of these factors include things like quality, the image of the company and the organization's relationship with its suppliers. Therefore, in as much as an organization may make good profits from taking a particular decision, the qualitative factors also count a great deal.

## **References**

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## Appendix

### Part b

4a) The estimated costs for producing 8, 000 units of output is as follows

Per Unit \$ Total \$

Direct Material 20 160000

Direct Labor 15 120000

Variable Factory Overhead 10 80000

Fixed Factory Overhead 12 96000 \$57 \$456000

The same product can be outsourced at a price of \$40 per unit. This will mean that 25% of the overheads incurred from the factory will be saved.

Per Unit \$ Total \$

Make Buy Make Buy

Purchase Price 40 320000

Direct Material 20 160000

Direct Labor 15 120000

Variable Overhead 10 80000

Relevant Fixed Overhead 3 24000

\$48 \$40 \$384000 \$320000

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Difference that is in favor of outsourcing \$8 \$64000

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Therefore, SMAs will opt to buy the product rather than manufacture it because of the incremental cost of \$8 per unit associated with making the product.