Effect of standard costing changes on firm operations

The Rise and Fall of Standard Costing and Its Effect on Everyday Operations For European and American Firms

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EXECUTIVE SUMMARY

The overall purpose of this paper and study is to investigate cost or lean accounting within the operations management realm and how its unpredictable rise and fall allow organisations to continuously learn and utilize knowledge management as a core value. It was also important to use a larger organisation that has history of outstanding operations and customer centered focus upon services. This investigation will require an in-depth study of work processes, communication and leadership with regard to knowledge management as a value within the team construct while looking at how this reflects leaning accounting principles. What tools are available and what kind of evolution is Nestle undergoing in order to remain competitive in a changing economy? How does this change knowledge management and communication company wide? What this study argues is that accounting practices are changing due to the evolving business plan. This is a movement toward modern accounting and it is important to see the relationships between costing accounting, its fluctuations and how they

impact the health of the organisation as a whole with regard to productivity and job satisfaction.

How an organisation applies methods of costing into its framework for accounting of expenses and its direct rise and fall over the time period of the product life cycle, directly influences the production, operation, distribution and employee retention of the global company. In fact changes in accounting practices have led to many tried and true business models to no longer exist. Costing and its rise and fall can have a direct relationship with success and competitive advantage in the market place. However the purpose of this study is to explore and reflect upon how accounting practices change operations management and the supply chain management model as a tool of managers and team members alike. Really it is how accounting practices have changed business practices because of new legislation focusing on global companies in Europe and the United States. Accounting costs, expenses and losses reflects the health of the organisation and with change comes confusion. This study argues that with such changes comes a lack of defining the company’s value within the market but also the value it has for its employees, as they become active participants and investors.

GENERAL OVERVIEW

How corporate accounting is handled is changing worldwide. How each expense is accounted for within an organisation’s financial sheets has been evolving. Such a proposal for change has received much commentary from not only the financial community and corporate America but also key members of Congress, European union leaders and the public. Such a response results from the uncertainty that such change will benefit

businesses and economic growth. It is feared that such change will have the opposite effect and cause world leaders to lose its competitive edge in the global market. The urgency for a solution has only been stressed recently in light of such debacles like Enron and Tyco. It is believed that companies do need to account honestly for expenses but at what price to its employees, the public and the economy? Part of the issue with current legislation to change the practice of accounting for employee stock options is that there is no real way to value their worth. This creates an unsettling feeling among investors and employees struggling to understand this benefit.

ACCOUNTING OVERVIEW

What this truly means for any corporation functioning globally or even locally this that effective cost accounting because a volatile issue for management to consider. One could argue that such rise and fall of how costing pays a part in the entire operation has a negative effect upon how the company's valuation is seen on the open market if done incorrectly. Costing at every step of the product life cycle plays a huge part in how this valuation is decided from inventory at the shop floor level, to everyday operations management, to an employee's value with the company and their net worth personally. Changes within the global economy in the recent years the disappearance of tried and true business models leaves many with a poor taste in their mouths because one must understand how efficiency, affordability and effective leadership come into play. Effective costing of routine operations and corporate behaviours must be tracked and studied in order to carve the fat. This study aims to look at exactly what the rise and fall of costing means to a global organisation conducting business on many

levels. For the purpose of proving the argument that such an evolution of accounting practices has a powerful influence on the organisation, one will look at examples from the shop floor to the continuous management of knowledge and communication. Accounting for such expensing and pricing correctly is what makes the organisation strong but also its people. The benefits of standard costing gives rise to more modern accounting practices today, which then lead to leaner functionality throughout the organisation. It can be argued that by putting a framework of standard costing as accounting practice also leads to a better defined operations team but also leads to a lean supply chain as further innovation is introduced into the organisation. With this in mind, evolved traditional business models like Wal-Mart and Nestle are discussed because these are globally operating corporations with high success rates.

LITERATURE REVIEW

PRICING STRATEGIES

It can be difficult to assess why a product has a certain cost or price to the consumer. How is it that companies arrive at certain amount for a product or service? What are the factors that play into this amount and do they change over time while in the market? Mish defines clearly, price as being " the value or worth; the quality of one thing that is exchanged or demanded in barter or sale for another" (2004, p. 985). A mistake that happens to many companies is they allow the market to manage the price of the product and avoid strategic management of pricing in general. What is usually done according to Nagle is " they list the prices based on their own needs and then adjust transaction prices to based on what customers say they are

willing to pay. Only a few companies question why someone is willing to pay no more that a particular amount or how that willingness could be changed" (2002, p. 1). In order to be strategic in pricing, a company must confident and understand that " pricing involves managing customers' expectations to induce them to pay for the value they receive" (Nagle 2002, p. 1). Fortunately, when it comes to financial products, many customers remain in the dark about product and services. Sometimes a service oriented company such as the Bank of England can take advantage of such undulation but as more information becomes available due to the Internet, it is becoming increasingly more difficult for a company to set the pace this way. More than not, more companies especially financial ones that rely on customer relationships, allow for a value-based price structure that is contingent on the customer paying when value is delivered. This type of pricing system relies heavily on segmentation of the demographic when it comes to offering promotions and incentives to buster customer loyalty. Much of this applies to financial type products that are well defined for the consumer either through education or these products are a must in life like the credit or loan product. Keeping this in mind, many financial products consist of high quality products and add-ons that when offered by one company allows that company to diversify and establish the price. The table here below aids in illustrating this point.

Table 1: Pricing Strategies

P/Q	*Higher*	*Lower*

	Price	*Price*
Higher Quality	Premium Strategy	Good Value Strategy
Lower Quality	Overcharging Strategy	Economy Strategy

(Anderson & Bailey 1998, p. 2)

It is also important for a company to keep in mind demand for the product or service. This is why diversification and globalization are quickly becoming elements of strategy as companies look for new ways to target consumers and enter new areas where their original product has a new life cycle. This is a matter of economics but important for understanding marketing strategy with regards to cost switching or price switching. “ The greater the price elasticity, the closer the company can price products to similar competitive products and vice versa” (Allen 2002). In an industry like the mortgage industry where homeownership is more prevalent in Western nations, elasticity is high and therefore, it is fair to remain competitive with other companies. Also a company like Nestle can bet that charging less may lead to more food products created as customers find they get more service for less money. In this respect elasticity can work either way. It really depends

on degree of risk one company is willing to take. Still it remains to be found if such a tactic even works when it comes to customer loyalty, as this will be explored in greater detail later. However, it remains to be seen if price loyalty does exist. It seems “ the key to effectively competing for loyalty is ensuring the quality of the customer experience, not the quantity of customer rewards or discount prices” (Compton 2005, p. 1). However, the price needs to be adjusted for what the customer expects. It can be a cycle that changing continuously depending on the product or service.

STANDARD COSTING AS ACCOUNTING PRACTICE

There is concern with standard costing accounting methods and when the practice is an effective method, what advantages and or disadvantages there are to the practice’s use over time within the operations realm and production of a product. What is the history of standard costing, how it came into practice and popularity with managerial accountants? Are there situations where other methods are more beneficial? This plays into mainly focus upon direct material costs and not necessarily labour because of the set hourly wage. Was this the reason for adopting leaner accounting methods with the advent of more expensive operating costs? The fall of standard costing accounting systems may be due to a need for an integrated chain of activities across multiple product life cycles especially when a company diversifies at a global level.

It should be notes here that standard costing is a only one method but can be used by management to estimate manufacturing costs of direct materials, direct labour and manufacturing overhead both fixed and variable across the chain of production. The fall of standard costing probably has taken place

due to a need for a multifaceted supply chain or layered supply chain. Generally speaking there will be overlapping in the supply chains of a global company and therefore a system to meet this need. This system will appear seamless but also where everything is integrated and communication is at the speed of light and technology is a mandatory tool so that the organisation may remain at a competitive advantage.

So how does standard costing accounting practice exactly differ from the other methods available? Obviously accounting practices have evolved to become leaner and applicable to a range of various business practices for a global company like Nestle. So how is standard costing still evident since it is no longer the popular choice?

HISTORY

Historically speaking the advent specifically for standard cost accounting systems began in the early 19 th century United States with the management of the railroads (Hoskin & Macve 2000, p. 18). Hoskin and Macve (2000) comment on standard costing always being a feature of the accounting practice from the beginning of business records. However, standard costing did not take an active role until modern business with this quote:

Accounting has always embraced cost and management accounting in the sense of analysis of activity and the use of accounting information for choosing, planning and controlling activity. These purposes remained embryonic until choice between significant economic alternatives became available. (p. 19).

Companies in the United Kingdom remained family based and therefore lacking formal, concrete accounting methods when compared with businesses found in the United States at the time. Any changes in accounting generally speaking remained with direct relations to changes in the business world.

Part of the evolution and the rise of standard costing are directly related to business practices of this time period. There was a need for measurement of productivity in a framework understood by management members. They wanted to calculate human performance on the shop room floor. This sets into place the post-modern ideology for Total Quality Management or TQM, to be discussed later. With these adjustments also came radical changes for an organisational structure, the management's strategy as this continued across the chain when further technology was introduced as useful tools (Hoskin & Macve 2000, p. 21). With adaptations sees as innovative, it was only a matter of time before British companies adopted similar practices toward accounting. This can be evident as the organisation's market presence gains global relationships and rely upon interaction and exchange of knowledge. At the end of the 19 th century United Kingdom companies were learning standard cost accounting principles and processes as a means of incorporating links into a wider organisational framework. While there was a need for streamlining, there was also a need for flexibility as standard costing started to lose its usefulness.

Morelli and Wiberg (2002) concur with other experts that standard costing emerged in the early 1900s. To mirror the Total Quality Management system

in place at factories, “ Engineers developed information about standards in order to establish ‘ the best way’ to use labour and material resources with manufacturing” (Morelli & Wiberg 2002, p. 18). This furthered how processes were put into place to achieve an organisation’s objectives.

In order to better understand how history influences practices within the business with regard to product production and the rise and fall of standard costing as an accounting practice, one must first understand different steps with in the standard costing system that defines the practice.

All processes or production steps along the supply chain have identifiable, calculable costs as raw materials result in the manufactured marketed product for consumer purchase. Each area of focus to make the product, the costs involved can be absorbed by the final product sale and then profit. This includes materials, labour, outsourcing and fixed or variable burdens. These absorbable costs reflect the true cost of goods as referred to on the general ledger. Variable costs are environmental factors, which fluctuate from day to day. Variables come into play for production measurements as one figures out the true cost of goods when compared with the actual costs incurred for that particular production run. Variable exist when determining quality of materials and labour. However labour becomes a ‘ grey’ area of contention when discussing standard costing. Indirect labour encompasses costs work-related but not task related. These become well defined further up the chain of command and less so at the shop floor level.

So what exactly is standard costing and why are trends in its use so important to understand? While much of standard costing explains business

evolution, organisational practices and diffusion of technology, making labour much different than the post-modernist view; standard costing still applies to business today as many eliminate fat from operations and look into clear streamlines for production purposes. This is mainly due to expenses being on the rise but also a need for reinvestment back into the company for technology needs when at a global level. In many ways, modern lean accounting allows for standard costing to be a framework from which other accounting practices emerge. Standard costing systems are good for production of items in volume but with very little diversification and stable costs. The benefit of this method is that organisations can trace specific cost flows from purchasing to inventory.

What distinguishes standard costing as an accounting practice but mostly a framework used today in business, what allows the method to remain a turning point in evolution to other methods like Activity Based Cost or ABC accounting and lean accounting, is by definition in its name. There is the standard by which the accounting practice is defined. By allocating a standard, the organisation already has a set of expectations and even core values of what the costs for production will be. Standards set the pace and atmosphere of production. They remain elemental to preconceived notions of the quantity and cost of inputs needed for production of one simple unit of output. With this backbone, one can develop a proper cost-volume-profit analysis. Still in order for a standard to work effectively it must be well defined and accepted by the organisation. This is where continuous improvement, communication and values for Knowledge Management or KM become important tools for managers. The accountant in charge of setting

standards must have a comprehension of the full organisational picture and its health. Along the line of command for accounting, standards become commonplace and procedures; or a methodical means of carrying out tasks. For instance, every accountant actively monitors the standards by which the standards apply to him or her. There is only a small window of time for payroll for a week. Without these standards in place, tasks become less defined and unachievable. In this respect and according to M. L. Houlton (1979): " There are basically two types of standard: (a) Ideal Standards which assume not wastage or inefficiency and (b) Expected Standards which allow for normal and expected losses" (p. 2). By creating such a system leads organisations to ways of measuring performance and other difficult erroneous concepts in need of a qualifier. Still a manager must also understand how standards create a regimented place to work, which may not work for every employee on the team.

Organisations like Nestle and Wal-Mart may see the advantage of utilizing a standard costing system because " actual costing has the ability to revalue inventory based on actual costs, which are most accurate" (Peoplesoft 2000, p. 12). Any changes are reflective immediately but also this leads to an organisation the chance to use other accounting methods as well like ABC. This could be especially important to inventory management. Remaining within the standard costing scheme affords the organisation a specialised function with respect to the types of activities. As activities become more detailed so does the accounting. For instance:

Technology or electronics industries benefit most from this type of costing because component variations affect total actual costs. Industries that deal

with commodities, for example, dairy products or precious metals, and are characterised by widely fluctuating costs, might use an actual costing system to provide the most current values. (Peoplesoft 2000, p. 12).

As organisations have grown into multiple national corporations or MNCs with multiple activities on different supply chains, maybe this is why standard costing has become less important to accountants because it called for too much detail where they too must remain efficient to keep their positions. A new leaner way needed to match the business practices because as much as standard costing applies to every product or service on the chain it also allots for more manpower and time. There had to be a way to allow for multiple operations and one accounting system that could branch off to meet multiple activities.

OTHER ACCOUNTING METHODS

Carmona, and et al (2004), writes of the origin of activity based costing method of accounting or ABC that came into vogue in Europe during the 1920s. What ABC does specifically as Carmona, and et al (2004) speak of Vollmers's work as:

Deployed significant efforts to account for distribution and marketing costs, which ' tend to be ignored today.' This first event is then taken as record of the origin (both in terms of time and space), from which the new practice mainly spread both temporally and spatially. (p. 36)

This is the start of a movement toward the double entry system and this saw delay and many weaknesses because it did not present a clear, complete picture of accounting. Its weaknesses were found in inefficiencies with

charges and discharges. As a result, early double-entry systems were seen as unreliable and not useful to big business. It would not be until later that advanced book keeping procedures would take into account advanced operating processes in production. Carmona, and et al (2004) found these systems although not perfected were used in England and the Colonies as early as 1760 (p. 37). It seems this was the trend as no real streamlined, conforming system would be adopted until modern business practices came into place in the United States.

Move to a global arena and model of production purposes and a more refined system is needed because a lot more is at stake. Global business is all about the details. It became common practice more investment applied, the more generally accepted accounting practices became as a diffusion of new technology. Accounting practices became more generally accepted behaviours as businesses became bigger and more prominent in communities across the world. Practices are implemented as Abu-Raddaha, and et al (2000) surmises the following:

The information provided by accounting should facilitate international trade and capital flows, not hamper them. It should inform, not just report. More importantly the information demands of both domestic and international financing and other commercial relationships, have to be satisfied. (p. 19).

Everything must remain in balance or presented as a well-oiled machine.

How does an organisation get to this point of transformation with its accounting practices? Modern accounting asks for more participation and optimisation from the start to finish by the corporate accountant. The actions

of the corporate accountants must change as the movement toward lean functioning continues to take place. It should not be a painful process but one of creativity, flexibility and growth. There is a concern that lean accounting requires one to turn off creativity and be boxed into one function or thought process. This will be explored late as a post-modern viewpoint of business where each person has a function within the total quality management or TQM perspective. Modern business may use this as a framework but the modern business model has evolved beyond this fixed view. The truth of the matter is that modern accounting practices could not be further from this view of being boxed in but rather goes beyond breaking the box and creating a different mindset where thinking is seen differently than before. Accounting is seen differently as not having finite possibilities but infinite reasoning. Traditional methods are flawed as proposed by Van Der Merwe and Thomson (2007), " the direct costing approach doesn't absorb any overhead or even fixed costs…resource consumption accounting or RCA makes no arbitrary assignments at all" (p. 29). A lean, effective method allows for a more detailed account of capacity costs and a basic approach to data collection. Modern times call modern values and thought processes with regard to business seamless behaviour across the production floor. The lean method maintains a " one-touch flow system" (Van Der Merwe & Thomson 2007, p. 29) for information diffusion across the life cycle. This one-touch flow system can be integrated with a supply chain easily and reflects this value added element as a method for better, honest accounting.

OPERATIONS MANAGEMENT

A most important factor for facilities management to recognize is the use of Total Quality Management (TQM) or a variation of TQM. TQM according to David Steingard is " a set of techniques and procedures used to reduce or eliminate variation from the production process or service delivery system in order to improve efficiency" (Steingard 2002, p. 2). TQM fits with the facilities management way of doing things as many of their functions require repetition or constant monitoring of daily, weekly and monthly items. Because this is a modernist concept and the modernist movement believed in certainty and static methods of looking at the world, there is not much room for the uncertainty that change creates in today's workplace using strictly TQM. Therefore either change in this environment must be controlled change or a variation of TQM must be used for the process to work and involve new technologies. Otherwise, TQM alone invents a work environment reminiscent of Franz Lang's *Metropolis* and dehumanizes the employee. A variation TQM can be used in facilities management to aid defining team member responsibilities as it sees the whole team as a " machine creates a system of interlocking parts each with clearly defined use, centralized authority and high degrees of worker discipline culminating with the goal of routinised, efficient and predictable system performance" (Steingard 2002, p. 2). Each team member plays a role in the functioning of the machine. Still much like today's business environment where change is constant, this system requires continued adjustment, modification improvement of function. TQM as way of defining a work process cannot operate entirely in today's global market because it succeeds at the expense of innovation and the growth of the employee. It also does not leave room to incorporate

change and new ways of improving functions. Still a memory of pure TQM feeds the “ modernist machine of consumer capitalism which encourages over-consumption, planned obsolescence, ecological damage and depletion of natural resources” (Steingard 2002, p. 4). This memory has also burdened management as the obsession for perfection, control, consistency, productivity and efficiency increases over time. In today’s facilities team, there must be a healthy medium to not only use past methods for increased productivity and efficiency but also to include modern tools and equipment to make the job easier.

In order to remain competitive, technology cannot be ignored, the systems it provides must be implemented in order for logistics to remain seamless and keep up with demand and customer expectation. For instance failure to embrace logistics and technology results in inventory costing a company more money to store than it is worth. McCullogh writes, “ Right now sitting around the globe is a bunch of inventory (worth an estimated) United States $1 trillion—United States $1 trillion of boxes of stuff is just sitting around a warehouse” (‘ Warning: Don’t Snub Logistics’, p. 1). This has the potential to represent about 60 percent of the average company’s working capital. This is capital in limbo that is not maximizing its investment potential.

A sign of successful shop floor operations is reliance on very little warehousing. In other words, warehousing is measured as the amount of days per month a product sits in the warehouse and if logistics is implemented effectively, this number will decrease and stabilize. The retail average storage of inventory is 26 days of investment not being utilized, profit being lost and daily expenses being incurred in an endless holding

pattern. In order to reduce the amount of days inventory sits means companies must create tighter relationships with suppliers via the web or perfect a system of communication between resources to cut out warehousing all together. Instead of inventory remaining stored because of wireless communication and data collection, the product can go straight from the supply source to the retailer's shelves via a distribution centre that acts much like mail sorting centre. This can work because technology enables a retailer to send data immediately to the supplier of products that are moving off the shelves with a click of a button. From this electronic message, the supplier knows what the retailer needs, what products are popular, how much and sends then instantly to the retailer's distribution centre. In organisations the size of Nestle or Wal-Mart, logistics strategy requires much forethought and planning, as there are many branches and divisions that are involved in the process. The idea is to reduce expenses and increase value to the organisation by making the company more productive and efficient. This needs to be done as seamlessly as possible to continue brand loyalty and customer relations while maintaining market share and competitive advantage. In many ways, implementation of this strategy creates a delicate balance.

In order to have better Business to Business or B2B relationships, one must understand the connection. Robert Thierauf and Hoctor (2003) explain, " B2B is about connecting shared businesses and information processes of the extended trading networks, planning, shipping and logistics, inventory management and customer retention to name a few" (Thierauf & Hoctor, p. 181). In other words, an optimized planning process can save millions dollars

and allow a multination corporation to carry out its objective and gain market share. This means applying advanced technology such as i2 used by Dell Computers and typical ERP vendors. In today's act of doing business, B2B exchanges are based on supply chain management or SCM technologies (Thierauf & Hoctor, 2003, p. 182). This will mean considerable investment in such technology but the benefit of market share will prove it to be a valued investment over the long-run (Burn & Hachney 2002; Scerbo 1999).

Running these centres effectively certainly poses a challenge of management. Manufacturers must develop new skills and confront channel conflicts with dealers, distributors and independent operators. Leaders in these positions must have an understanding of managing the conflicts in these channels. But well-managed distribution centres would more than justify the risks, as it would save the organisation a significant amount of overhead.

With operating expenses as the main cost, it is possible to make the distribution venture essentially self-funding. Facilities can be rented on short-term leases and surrendered if the location isn't successful within a year or two. The cost of goods and labour can be managed as volume grows. Companies should remember that a manufacturer's original warranty work usually accounts for about half of the labour expenses and for as much as 20 percent of the total value of services rendered, but these costs are typically charged back to the business unit rather than borne by the company's distribution. In markets poorly served by local dealers or other distributors, for instance, a centre should gear itself to its company's end users or consumers b