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The Management Accountant, is the most important and challenging profession in the world economy today, in terms of resource allocation, and controlling & measuring business performance. Its role has become more important now, than at any other time in our lifetime. The role of the Management Accountant in particular, has become more important, not only in the corporate level, but also at the national level, and even more importantly, at the international level.

Management Accountants are closely involved in supporting, planning, controlling, directing, communicating & coordinating the decision-making activities of organizations in the private sector, as well as the public sector. Managers of an organization are considered to be the Customers of the Management Accountant, so far as management accounting information is concerned, and Management Accountants should be continuously aware of the need to satisfy their requirements.

Some believe ' advisory services' and ' information services' to be the two main work areas of Management Accountants. ' Advisory services' include the tendering of opinions, assisting the making of evaluations or the formation of expectations, and the development of norms or objectives. ' Information services' include the provision of historical information, and future-oriented information. It has also been identified that Compliance, Control and Competitive support, are the three factors which influence management accounting work.

Over time, the relative emphasis on these three factors has changed.

Previously, a great deal of management accounting work was driven by the

need for Compliance and Control. But now, the emphasis on Compliance and Control is declining, while the emphasis on Competitive support is increasing. The greater need for Competitive support has risen due to increased competition, greater customer focus, globalization, and the importance of quality. At the same time, organizations have responded to the changing competitive environment with flatter organizational structures, which are more flexible, responsive & customer-focused.

The increased emphasis on Competitive support now requires management accountants to have strong Analytical and Communication skills.

Furthermore, they must now actively support the line & process managers, and be directly involved in the decision processes. They must also consider long-term as well as short-term planning horizons. They must develop management accounting systems capable of providing information which supports both strategic & operational decisions. Importantly, management accountants must become directly involved in the formulation, and the implementation of organizational strategies.

It has been established that the role of the management accountant in an organization is to support the information needs of management. The type, size, structure and form of ownership of the organization will influence the management role, and thus, determine the complexity of the management accountant's role. Such differences in size do not change the basic role of the management accountant, nor the basic work which he or she does.

However, the size of the organization may change the degree of formality or sophistication with which the function is carried out, or the level of resources

devoted to management accounting. But, the management accounting function remains essentially the same.

Relevant Cost and Irrelevant Cost for Decision-making

Relevance is one of the key characteristics of good management accounting information. This means that management accounting information produced for each manager must relate to the decisions which he/she will have to make.

‘ Relevant costs’ are the costs that meet this requirement of good management accounting information. The Chartered Institute of Management Accounting defines relevant costs as:

‘ The costs appropriate to a specific management decision’

This definition could be restated as ‘ the amount by which costs increase and benefits decrease as a direct result of a specific management decision’.

Relevant benefits are ‘ the amounts by which costs decrease and benefits increase as a direct result of a specific management decision.

Before the management of an enterprise can make an informed decision on any matter, they need to incorporate all of the relevant costs which apply to the specific decision at hand in their decision making process. To include any non-relevant costs or to exclude any relevant costs will result in management basing their decision on misleading information and ultimately to poor decisions being taken.

Relevant costs and benefits only deal with the quantitative aspects of decisions. The qualitative aspects of decisions are of equal importance to the quantitative and no decision should be made in practice without full consideration being given to both aspects.

Identifying relevant and irrelevant costs:

The identification of relevant and non-relevant costs in various decision-making situations is based primarily on common sense and the knowledge of the decision maker of the area in which the decision is being made. Armed with these two tools you should be able to sift through all the information that is available in respect of any decision and extract those costs (and benefits) which are appropriate to the decision at hand.

In identifying relevant costs for various decisions, it may find that some costs not included in the normal accounting records of an enterprise are relevant and some costs included in such records are non-relevant. It is important that there is a substantial difference between recorded accounting costs and relevant costs for decision making, and while the latter may be recorded in the former this is not always the case. Accounting records are used to record the incidence of actual costs and revenues as they arise. Decisions, on the other hand, are based only on the relevant costs and benefits appropriate to each decision while the decision is being made. This point is particularly appropriate when you come to examine opportunity costs and sunk costs that are dealt with below.

In practice, you may also find that the information presented in respect of a decision does not include all the relevant costs appropriate to the decision

but the identification of this omission is very difficult unless you are familiar with the area in which the decision is being made.

Exercise

The more common types of costs which you will meet when evaluating different decisions are incremental, non-incremental and spare capacity costs. Are these likely to be relevant or non-relevant?

Suggested Solution

Incremental costs: An incremental cost can be defined as a cost which is specifically incurred by following a course of action and which is avoidable if such action is not taken. Incremental costs are, by definition, relevant costs because they are directly affected by the decision (i. e. they will be incurred if the decision goes ahead and they will not be incurred if the decision is scrapped). For example, if an enterprise is deciding whether or not to accept a special order for its product, the extra variable costs (i. e. number of units in special order x variable cost per unit) which would be incurred in filling the order are an incremental cost because they would not be incurred if the special order were to be rejected.

Non-incremental costs: These are costs which will not be affected by the decision at hand. Non-incremental costs are non-relevant costs because they are not related to the decision at hand (i. e. non-incremental costs stay the same no matter what decision is taken). An example of non-incremental costs would be fixed costs which by their very nature should not be affected by decisions (at least in the short term). If, however, a decision gives rise to a specific increase in fixed costs then the increase in fixed costs would be an

incremental and, hence, relevant cost. For example, in a decision on whether to extend the factory floor area of an enterprise, the extra rent to be incurred would be a relevant cost for that decision.

Spare capacity costs: Because of the recent advancements in manufacturing technology most enterprises have greatly increased their efficiency and as a result are often operating at below full capacity. Operating with spare capacity can have a significant impact on the relevant costs for any short-term production decision the management of such an enterprise might have to make.

If spare capacity exists in an enterprise, some costs which are generally considered incremental may in fact be non-incremental and thus, non-relevant, in the short term. For example, if an enterprise is operating at less than full capacity then its work force is probably underutilized. If it is the policy of the enterprise to maintain the level of its work force in the short term, until activity increases, then the labour cost of this work force would be a non-relevant cost for a decision on whether to accept or reject a once-off special order. The labour cost is non-relevant because the wages will have to be paid whether the order is accepted or not. If the special order involved an element of overtime then the cost of such overtime would of course be a relevant cost (as it is an incremental cost) for the decision.

Two further types of costs that have to be considered are opportunity costs and sunk costs.

Opportunity costs: An opportunity cost is a level of profit or benefit foregone by the pursuit of a particular course of action. In other words, it is the value
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of an option, which cannot be taken as a result of following a different option. For example, if an enterprise has a quantity of raw material in stock which cost \$7 per kg and it plans to use this material in the filling of a special order then you would normally incorporate \$7 per kg as part of your cost calculations for filling the order. If, however, this quantity of material could be resold without further processing for \$8 per kg, then the opportunity cost of using this material in the special order is \$8 per kg; by filling the order you forego the \$8 per kg which was available for a straight sale of the material. Opportunity costs are, therefore, the 'real' economic costs of taking one course of action as opposed to another.

In the above decision-making situation it is the opportunity cost which is the relevant cost and, hence, the cost which should be incorporated into your cost-versus-benefit analysis. It is because the loss of the \$8 per kg is directly related to the filling of the order and the opportunity cost is greater than the book cost. Opportunity costs are relevant costs for a decision only when they exceed the costs of the same item in the option to the decision under consideration.

You may find the idea of opportunity costs difficult to grasp at first because they are notional costs, which may never be included in the books and records of an enterprise. They are, however, relevant in certain decision-making situation and you must bear in mind the fact that they exist when assessing any such situations.

Sunk costs: a sunk cost is a cost that has already been incurred and cannot be altered by any future decision. If sunk costs are not affected by a decision

then they must be non-relevant costs for decision-making purposes.

Common examples of sunk costs are market research costs and development expenditure incurred by enterprises in getting a product or service ready for sale. The final decision on whether to launch the product or service would regard these costs as 'sunk' (i. e. irrecoverable) and thus, not incorporate them into the launch decision.

Sunk costs are the opposite to opportunity costs in that they are not incorporated in the decision making process even though they have already been recorded in the books and records of the enterprise.

Exercise

(a) An enterprise is considering replacing its professional legal advisers with its own newly trained personnel. The relevant personnel are currently employed in the secretarial department of the enterprise and will receive no pay increase when taking up their new responsibilities. They will also be required to continue to perform their old duties. The current annual salary bill of these employees amounts to \$100, 000. Is the \$100, 000 a relevant cost in the decision on whether to replace the professional advisers?

(b) An enterprise is considering the upgrading of its computer system. The upgrading would result in the annual maintenance contract fee charged by the suppliers rising from \$30, 000 to \$40, 000.

Is the maintenance fee a relevant cost to the upgrading decision? Briefly explain your reasoning.

(c) The relevant cost of X in the filling of the special order is nil. The cost of the 200 kg of X in stock is a sunk cost and thus non-relevant. This is so due to the fact that no amount of the purchase price appears to be recoverable through either a straight sale of the material or by incorporating X in the manufacture of a product (other than the special order) which could then be sold by the enterprise.

Evaluating decisions involving relevant and non-relevant costs

It is observed that two tasks are to be performed before making final decision:

Evaluate the options in the decision on a monetary basis using cost versus benefit analysis.

Take account of the qualitative factors associated with each option in the decision.

The performance of the first task is dealt with in this section. Performance of the second task is influenced by experience and common sense.

Nearly all decisions ever made will involve some relevant and non-relevant costs. As stated earlier the hardest part of the evaluation process will be the identification of the relevant costs for the decision at hand. This identification is often required from a plethora of information that you will have to carefully sift through to ensure the completeness of your evaluation.

Once the relevant costs are identified for each option you simply perform a cost versus benefit analysis for each option and select the one that results in the greatest gain or least cost to the enterprise.

Don't forget that, in practice, qualitative factors can result in a different option being selected than that suggested by the quantitative evaluation.

Exercise

The local authority of a small town maintains a theatre and arts centre for the use of a local repertory company, other visiting groups and exhibitions. Management decisions are taken by a committee which meets regularly to review the accounts and plan the use of the facilities.

The theatre employs a full-time staff and a number of artists at costs of \$4,800 and \$17,600 per month respectively. They mount a new production every month for 20 performances. Other monthly expenditure of the theatre is as follows:

\$

Costumes

2,800

Scenery

1,650

Heat and light

5,150

Apportionment of administration costs of local authority

8,000

Casual staff

1, 760

Refreshments

1, 180

On average the theatre is half full for the performances of the repertory company. The capacity and seat prices in the theatre are:

200 seats at \$6 each

500 seats at \$4 each

300 seats at \$3 each

In addition, the theatre sells refreshments during the performances for \$3, 880 per month. Programme sales cover their costs but advertising in the programme generates \$3, 360.

The management committee has received proposals from a popular touring group to take over the theatre for one month (25 performances). The group is prepared to pay half of their ticket income for the booking. They expect to fill the theatre for 10 nights and achieve two-thirds full on the remaining 15 nights. The prices charged are 50 cents less than those normally applied in the theatre.

The local authority will pay for heat and light costs and will still honour the contracts of all artists and pay full-time employees who will sell refreshments

and programmes, etc. The committee does not expect any change in the level of refreshments or programme sales if they agree to this booking.

Note: The committee includes allocated costs when making profit calculations. They assume occupancy applies equally across all seat prices.

On financial grounds should the management committee agree to the approach from the touring group?

Suggested Solution

To make a decision on the use of the theatre for one month the committee would calculate the relevant cost or benefit of accepting the tour group's offer as opposed to continuing as is (i. e. with the repertory company).

Relevant benefits

Costs saved with touring group:

\$

– Costumes

2, 800

– Scenery

1, 650

– Casual staff

1, 760

Relevant benefits

6, 210

Relevant costs

Decrease in revenue with touring group:

Revenue with repertory company

$200 \times \$6$

1, 200

$500 \times \$4$

2, 000

$300 \times \$3$

900

4, 100

$\$4, 100 \times \frac{1}{2} \times 20$

41, 000

Revenue with touring company

$200 \times \$5. 5$

1, 100

$500 \times \$3. 5$

1, 750

300 x \$2. 5

750

3, 600

$(\$3, 600 \times 10) + (\$3, 600 \times 15 \times 2/3)$

= 72, 000

Half kept by touring company leaving,

36, 000

Relevant costs (41, 000 – 36, 000)

5, 000

Net relevant benefit (6, 210 – 5, 000)

1, 210

Therefore, the committee should accept the touring company's offer as it results in a net benefit to the theatre of \$1, 210 for that month.

Non-relevant costs were full time salaries, heat and light, apportionment of administration costs and refreshments. ' Re non-relevant benefits were refreshment sales and advertising revenue. All of the above were non-relevant because they were unaffected by the decision (i. e. they were the

same whether the repertory or the touring company occupied the theatre for the month).

The qualitative factors that might apply to this decision include:

The desirability of offering a range of activities in the theatre and thus to cater for a wider audience fulfils an important social role.

The opinions of the artists who are employed by the theatre should be consulted. They may welcome some months for rehearsal or personal development. But if this were regular, the more talented people who were in demand may seek opportunities elsewhere.

A different number of performances may have implications for predicted cost levels and the accuracy of the theatre occupancy predictions should be confirmed.

Exercise

Lombard Ltd. has been offered a contract for which there is available production capacity. The contract is for 20, 000 items, manufactured by an intricate assembly operation, to be produced and delivered in the next financial year at a price of \$80 each.

The specification is as follows:

Assembly labour 4 hours

Component X 4 units

Component Y 3 units

There would also be the need to hire equipment which would increase next year's fixed overheads by \$200, 000.

The assembly is a highly skilled operation and the work force is currently under-utilized. It is company policy to retain this work force on full pay in anticipation of high demand, in a few years time, for a new product currently being developed. In the meantime, all non-productive time (about 150, 000 hours per annum) is charged to fixed production overhead at a current rate of pay of \$5 per hour.

Component X is used in a number of other sub-assemblies produced by the company. It is readily available. A small stock is held and replenished regularly. Component Y was a special purchase in anticipation of an order which did not materialize. It is, therefore, surplus to requirements and the 100, 000 units which are in stock may have to be sold at a loss. An estimate of alternative values for components X and Y provided by the material planning department are:

X

Y

\$ per unit

\$ per unit

Book value

4

10

Replacement cost

5

11

Net realizable value

3

8

Overhead costs are applied on a labour hour basis. Variable overhead is \$2 per hour worked. Provisionally, fixed overheads, before the contract was envisaged, were budgeted next year at \$3, 560, 000 for productive direct labour hours of 1, 040, 000. There is sufficient time available to revise the budgeted overhead rate.

Analyze the information in order to advise Lombard Ltd. on the desirability of the contract and briefly explain your reasoning.

Suggested solution

Advice on the contract will be based on the relevant costs or incremental costs incurred for the contract using the values provided in the question.

\$ per unit

Labour: 4 hours x 0

0

Component X: 4 units x \$5

20

Component Y: 3 units x \$8

24

Variable overhead: 4 x \$2

8

Relevant cost per unit

52

Total relevant cost = $(\$52 \times 20,000) + \$200,000 = \$1,240,000$

Revenue = $\$80 \times 20,000 = \$1,600,000$

A surplus of revenue over costs of \$360,000 is revealed so the contract would appear to be attractive.

The recommendation is based on the following reasoning: Labour will be paid anyway as non-productive time so the incremental cost is zero. Component X will be replenished at the current replacement cost. Component Y is costed at its opportunity cost, that is, what could be obtained if sold at its disposable or realizable value. It is already in stock and has no alternative use. Variable overhead is incurred in relation to the direct labour hours

worked. The only incremental fixed overhead is \$200, 000. The remainder is common and unavoidable in all situations.

Advantages and disadvantages of Activity Base Costing

Advantages of an Activity Based Costing System:

- The first and most important advantage is the accuracy in the process of costing with regards to the product line, the end-users of the product, the stock-keeping units employed by the management and the channel and category which streamline the flow of the product from the producer to the end user.
- This system better assists in the process of understanding the concept of overhead costs i. e. the allocation of common business resources as they are used by specific product lines and their relation to specific cost driver.
- The system is easy to understand and interpret is it is accessible, useable and practically implement able across all norms of business set-ups.
- This process uses unitary cost, or marginal cost as the computation base in contrast to the traditional cost accounting methods which employ total cost.
- The system works exceptionally well will quality improvement and up gradation programs e. g. Six Sigma
- This system is particularly helpful in identifying and ear-marking some of the matters business activities which are a burden or stress on the business i. e. wasteful or non value adding services.

-The system also works exceptionally with performance management systems which are employed by most human resource departments in contemporary businesses.

-This process allows companies to implement costing strategies across another diagonal of the firm as business processes, supply chains and value addition channels are ably and optimally analyzed in this process.

-This system mimics the actual business process as the appropriation of common pool resources takes place in the same way as common resources are used in the business.

-This system aids in the process of benchmarking which is an integral part of the quality control system.

Disadvantages of an Activity Based Costing System:

-Data collection process for this system is very time consuming.

-The capital expenditure on the activity based system and its subsequent running costs can be a road block for firms.

-The system is very transparent which some managers would not approve of as they would like to keep some things out of the view of the owners of the company.

Technical Limitations:

The major technical limitation that will be faced is testing the hypothesis in the real world. Testing the hypothesis whether ABC is a more appropriate accounting solution is certainly possible on paper but its desirable effects in

the real world cannot be properly gauged unless it is directly implemented by companies operating in the world today and the analysis is conducted in a kinetic time mechanism. This is a major stumbling block for most organizations who are remain transfixed to their current accounting mechanism and don't want to change over to this new system, which despite its obvious benefits, seems to come a great switching or even multi-homing cost.