Complicating the situation further

Business, Management

The proposed solution will be useful to agricultural enterprises because it will enhance the level of efficiency in cost control. The organization presented in thecase studyproduces two commodities: corn and soybeans.

Additionally, the equipment used is shared between two parties. Complicating the situation further is that the ownership of the farm is distributed among several parties. Therefore the establishment of cost and profit centers is a must for correctly assessing the level of costs and earnings.

Currently the management focus is on production. However the management intent is to shift greater focus to implementing a managerial accounting system that will correctly allocate costs and assign the level of profits proportionally.

In thisrespect, implementation of activity based costing is the best solution inasmuch as it facilitates the identification of allocation criteria based upon which costs and profits can be assigned.

The advantage of using the managerial accounting system mentioned above is that the management can exercise its own discretion about how to allocate costs between different processes and commodities.

Unlike the financial statements prepared under the strict scrutiny of the GAAP, internal reports generated by the managerial accounting system mentioned above do not have to follow any hard and fast rules. As a result the management can customize the system to the specific characteristics of its own business.

This customizability is one of the most important features in favor of implementing an activity based costing system. The customizability enables the management not only to assign costs to different processes and commodities based upon resources consumed but also to enhance the level of process efficiency.

For example, the proposed solution for the organization in the case study enables John and Mary Farmer to allocate costs to the equipment based upon their level of usage in producing different commodities. As a result, the cost driver is this case is identified as the two commodities. The cost of production for each of the commodities is calculated accordingly.

The advantage from using this system is that the overhead is allocated in proportion to the level of resources expended in producing each commodity. This strengthens the quality of the cost structure. The result is that the management is in a much better position to measure performance and formulate strategies accordingly.

As illustrated in the case, John and Mary Farmer are going to have to collect a considerable level of information in order to implement an activity based costing system.

Therefore in conducting a cost benefit analysis of implementing the managerial accounting system, the cost of collecting the information will have to be taken into account. Additional costs will be incurred by the maintenance of the information system which will have to be supported by expensive hardware and software requirements.

These are some of the drawbacks that agricultural enterprises can run up against when implementing the proposed solution. However these drawbacks must be the weighed against the benefits of more cost-efficient strategy formulation.

Question 2

If the Farm Council Case did not use activity based costing, then it would not be in a position to correctly assess the cost of producing each commodity. As a result some costs would be overstated and some understated. This would distort profit comparisons between the two commodities. Consequently, any future investment decisions would be distorted as well.

The traditional cost allocation method would be particularly harmful in the Farm Council case because the resources being used belong to several different parties. For this reason it is particularly important for the management to use the activity based costing method in order to allocate costs based on the level of consumption.

Although the costs of implementing an advanced managerial accounting system would be high, the long term benefits of more effective strategy formulation outweigh the costs. Such would not be the case when implementing the traditional cost allocation method.

According to the traditional cost allocation method, product costs are calculated according to the number of units produced. As a result, this method does not take into account the level of resources expended in producing these units.

This cost distortion is particularly pronounced in the Farm Council Case because the same level of production for two different commodities necessitates different levels of resource consumption.

If John and Mary were to use the traditional cost allocation method, then these differences would not be taken into account and the unit costs that would be calculated would be incorrect. As a result, they would not be in a position to make decisions about which product line to invest in more.

Currently the focus at the farm was on production rather than on cost control. Therefore, the traditional cost allocation method seemed to satisfy the requirements. However there were massive pools of overhead that were being improperly assigned. These errors in the costing system would be perpetuated under the traditional cost allocation system.

The problem with the alternative solution was that the identification of resource drivers for support and production cost centers would be difficult. This would complicate the process of assigning costs.

The support cost centers in terms of equipment, shop & maintenance, and general farm would have to be defined in terms of the activities involved. Otherwise it would not be possible to assess the level of resources consumed by each of the cost centers. Therefore the unit costs for different commodities would not reflect the true expenditures and the management would be stuck with a costing system that would be misleading.

Commodities which consumed a lower level of resources would have unit costs overstated and vice versa. The reason why this would happen under

the alternative solution is that the costs would be divided equally between different cost centers based on production volume. As a result, the alternative solution is not recommended.

References

Atkinson, Anthony A., et al. (2006) Management Accounting. McGraw Hill/Irwin.