Strategic management in terms of cost accounting

Business

Consideration of the costs associated with specific activities in the private sector is a routine affair. Activities carried out in the public sector, particularly those relating to services, are quite another matter, though, for in that field cost accounting is still a little-used tool and there is little understanding of its function and potential benefits. As a general rule, social welfare policies have unleashed substantial public spending increases in most developed countries. Since such spending exceeds income, those countries' deficits are growing at an alarming rate. The constant expansion seen in public services in recent decades is the result of consumers' growing demand for more and better services.

Yet the paucity of public resources calls for an increasingly effective rationalization of the management of spending. And this is where cost accounting plays an important role, because it accurately identifies and analysis's costs, broken down by activity, can help an organization to: Achieve effective management control as a basic tool in the decision-making process; Ascertain in a transparent manner how effectively public resources are being used; Use rigorous procedures in order rationally to establish public rates and prices, thereby avoiding inaccuracies that result from arbitrary estimates; Indicate the variations that could occur in the execution of budgetary spending and evaluate the budgetary funds requested from, and justified before, the relevant Ministry of Finance; andFacilitate the submission of data to supranational organizations. Advantages of cost accountingsTraditionally, economic information is provided by general accounting activities. Yet this information is not sufficient to enable upper management to take certain decisions regarding the structure of the organization, an exercise that requires cost accounting. Its purpose is not to provide information on the organization's cash flows, but rather to analyse its productive processes by focusing on the organization's consumption (cost elements); units where consumption takes place (cost centres); its purpose (activities); and the relations between all of the above (distribution criteria).

For this reason, and given that cost accounting has no standardized methodology, there is a need for a conceptual model in which the centres and activities are sufficiently well defined in relation to the organization's information. Excessive aggregation may mean that the information supplied by the system is both irrelevant and of little interest to managers, while excessive breakdown is burdensome for the management systems which provide data for accounting. In some cases, this might indicate either the presence of information distorted by repetition of distribution criteria, or an infrastructure with a non-viable system. Benefits of a cost accounting systemManagers can derive two main types of information from a cost accounting system: Information on the cost of the organization's products; andInformation required for decision-making. Analysis of the first type of information shows that, in a context of increasing competition in services between public-sector and private-sector meteorological organizations, it is essential to identify the cost of the organization's products in order to: Recover the real cost of meteorological products from users; Establish the price that public or private entities should pay for agreed provision of services, such as: Services provided to aviation; Products supplied to the armed forces; Information provided to civil defence services; and Agreements with universities; andFrom the point of view of decision-making, for which information is scarcer, cost accounting provides information needed in order to take strategic decisions which influence an organization in both the short and the long term.

This includes the following aspects: Economic: for evaluating how much the organizational units of a centre cost. It is certainly of interest to management to identify each production centre's expenditure on the following: Staff: demand for staff on the part of unit heads may, in the absence of sufficient information, lead to such requests being considered unnecessarily. Comparing staffing costs between similar units and the products of those units issue also allows management and methods to be optimized; Overhead costs: it may be interesting to compare various units' expenditure; Depreciation: this idenitifies the degree of obsolescence of each centre's equipment and its level of mechanization;; Temporal aspects: the cost accounting software can, if the necessary information is entered, provide simulations of the cost of:; Implementing investment policies to automize production and reduce the workforce; Creating or cutting organizational units; orEstablishing, modifying or eliminating specific product lines, with analysis of the impact on the remaining products; andStructural aspects: as explained above, information obtained through cost accounting is not only economic in nature. An in-depth analysis of the production process requires that the criteria for cost distribution among the various parts of the model be properly structured. This analysis, once in place, provides information on the relations between the various areas of the organization and helps detect flows which hinder or hamper the productive process, leading in turn to increased spending. RequirementsImplementation of cost accounting requires the following: A sufficiently developed informational infrastructure; andA data model.

Experience of implementing management systems indicates that public organizations’ computer systems are geared primarily to providing information for: Financial accounting; and Budget execution. What activities are carried out and to what end. Since insufficient information is available, implementing a cost accounting system involves a profound change in the management methods and tools of the organization. It should be pointed out that the information necessary for the points mentioned above needs to be compatible with the relevant strategy. Developing a data model requires that the following be analysed: The structure of cost elements; The structure of cost centres; The structure of activities; Distribution criteria.

The structure of cost elements provides information on what the money is spent on, divided into staff, overheads and depreciation costs. This information is in some cases supplied by general accounting, but not in all, since costs are not always identified with expenditure. As regards the structure of cost centres, this identifies where goods, services and products are created. The chief difficulty lies in determining the level of breakdown needed by the organization. As a general rule, the structure is broken down into units which concentrate on particular activities and may not match the organic units of the broader organization. For example, it may be considered that administrative units can be grouped into one centre as they practice fundamentally the same activities, and that a unit which carries out computer development activities as well as general technical maintenance should be broken down into two.

The “ structure of activities” heading determines to what end expenditure is incurred. The activities are the organization’s raison d’être and should be product-led and not demand-led. For example, a general weather forecast is the same product whether issued to television or aviation, provided that no transformation occurs during the supply process. Lastly, distribution criteria are essential to the procedure in which costs are charged to the centres where they occur or per end activity. For example, distribution criteria for power consumption per cost centre could be the installed power system or the space occupied by the centre; and a distribution criterion for staff, comparing between activities, could be the amount of time spent per member of staff per activity.

DETERMINING HOW TO ALLOCATE COSTSThe first step in developing a cost-accounting system is to determine whether costs and revenue are assigned to the proper operating units. The chart of accounts should reflect current operations. If the chart of accounts does not match the organizational chart, then the accounting system needs to be revised. When the accounting system reflects current operations, the total cost of operating patient care departments can be determined. In cost accounting, when a cost can be traced directly to a department, the cost should be charged to that department and not allocated. Only costs that are common to more than one operating unit should be allocated.

For example, many healthcare organizations pool employee benefits and building and equipment depreciation. These pools then are allocated by statistics, or cost drivers, which are factors, such as square feet, hours of operation, or meals served, that can be used to distribute support costs to revenue departments. For example, the equitable distribution of employee benefit costs could use total cost center wage expense as its statistic, or cost driver. The specific cost driver wage expense divided by total wage expense results in the percentage of employee benefit costs allocated to a department. It is very important to use the appropriate cost driver for the cost being allocated. Selecting an inappropriate cost driver will result in poor cost allocation regardless of the method of allocation used.

The bases on which costs are allocated should relate to the amount of services provided to other departments and should result in equitable cost allocations. FOUR METHODS OF COST ALLOCATIONFour methods can be used to allocate service department costs to revenue departments: the direct method, the step-down method, the double-apportionment method, and the reciprocal methodHence, the success and speed of implementing a cost accounting system will depend on the developmental level of the management methods used, as well as on the level of computerization of the processes involved. It is therefore recommended that centres with low levels of development use simplified cost models with as few centres and activities as possible, reducing the number and use of distribution criteria. SourceCost accounting in meteorology: a pressing need? By Benito R. Mallol and Francisco Almonte Gregoria