

Definition of relevant costs and irrelevant costs such as future costs accounting...



Ref: A report submitted to Board of Directors on key roles of strategic management accountant, relevant and irrelevant costs and revenues term in strategic management accounting decision making and benefit and limitation of activity based costing.

EXECUTIVE SUMMARY

Jessup Ltd is a medium to large, a fast growing company in advertising and public relations. The company is run by four directors who are advertising experts. The purpose of this report is to addresses key roles of strategic management accountant, relevant and irrelevant costs and revenues term in strategic management accounting decision making and benefit and limitation of activity based costing.

In first part of the report has already highlighted the key roles of strategic management accountant roles. The strategic management accountant's roles are in economic market and transfer pricing. The strategic management accountants are in corporate government. This will explain how the strategic management accountant in performance measurement, practical and also strategic management accounting techniques.

Secondly, the term of relevant and irrelevant cost and revenues in decision making. Definition of relevant costs and irrelevant costs such as future costs, sunk costs and etc. The impact of relevant costs and revenues while organisation wish to improving making decision. The sunk costs effect while decision made related to risk. How to determine sunk costs and opportunity costs with will affect decision making. Reason of the organisation adopts

relevant costs and full costs in practice and also difficulty of relevant cost in practice.

Finally part of report mention about activity based costing. Definition of activity based costing, benefit of activity based costing and limitation of activity based costing in different prospective.

List of Table

Table 1: Management accounting techniques exhibiting strategy orientation (source: Cadez and Guilding (2008)) 9

Table 2: Strategic management accounting techniques usage means (sources: Guilding et al (2000) and Cinquini and Tenucci (2007) 19

Table 3: Definition of the Strategic Management Accounting Techniques (sources: Guilding et al (2000) and Cinquini and Tenucci (2007) 20

Table 4: ABC applications (sources: Innes, J; Mitchell, F and Sinclair, D (2000)) 22

Contents

EXECUTIVE SUMMARY 2

List of Table 3

Contents 4

1)STRATEGIC MANAGEMENT ACCOUNTANT 6

Introduction 6

Strategic Management Accountants Roles 6

Strategic Management Accountant Role in Market 7

Strategic Management Accountant Role in Transfer Pricing 7

Strategic Management Accountant Power in Strategy Management Process 7

Strategic Management Accountant and Corporate Governance 7

Strategic Management Accountants in Performance Measurement 8

Strategic Management Accounting Techniques 8

Strategic Management Accountant Roles in Practice 10

Conclusion 10

2)RELEVANT AND IRRELEVANT COSTS AND REVENUES 10

Introduction 10

Relevant Costs 11

Future Costs and Cash Costs 11

Incremental Costs 11

Opportunity Costs 11

Irrelevant Costs 11

Sunk Costs 11

Fixed Costs 12

Notional Costs 12

Impact of Relevant Costs and Revenue by Improve Decision Making 12

Sunk Costs Effect in Risky Decision Making 12

Sunk Costs and Opportunity Costs for Decision Making 13

Relevant Costs vs. Full Costs 14

Difficulty of Relevant Costs in Practices 14

Conclusion 14

3)ACTIVITY BASED COSTING 15

Introduction 15

Benefits 16

ABC approach for Cost Allocation 16

ABC approach in Performance Measurement 16

ABC approach in Customer Profitability 16

ABC approach in Budget 16

ABC approach in Decision Making 17

ABC approach in Project Costing 17

Problems 17

High Implement Cost 17

Problem in Data Collection 17

Misinterpreted and Misunderstanding for ABC Data 18

Uncertain Improvement and Benefit 18

ABC approach in Resource View 18

Conclusion 18

APPENDIX 19

REFERENCE 23

STRATEGIC MANAGEMENT ACCOUNTANT

Introduction

Strategic management accountant is an information provider for both financial and non financial and data custodian to achieve organization strategic objectives (Jack, L and Kholeif, A, 2008). Information provided by strategic management accountant should be relevant, reliable, comparable, understandable and materiality for manager in making decision.

Simmonds (1981) was the first article wrote about strategic management accounting, it explored the competitor appraisal base on accounting perspective, so it seen as a tool to gain competitive advantages and clarify strategy intent of organisation.

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

Strategic Management Accountants Roles

Shank and Govindarajan (1998) suggested that strategic management accounting as a framework for decision-making that may replace management accounting. Strategic management accounting is important in long term project; forecasting; planning and controlling. Strategic management accounting had several standards which include:

Extension of traditional management accounting by analysis not only internal factors (manager, employee and etc) but also external factors (competitors and etc) which related to business.

Emphasis on management accounting and relationship between strategic positions chosen by organization to achieve its goal and objective.

Enhance competitive advantages by reducing costs in extremely competitive markets to maximize the profit

Strategic management accountant uses a combination of conceptual and technical approaches as significant element during strategic planning process. In 2006, a study in UK concluded that the strategic issues such as cost-efficiency and quality will bring potential competitive advantages (Esa Puolamaki, 2006). Thus interactive usage of strategic management accountant aims to achieve goal congruence and mutual understanding among different functional areas in an organization. (Esa Puolamaki, 2006).

Strategic Management Accountant Role in Market

Strategic management accountants evaluate economic market condition and provide relevant information to manager in making strategic planning and

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

decisions. Strategic management accountant helps in reviewing new market threat and competitor that may influence organization growth.

Strategic Management Accountant Role in Transfer Pricing

Strategic management accountant analyses tax saving for different location of office. Example: main rate of corporation tax in UK for 2001 is 27% and for Malaysia is 25%. Thus, Jessup Ltd able to save 2% tax by applying transfers pricing technique.

Strategic Management Accountant Power in Strategy Management Process

Strategic management accountant plays vital role in strategy management process to achieve their goal (Chenhall, 2003). Kaplan and (2004) stated that in practice different organisations or manager in same organization have different way to establish and maintain alignment in operational level between strategy and management accounting due to different perspectives.

Strategic Management Accountant and Corporate Governance

According to Seal (2006), strategic management accountant can embed better corporate governance practices as compare to management accountant. CIMA had involved in concept of Enterprise Governance Framework that recognises tensions between governance and value creation; performance; conformance and roles of accountants.

CIMA also suggested to implement Enterprise Governance Framework include formation of strategy committee and development of strategic scorecard to balance strategic position, option, risk and implementation.

As mentioned by Guilding et al (2000), in practice non-executive directors are not interest to adopt strategic management accountant data due to unwilling to collect information by accounting officials.

Strategic Management Accountants in Performance Measurement

Survey done by Cadez and Guilding (2008) show organisation performance depends on the organization structure and context. This has been extended strategic management accounting usage is not associated with market orientation. Survey exhibits strategic decision making participation is not directly influence and related to performance.

According to Cadez and Guilding (2008); company size, prospector strategy, strategy decision making participation and deliberate strategy formulation are positive associated with strategic management accountant usage. In turn, strategic management accounting usages also positively influence performance.

Strategic Management Accounting Techniques

In literature, Guilding et al. (2000) drew 12 strategic management accounting techniques. In subsequent work, Cravens and Guilding (2001); Cadez and Guilding (2008) drew additional 4 strategic management accounting techniques. Those techniques had classified into 5 different categories such as (1) costing, (2) planning, control and performance

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

measurement, (3) strategic decision making (4) competitor accounting and (5) customer accounting” (Table 1).

Table 1: Management accounting techniques exhibiting strategy orientation (source: Cadez and Guilding (2008))

Strategic Management Accounting Technique Categories

Strategic Management Accounting Techniques

Strategy Costing

1. Attribute costing
2. Life-cycle costing
3. Quality costing
4. Target costing
5. Value chain costing

Strategy planning, control and performance measurement

1. Benchmarking
2. Integrated performance measurement

Strategy decision making

1. Strategy costing
2. Strategy pricing
3. Brand valuation

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

Competitor accounting

1. Competitor cost assessment
2. Competitive position monitoring
3. Competitor performance appraisal

Customer accounting

1. Customer profitability analysis
2. Lifetime customer profitability analysis
3. Valuation of customers as assets

* Brief description of strategic management accounting techniques are provided in Appendix (Table 3)

According to survey conducted by Guilding, C et al (2000), competitor accounting and strategic pricing are the most widely used strategic management accounting techniques. Cinquini and Tenucci (2007) found that attribute costing and customer accounting techniques are also popular strategic management accounting techniques. Please refer to the results in Table 2. Adoption of strategic management accounting techniques not seem be “ strategy-driven”.

In contrast, integrated performance measurement and life cycle costing are not frequently used techniques (Cinquini and Tenucci, 2007). The same study also discovered that there is no significant relationship between the techniques used and the industry or the size of an organization.

Strategic Management Accountant Roles in Practice

According to Dixon (1998), collection and use of information for competitive advantage can be achieved without implementing formal strategic management accounting techniques. The study concluded that there is only little evidence that strategic management accounting concept can be applied.

The cost to get the information via strategic management accounting technique might be higher than its benefit especially when the information is subjective, lacking in validity and not purely for competitive advantages (Dixon, 1998).

Management accountant may face difficulty in providing and identifying potential information due to the complicated strategic process (Granlund & Lukka, 1998a; Esa Puolamaki, 2006). In addition, consultants are more concerned about special areas such as activity base costing rather than strategic ideas on performing daily functions. (Esa Puolamaki, 2006).

Conclusion

Based on the above findings, there are four most widely used strategic management accounting techniques in practice. Thus it is highly recommended that the Jessup Ltd should look into these four areas of strategic management accounting practices.

Although the selection of the techniques is not affected by the industry, it is appropriate for Jessup Ltd to focus on customer accounting since Jessup Ltd

in a service industry. Therefore, Jessup Ltd can gain competitive advantages and achieve organization objectives.

RELEVANT AND IRRELEVANT COSTS AND REVENUES

Introduction

Relevant information used by manager to make a decision to achieve objectives and goals. Decision make involves a choice between various alternatives courses of action. In other words, manager should consider associated between relevant costs and revenues while making alternative choice.

Relevant information in decision making are relate to costs and revenue. Drury (2004, p. 37) defines relevant costs and revenue are future costs and revenue that will affect future decision. Nevertheless irrelevant costs and revenue are costs and revenue that will not changed by decision.

Relevant Costs

Future Costs and Cash Costs

Relevant costs are future costs and cash costs that are related to the decision made. It's a real cost in cash flow and not estimate costs in accounting. Relevant costs for long term decision are assumed to maximise shareholder wealth. Shareholder wealth will not affect in short term decision unless they increase net cash flows.

Incremental Costs

Incremental costs are avoidable costs and it direct impact on decision making. This cost can be eliminated and saved by choosing one alternative over another. Incremental costs and revenue have similar principle to economist's concept of marginal costs and revenue.

The only different between these two concepts is marginal costs/revenue show additional costs/revenue of single extra output. Incremental costs/revenue show additional cost/revenue of group single extra units of output.

Opportunity Costs

Opportunity costs are relevant costs not consist only of future cash flow. It presents the best alternative or the benefit forgone by not accepting another when allocation limited resources. This decision is making by ranking alternative according to their contribution per unit of the resources.

Irrelevant Costs

Sunk Costs

Historical costs are not relevant to decision making but used as a basis to predict future costs. According to Jay (2004), sunk costs are irrelevant to decision due to such costs had been incurred in the past and unavoidable. The original costs of the assets are irrelevant costs. However changes in resale or written down values resulting from the used of assets are relevant costs of using the assets.

Fixed Costs

Fixed costs are irrelevant for decision because it is cash outflow that incurred anyway. Fixed costs such as office rental exist because the contracts had been entered into by organization. Moreover uncontrollable costs at operation level like design costs are fixed costs and irrelevant to decision.

Notional Costs

CIMA terminology defined notional costs is support or estimate costs that take into account. Depreciation is notional costs which represent a benefit in account. Therefore it's not actual expenses incurred and will not influence cash flow.

Impact of Relevant Costs and Revenue by Improve Decision Making

As mentioned by Dirks (1994), management information system has potential to improve decision making and estimate future cash flow. This improvement will cause changes in relevant costs and revenue. However those costs and revenue are too high inventory, expensive capacity and low delivery performance.

Sunk Costs Effect in Risky Decision Making

Analysis of decision making under risk is so call prospect theory. Prospect theory implies that previous investments are not totally discounted is known as sunk costs effect. Kahneman and Tversky (1979); Zeelenbery and Van Dijk (1997), suggested sunk costs results in risk seeking behavior.

This had been extended by Zeelenbery and Van Dijk (1997); sunk costs also result in risk avoiding behavior. Thus Decision making are influence by the mind of people and also on gain and loss but not on the calculation.

Sunk Costs and Opportunity Costs for Decision Making

Example: Jessup Ltd has taken out a lease on a property for a down payment of £20, 000. Additionally, the rent under the lease amount to £10, 000 per annum. Initial payment of £20, 000 is forfeit if lease is cancel. Jessup Ltd plans to use the property as new branch and has estimated operation for the next twelve months as follows:

£

£

Sales

150, 000. 00

wages and wage related costs

15, 000. 00

rent including the down payment

30, 000. 00

Operating expenses

17, 000. 00

General administrative expenses

5, 000. 00

67, 000. 00

Net profit before tax

83, 000. 00

There is no provision has been made for the costs. Jessup Ltd is considering whether to continue with this plan because they can sublet the property for a monthly rent of £2, 000 if they not use the property.

In this case, down payment of £20, 000 is a sunk cost and must exclude from calculation. £4, 000 p. a. ((£2, 000 x 12 month) – £2, 000) is opportunity costs from subletting the property.

£

Net sales

150, 000. 00

Costs (67, 000 – 20, 000 sunk costs)

47, 000. 00

103, 000. 00

Less: opportunity costs from subletting

4, 000. 00

Profit

99, 000. 00

The above calculation indicated that £16, 000 (£99, 000 – £83, 000) additional profits will be obtained from using the property.

Relevant Costs vs. Full Costs

Cooper and Kaplan (1988, 1992) and Kaplan et al. (1990) argue that when making decision, full cost should be used. This is supported by Drury et al (1993), full cost information is more flexible and used frequently with incremental costs analysis.

Drury and Tales (1995) summaries the reasons of widespread use of full cost as below:

price provided are reasonable due to all costs had been covered

obtain more accurate measure of profitability

indication of long term incremental and avoidable costs

Difficulty of Relevant Costs in Practices

Corbey (1994) concluded relevant costs for decision making is not widespread in practice because lack of providing relevant cost information. This has been extended manager will used irrelevant costs for decision if relevant costs are partially missing.

This is support by Paul and Weaver (2002) relevant costs for decision are difficult to separate into fixed and variable. Furthermore incremental decision may affect support costs in long term but no impact in short term.

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

Conclusion

Normally fixed costs are irrelevant costs but it might be a relevant costs. In case, fixed costs are avoidable or may affect decision it will be relevant costs. Direct material can either be relevant or irrelevant. If material have an alternative use value or resale value it will be relevant costs. Otherwise, direct material cost is irrelevant because it remain the same but not a sunk costs since will be incurred in future.

Consequently, it is suggest Jessup Ltd must identify the objective and goal of the organization before decision is made. Thus decision maker able to identify relevant costs and revenue that may affect decision and choosing a better action before replace by another one.

ACTIVITY BASED COSTING

Introduction

Activity based costing (ABC) is developing to implemented as an alternative and rectifies weaknesses of traditional cost (TC). ABC show more consistent and accurate cost of operations in organization than TC.

ABC allocates indirect costs to costs centre based on individual activities rather than departments. The major different between ABC and TC is overhead costs allocation. ABC allocates overhead costs to many different types of volume-based and non volume-based.

Benefits

Borjesson (1994) and Andrade et al (1999) presents ABC can play a major role in planning and controlling in cost reduction. This is supported and

extended by Innes et al (2000), besides costs reduction other major benefit of ABC are better cost control, product cost/profitability information, performance measurement, customer profitability analysis and decision making information (please refer table 4 in appendix).

ABC approach for Cost Allocation

ABC is cost pools with relevant cost drivers. It enhanced control of overhead costs because overhead costs are traced directly to activities. Thus cost units are allocating to individual activities rather than total costs. Therefore ABC has clear and better understanding for overhead costs. ABC also enables processes, supply chain and values streams cost. Consequently, ABC mirrors the way of work in wastage and non-value added activities.

ABC approach in Performance Measurement

Performance measurement used to measure organisation goal, provide feedback on performance and predict future performance. Therefore ABC is an important source to support organization performance and scorecards where activity costs provide important point for target setting.

ABC approach in Customer Profitability

ABC measure on goals set related to customer profitability too. Its might be difficult to include these goals in absence of ABC. However it helps correspond the insights of the profit and drive action by responsible managers. Thus it has greater understanding of customer profitability.

ABC approach in Budget

In addition, ABC support preparation of budgets and long term plan. Plan must be consistent with assumption that goal achievement and resource concentration. Face-based scenario developments are supported by ABC with predictive capability combine with forecasting and other analytic techniques. As a result, accountant can contribute to more on organization future rather than report on past.

ABC approach in Decision Making

ABC help manger to understand and control costs in their area due to proper allocate of overhead costs. Moreover, it helps to improve accuracy and utility values of management information. Manager able to make better decision in both tactical and strategic level base on accurate information provided.

ABC approach in Project Costing

Raz and Elnathan (1998) survey find that ABC is better approach to project costing. This is because ABC focuses on activities of the entire project and identifies various levels of activities which related to deliverables of the project.

Another, ABC support cost estimation of new project or ongoing project control of project execution in term of costs, performance evaluation and team member responsible on various activities.

Problems

According to Innes et al (2000), proportion of the organisations adopted ABC has remained significantly higher among larger companies and those from

the finance sector between 1994 and 1999. Same survey show percentage of current adopter had been fallen and there is no growth over 5 year period.

High Implement Cost

The major problem organisation not adopt ABC is costs to implement, use and maintain are exceed its benefits then the result. In addition, managers are familiar with traditional costing to runs their operation and evaluate performance. According to Walley et al (1994), its human nature with comfortable life; so managers might not interest and support to adopt ABC.

Problem in Data Collection

Furthermore ABC is difficult to arise during its use. This is because the various activities that may appear and time consuming for data collection. There is a problem in identifying cost drivers because need to explore to different department manger. In other words, lack of relevance and suitable to the respondents' business.

Misinterpreted and Misunderstanding for ABC Data

ABC data collection can be easily misinterpreted and misunderstanding. Cost allocates to products and customer might be irrelevant costs. Therefore manager must careful and identify relevant costs when make a decision by using ABC data.

Uncertain Improvement and Benefit

According to findings of Shields (1995), there is no evidence show that the involvement of accountants in ABC has a beneficial effect. Walley et al

(1994) concluded there is not necessarily have long-term improvement in collection of the basic information by adopt ABC.

ABC approach in Resource View

Manager need to balance both demand for resources and supply in order to assess potential profitability which related to operational changes. However ABC approach only provides resource demand view and traditional costs only provide resources supply view.

According to Salafatinos (1996) ABC fails to inform manager of the future economic effects of proposed decision. This is because there is no method able to reconciling both resources demands view and resources supply view that provide by different costing method.

Conclusion

Jessup Ltd is in services industry that are more concern on customer accounting. It is suggested Jessup Ltd to adopt ABC even though implement and maintenance costs is high. Research done by Andrade et al (1999) support activities suggests itself as means of evaluating the application of ABC in cost deduction.

As mentioned by Innes et al (2000), adopted ABC has remained in large companies from 1994 to 1999. Innes et al (2000) concluded ABC is useful in historical and predictive cost measurement, resources and capacity planning, performance measurement. As a result Jessup Ltd able to gain competitive advantages due to better costs control.

APPENDIX

Table 2: Strategic management accounting techniques usage means
(sources: Guilding et al (2000) and Cinquini and Tenucci (2007))

Strategic Management Accounting (SMA) Techniques

Full sample (Guilding, 2000)

No of respondents (Cinquini and Tenucci, 2007)

Attribute costing

2. 33

90

Life-cycle costing

2. 60

79

Quality costing

3. 22

87

Target costing

3. 12

82

Value chain costing

3. 04

84

Integrated performance measurement

*

83

Strategy costing

3. 49

85

Strategy pricing

4. 54

86

Competitor cost assessment

4. 07

86

Competitive position monitoring

4. 99

87

Competitor performance appraisal

4. 42

85

Customer accounting

*

89

* there is no result and respond base on survey conducted

Table 3: Definition of the Strategic Management Accounting Techniques
(sources: Guilding et al (2000) and Cinquini and Tenucci (2007))

SMA Techniques

Definitions

Attribute costing

Costing of specific product attributes that appeal to customers. Attributes that may be costed include: reliability, assurance of supply and after sales services

Competitive position monitoring

The analysis of competitor positions within the industry by assessing and monitoring trends in competitor sales, market value, volume, unit costs and return on sales. This information can provide a basis for the assessment of competitor's market strategy.

Competitor cost assessment

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

The provision of regularly scheduled update estimate of a competitor' unit cost such as: direct observation, common suppliers or customers or competitors ex-employees.

Competitor performance appraisal based on published financial statement

The numerical analysis of a competitor's published financial statements (balance sheets) as a part of an assessment of a competitor's key sources of competitive advantage.

Customer accounting

Analysis directed to appraise profit, sales or costs deriving from customers or customer segments.

Integrated performance measurement systems

A measurement system which focuses typically on acquiring performance knowledge based on customer requirements and frequently encompasses non -financial measures. These measures imply the monitoring of factors for the attainment of customer satisfaction and competitive advantages.

Life cycle costing

The appraisal of costs along all the stages of a product or service's life. In general these stages may include design, introduction, growth, decline and eventually abandonment.

Quality costing

Identification and control of the costs associated with the creation, identification, repair and prevention of defects. The target is to direct management attention to prioritise quality (in a broader sense also safety and environment) problems.

Strategic costing

The use of cost data based strategic and marketing information to develop and identify superior strategies that will produce a sustainable competitive advantage.

Strategic pricing

The analysis of strategic factors in the pricing decision process. These factors may include: competitor price reaction, elasticity, market growth, economies of scale and experience.

Target costing

A method used during product and process design that involves estimating a cost calculated by subtracting a desired profit margin from an estimated (or market based) price to arrive at a desired production, engineering or marketing cost. The product is then designed to meet that costs.

Value chain costing

An activity-based approach where costs are allocated to activities required to design, procure, produce, market, distribute and service a product/service

along the entire industry value chain. It embraces the consideration of the linkages with suppliers and customers to attain higher efficiency.

Table 4: ABC applications (sources: Innes, J; Mitchell, F and Sinclair, D (2000))

Purpose

Adopters

Number

Number

Year 1999

Year 1994

Cost reduction

28

66

Product/service pricing

25

51

Performance measurement/improvement

23

<https://assignbuster.com/definition-of-relevant-costs-and-irrelevant-costs-such-as-future-costs-accounting-essay/>

45

Cost modeling

20

46

Budgeting

17

42

Customer profitability analysis

16

38

Output decisions

16

35

New product/service design

13

26

Stock valuation

5

16

Othe