

# ACCY 403: Managerial Accounting

## Review Part II

### Chapter 11 ... ABC

It is argued that traditional cost systems lead to inaccurate product costs. The traditional cost drivers DM, DL and MacHrs do not adequately represent all the forces that drive costs in a modern organization. ABC is supposed to produce more accurate costs by using multiple drivers over and above the traditional ones. Setups, number of orders, number of design changes etc. are all used as cost drivers, costs of activities are estimated and products are costed based on the activities required to produce them.

Usually low-volume products tend to have higher ABC costs than they do under traditional systems while ABC tends to report lower costs for high volume products than is the case under absorption costing. Since the high volume products use most of the cost drivers used as allocation bases under traditional costing systems, this should not be so surprising.

ABC does map closely into resource consumption patterns. However it is complex, time-consuming and costly. Also if there are changes in the production process, ABC systems may have to completely re-specified since cost-drivers will have changed.

Also ABC measures only the costs of products, not the benefits so to the extent that some products may deliberately be used as loss-leaders, or confer benefits on other products by creating brand-awareness, ABC distorts the "true economic contribution" of the product. Also ABC is hard to combine with standard costing.

In sum, ABC is useful for decision making but not decision control.

### Ch 12 & 13 ... Standard Costing

Standard costing is the classic control tool. It sets out standard or expected costs for each category and then after the fact, one compares actuals to budgets to identify "variances". You need to be able to compute price and efficiency variances for DM and DL and spending, efficiency and volume variances for OH. The other important topic is the incentive effects of standard costing.

$PV = AQ \times (SP - AP)$  ( $PV > 0$  is favorable)

$EV = SP \times (SQ - AQ)$  ( $EV > 0$  is favorable)

$OH_{Spending}V = \text{Actual Expenditure} - \text{flexible budget for actual hours used}$

$OH_{Efficiency}V = \text{flexible budget for actual hours used} - \text{flexible budget for standard hours for actual output.}$

$VoIV = \text{flexible budget for standard hours for actual output} - \text{flexible budget for standard hours for budgeted output.}$

Using standard costs to control managerial behavior leads to incentives to beat standards by cutting corners that affect other operations, to accumulate inventories (more production leads to a bigger flexible budget), to discourage cooperation and to trying to beat standards rather than beat the competition. However holding people throughout the organization responsible for a key set of variances may also promote mutual monitoring and cooperation.

#### Ch 14 ... JIT TQM and all that ...

In a market economy, good organizations produce value by being the efficient producer in the market for their goods and services. Organizational well-functioning requires information, coordination and incentives. Business strategy, competitive conditions and organization architecture play a key role in determining how well an organization uses its resources.

In recent times accounting systems have been unable to provide information managers need in a highly unstable and competitive environment so a number of techniques have been developed to support managerial decision-making in highly changing contexts. The key is to focus on organizational productivity. One way to improve productivity is to reduce errors and so TQM was developed as way to ensure quality. This leads to a focus on finding activities that are essential to ensuring quality and eliminating unnecessary and redundant operations. Moreover by tracking cost of rework and servicing one tries to find out how much waste is going on (under the assumption that rework should never have been needed).

Finally JIT has enjoyed quite a bit of popularity in the recent past and we should understand how JIT computes product costs. Basically there is no WIP account, there is only a FGI account. The rule is to debit material when the job is done, debit all other costs as incurred. Since FGI under JIT is small, the fact that material costs do not hit FGI even though production may have been started is not usually material, so this highly simplified or "backflush" costing systems is acceptable under JIT.

**Overall, the focus of management accounting in turbulent environments is to understand and explain the firm's cost systems to managers so that both the coordination and control functions are facilitated. The cost accountant must understand the strengths and weaknesses of each tool and be able to help managers decide when and for what purpose which tool is the best. There are no perfect answers in management accounting, all one can hope for is to address the ever-changing information needs of control and coordination activities that managers must perform.**