15.963 Managerial Accounting and Control

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Wrap-up

- Management accounting provides information for a firm’s internal users. The information can be customized to meet the user’s needs.
- This information is used for decision making and control.
- Control is necessary because of agency problems, whereby the self-interests of individual employees diverge from the interests of the firm.
- Control becomes more important in larger, more decentralized firms.
Wrap-up

- Decentralized organizations have to partition decision rights.
- If agency problems were non-existent, decision rights would be based on the locus of knowledge:
  - where the knowledge resides in the organization would entirely determine how decision rights are partitioned.
  - This would increase the quality and timeliness of decision making.
- For control, however, it may be necessary to detach knowledge and decision rights.
- A choice with regard to this matter will depend on the relative importance of decision making vs. control.
Wrap-up

• This choice will depend on the context: the user, the time, the internal environment and the external or competitive environment.

• Once decision rights have been partitioned, it becomes important to evaluate performance (for control).

• Performance measures should be determined by desired behavior, which in turn should be determined by the firm’s goal.

• Rewards motivate performance. Do not reward “A while hoping for B” (Kerr, case packet).
Wrap-up

• Good controls will mitigate, but never eliminate, agency problems.
• Controls are costly. Ensure that their benefits outweigh their costs.
• Different performance measurement systems will distort behaviors under different circumstances. No system is perfect. Remember the cost/benefit tradeoff.
• If subjective information is solicited for decision making, and the provider suspects that it may potentially be used for control, this information will not be unbiased. Beware.
Wrap-up

• This problem is pervasive. It arises during budgeting, when determining standards, and in myriad other circumstances.

• The controllability principle suggests that a valid performance measure is one that is sensitive to the employee’s effort / actions.

• Non-insulating performance measurement and reward mechanisms introduce uncontrollability, but are useful for risk sharing and mutual monitoring.
Wrap-up

• Cost behavior can be variable, fixed or some combination thereof.
• Cost assignment is either direct or indirect.
• The fundamental problem in costing is assignment (or allocation) of indirect or common costs.
• A costing system describes how indirect costs are allocated.
• Since refining costing systems is costly, there is some residual and inescapable arbitrariness in product costing. Beware when using allocated costs in decision making and control.
Wrap-up

• ALL costs are variable in the long run. Therefore, fully-allocated costs should be used for long-run decisions.

• Fixed costs are unavoidable in the short run. For short-run decisions such as accepting / rejecting one-time special orders, only variable costs should be considered.

• The contribution margin is the difference between selling price and variable costs. Contribution margin analysis is appropriate for short run decisions.
Wrap-up

• Operating leverage is the sensitivity of the bottom line (operating income) to changes in the top line (sales).
• Firms with high fixed costs and low unit variable costs have high operating leverage.
• Firms with high fixed cost structures are more vulnerable during economic downturns.
• Firms with high fixed cost structures can also be more aggressive in short run price wars.
Wrap-up

• If fixed indirect costs are allocated based on volume measures that vary with market conditions, changes in the reported unit product cost are not necessarily indicators of changes in efficiency. **Beware** of unit product costs.

• **Be aware** of the cost of excess capacity that is discretionary or avoidable. Non-discretionary excess capacity is:
  – inherent in the production process;
  – required by a customer; or
  – optimal in the sense of minimizing total cost (tradeoff between fixed and variable costs).
Wrap-up

• Beware of the death spiral, and other costing problems, when excess capacity is charged to products.
• A cost is sunk if it is irrecoverable at a given point regardless of the decision made at that point.
  – Sunk costs are irrelevant, except for the guy who sunk them.
  – i.e., sunk costs are irrelevant for decision making, but not for control.
• Despite some arbitrariness in indirect cost allocation, it is required for a variety of purposes.
• Activity-based costing systems are more refined but more costly.
A more refined costing system, such as ABC, is likely to be of value:

– When overhead costs are a large proportion of total costs;
– When multiple products are produced, and they place asymmetric demand on resources, e.g., when there are
  • commodity and specialized products, or
  • Low volume and high volume products;
– When competitive and profit pressures are intense;
– When the product market is mature, with low prospects for innovation or differentiation;
Wrap-up

- The theory of constraints (TOC) suggests that, in the presence of binding constraints (bottlenecks), it is optimal to maximize throughput per unit of the constrained resource.
- TOC is a short run decision rule, since all constraints can be relaxed in the long run.
- In decentralized organizations, transfer prices between business units can promote
  - goal congruence,
  - mutual monitoring, and
  - proper resource allocation (i.e., mitigate under- or over-consumption).
- Transfer prices also help preserve subunit autonomy, are useful in measuring subunit performance, and are important for tax purposes in international settings.
• A budget is a formal and quantitative expression of future plans.

• Budgets are important for transferring knowledge both horizontally and vertically throughout the firm.

• Since this knowledge is used to coordinate plans for the future, the budget forms an internal contract or commitment.

• To induce commitment to the plans, budgets are also used for performance evaluation at the end of the period.

• This in turn induces a bias in the transferred knowledge that forms the basis of the budget.
Wrap-up

• When deviations from budgets, or variances, are used for control, it becomes important to understand the reasons for the variances.

• Variance analysis decomposes the static budget variance into progressively finer components.

• The controllability principle suggests that it is important to insulate downstream units from variances occurring upstream. This is one control feature of standard costing systems.

• Isolating and separately recording variances as soon as they occur facilitates timely control.
• The balanced scorecard broadens the managerial perspective and links specific actions to goals.
• However, the balanced scorecard can be confusing / distracting if it does not specify the tradeoffs between the various performance measures.
• Not specifying the tradeoffs between the multiple measures could also lead to value-consuming, instead of value-addsing, behavior.
Mgmt. Acct and Control

• Best of Luck!