15.963 Management Accounting and Control
Spring 2007

15.963 Managerial Accounting and Control

Spring 2007

Prof. Mozaffar Khan

MIT Sloan School of Management

Wrap-up

- **Management accounting provides information for a firm's <u>internal</u> users. The information can be customized to meet the user's needs.**
- **This information is used for <u>decision making</u> and <u>control</u>.**
- **Control is necessary because of <u>agency problems</u>, 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 <u>decision rights</u>.**
- **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 <u>evaluate</u> performance (for control).**
- **Performance measures should be determined by desired behavior, which in turn should be determined by the firm's goal.**
- **<u>Rewards</u> motivate performance. Do not reward "A while hoping for B" (Kerr, case packet).**

Wrap-up

- **Good controls will mitigate, but <u>never eliminate</u>, agency problems.**
- **Controls are costly. <u>Ensure that their benefits outweigh their costs</u>.**
- **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. <u>Beware</u>.**

Wrap-up

- **This problem is pervasive. It arises during budgeting, when determining standards, and in myriad other circumstances.**
- **The <u>controllability principle</u> suggests that a valid performance measure is one that is sensitive to the employee's effort / actions.**
- **<u>Non-insulating</u> performance measurement and reward mechanisms introduce uncontrollability, but are useful for <u>risk sharing</u> and <u>mutual monitoring</u>.**

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. <u>Beware</u> of unit product costs.**
- **<u>Be aware</u> 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 <u>death spiral</u>, and other costing problems, when excess capacity is charged to products.**
- **A <u>cost is sunk</u> 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.**
  - **<u>i.e., sunk costs are irrelevant for decision making</u>, <u>but not for control</u>.**
- **Despite some arbitrariness in indirect <u>cost allocation</u>, it is <u>required</u> 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-adding, behavior.**

Mgmt. Acct and Control

- Best of Luck!