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MANAGEMENT ACCOUNTING | BASIC

Video Transcription: Management Accounting: The Control Function

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Good day my name is Jacqui. One of the functions of a management accountant is to implement and exercise control. This is the process of putting procedures in place to make sure that a company's activities conform to its plan, and that the company's objectives are met.

In this video we will look at the control function within the Management Accounting discipline, and why it is necessary. We will also look at the different tools that a business manager can use to implement control. These tools include performance evaluation measures, transfer pricing, and variance analysis using either budgets or standards costing.

Let us first look at why controls are necessary. Think of a company such as Vodacom. Vodacom is an African mobile communications company providing voice, messaging, data and converged services to around 60 million customers. Vodacom has 7 225 employees and thousands of stores and provides business services to customers in over 40 African countries.

Do you think the board of directors know of and authorise every single decision made in the company? Definitely not. It would be physically impossible for them to do this. Often a company of this size will have a decentralised organisational structure, which allows senior management to delegate authority for decision-making to lower levels of management. In such an organisational structure, the organisation is often split into divisions, in accordance with the products that are made, or it can be done according to geographical areas.

In a decentralised organisation, managers of divisions become autonomous, which means they can make important decisions affecting their divisions. This process frees up the time of the board of directors to focus on the overall strategy of the business and ensure sustainable success.

The decentralised organisational structure results in an agency relationship where the lower levels of management acts as an agent of the board of directors. Lower management can make decisions without first informing senior management.

As a result, the board of directors lose control over those activities to some extent. To ensure that lower management act according to the board of directors' instructions, certain controls are put in place. When it comes to controls we must realise that we are dealing with human beings who behave in a certain way. A key component of any control system, therefore, is understanding human behaviour.

Let us look at the various financial control measures that the Board of Directors can use. These are performance evaluation measures, transfer pricing, and variance analysis using budgets or standards costing.

Performance measures that are often used include Net Profit, Return on Investment (RoI), Residual income (RI) and EVA. Divisional managers will tend to behave in a way that benefits themselves the most, which is where their performance bonus is the largest. So the measures have to be carefully designed to get management to behave in a way that is both in the best interest of the company and provides a fair performance bonus. If it is not done correctly management can make decisions that harm the company but still give them a great performance bonus. A further complication is where the divisions interact with each other by transacting in some way. In other words, one division sells a product to another division.

Consider the following scenario: Assume the company has a head office (representing senior management) and two divisions (Division S and Division R). Division S supplies a component to Division R who uses the component as an input in its production process, the products of which is sold to the external market. The component is known as an intermediate product and the product produced by Division R is known as the final product.

The transaction will be a cost item to the receiving division (division R) and a revenue item to the supplying division (Division S). So, it affects the financial performance of both divisions. If the managers' performance bonuses are based on a profit measure, the managers will be motivated to make decisions that enhance their own division's profits.

Remember that the decision-making authority for this transaction has been delegated to the divisional managers. This means they can make decisions regarding this transaction without consulting head office (senior management). In fact head office will most likely only find out about what happened at the end of the reporting period. These decisions may be in the best interest of the divisional manager but not be in the best interest of the company, as a whole.

This is where transfer pricing comes in. A transfer price is a control measure put in place to ensure that divisional managers act in the company's best interest. The primary objective of transfer pricing is that is ensure that a company maximises the profit of the company as a whole rather than just the division's profit. Other objectives are to aid performance evaluation and to ensure divisional autonomy. If we need to determine the best transfer price between the two divisions, the question we ask ourselves is, "Will the transfer price get divisional managers to act in the best interest of the company?" We need to understand how divisional managers will behave.

Another commonly used control tool is variance analysis. A company prepares a budget at the beginning of a reporting period, and compares the actual financial results at the end of the reporting period to this budget. The difference between the actual results and the planned budget is known as the total variance. The variance is an indicator of a deviation from original plans and can therefore be investigated to determine what caused this. This variance can also be used to determine the performance of a division and of the person responsible for the variance. The total variance can be further analysed by using standard costing principles to see if the deviation is as a result of a change in the price of the input or in the quantity used.

Finally, since control measures are often used in determining the performance of a company, division or manager, and impacts on the remuneration and bonuses paid out, it is important to be fair and only evaluate aspects that can actually be controlled. To assist in this, costs and revenues are classified according to the principle of controllability.

Remember that the control function involves putting measures in place to ensure that the objectives of a business are met. It becomes more necessary as decision-making authority is delegated. An important consideration in the design of these measures is how they affect the behaviour of employees and achieve the objectives of the business. The tools mentioned in this video are performance evaluation, transfer pricing and variance analysis using budgets or standard costing.

I hope this video has helped you, thank you very much for watching.