Case Study

What Constitutes Management Accounting Information

You are the Costco executive who has been chosen to decide whether or not the company should continue its policy of sourcing its finest coffee from Rwanda.

What constitutes management accounting information is growing considerably as organisations must take decisions that include the global consequences of their actions, as well as the impact on an increasingly large number of vocal, well-informed, and powerful stakeholders. Stakeholders include the company's customers, suppliers, employees, regulators, politicians, lawmakers and local community members. Generally, management accounting information can be financial in nature, such as sales revenue or cost of sales, or nonfinancial in nature, such as the number of quality defects or the percentage of manufacturing plants that are inspected for compliance with human rights policies. One of the most exciting and yet daunting aspects of management accounting is that one can choose to measure anything, assuming the resources, information technology, and creativity exist to capture the desired performance measure.

As a Costco executive, one of the first nonfinancial factors you likely would consider measuring is the quality of the Rwandan coffee to ensure that it fulfils Costco's strategic goal of creating a competitive advantage by providing premium coffee to customers. Quality could be defined by the bean's taste, shelf life longevity, or other factors valued by customers. Other important nonfinancial performance measures might include the time required to ship the harvested beans from Rwanda to Costco stores around North America and the presence of a local farming workforce in Rwanda critical to successfully sustaining a long-term supply chain between Rwandan fields and Costco customers.

One of the most important financial items to measure would be the importance to Costco's customers of purchasing premium quality coffee, which could be measured by the additional price they are willing to pay for Rwandan coffee over and above more average quality coffee. Other financial measures might include the cost of harvesting, inspecting, and shipping beans, as well as investments in Rwandan farming communities (e.g., physical infrastructure and schools) that ensure the relationship is sustainable for future generations.

Finally, you should consider how the decision to continue sourcing premium coffee from Rwanda will be perceived by Costco's important stakeholders, including its customers who buy the coffee, suppliers who provide the coffee beans, and government officials in the United States and Rwanda who set trading policies between the two countries. Accurately measuring issues like stakeholder perceptions of such decisions can be difficult because the management accountant often times must invent new measures, figure out where the data to create such measures might come from, and estimate how accurate these measures will be once collected.

The management accountant's ability to inform executive decision makers by providing innovative, accurate, and timely performance measures can create an important competitive advantage for the organisation by improving its key decisions.

Question

a. What types of information should you consider as you decide how best to structure and analyze this important long-term strategic decision?

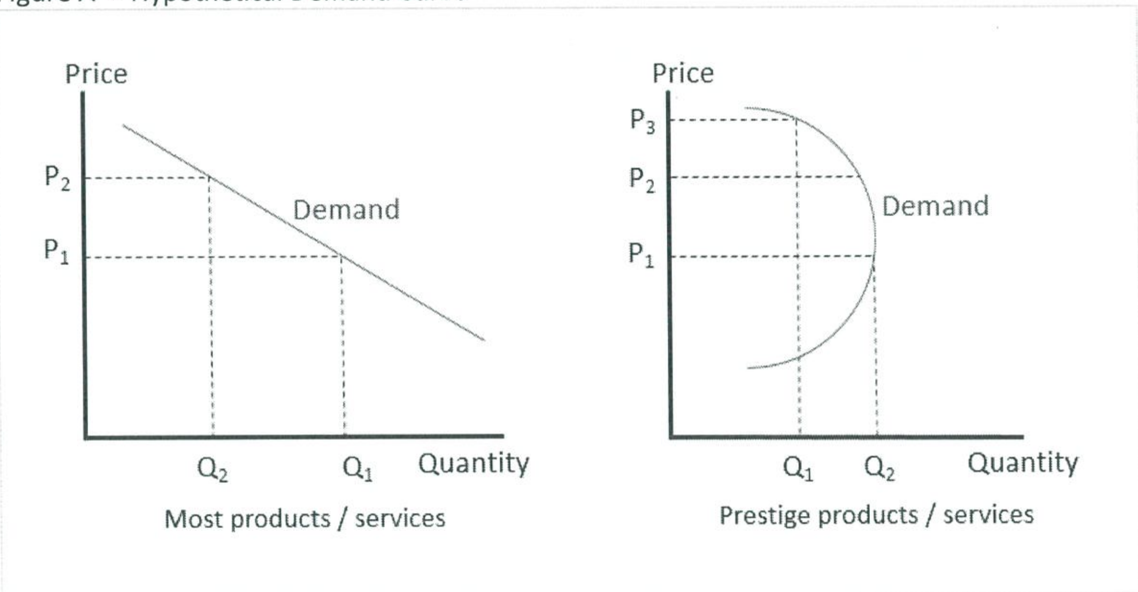
b. What challenges do you expect to face in making this decision?

Source: Mowen et. al. (2014) Cornerstone of Managerial Accounting, 5th Edition, International Edition, South-Western Cengage-Learning.

Each price a company can charge leads to a different level of demand. The demand curve illustrate the relationship between price charged and the resulting demand. It shows the number of units the market will buy in a given period at different prices that might be charged. In the normal case, demand and price are inversely related; that is, the higher the price, the lower the demand (Figure A). Thus, the company would sell less if it raised its price P_1 to P_2. Consumers with limited budget usually buy less of something if the price is too high.

Most demand curves slope downward in either a straight or a curved line. But for prestige goods, the demand curve slope sometimes slopes upward. For example, a luxury hotel may find that by raising its price, it sells more room rather than fewer: Consumers do not perceive it as a luxury hotel at the lower price. However, if the hotel charges too high a price P_3, the level of demand will be lower than at P_2.

Figure A - Hypothetical Demand Curve



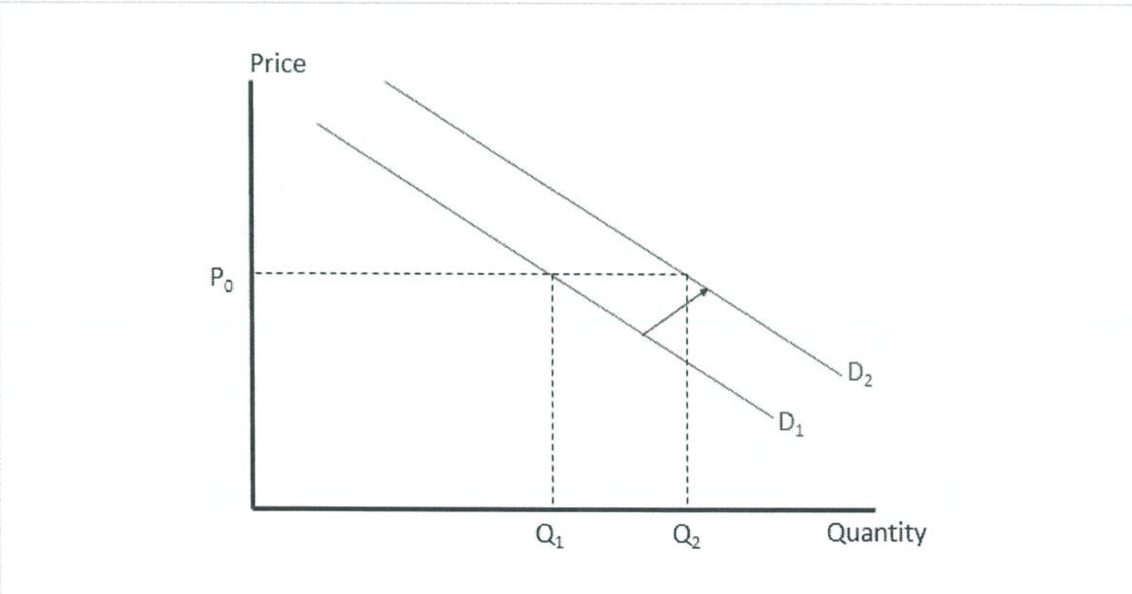
Most company managers understand the basics of a demand curve, but few are able to measure their demand curves. The type of market determines the type of demand curve. In a monopoly, the demand curve shows the total market demand resulting from different prices. But if the company faces competition, its demand at different prices will depend on whether competitors' prices remain constant or change with the company's own prices.

Estimating demand curves requires forecasting demand at different prices. For example, a study by the Economic Intelligence Unit (EIU) estimated the demand curve for holiday travel in Europe. Its findings suggested that a 20% reduction in the price of visiting a holiday destination increases demand by 35%, whereas a 5% decrease results in a 15% increase demand. The EIU study used vacation destinations in the Mediterranean and assumed that other variables were constant.

Researchers develop models that assume other variables remain constant. For managers, it is not that simple. In normal business situations, other factors affect demand along with price. These factors include competition, the economy, advertising, and sales effort. If a resort cut it price, and then advertised, it would be hard to tell what portion of the increased demand came from the price decrease and what portion came from the advertising. Price cannot be isolated from other factors.

Economists show the impact of non-price factors on demand through shifts in the demand curve rather than movement along it. Suppose that the initial demand curve is D_1 (Figure B), the seller is charging P and selling Q_1. Now suppose that the economy suddenly improves or the seller doubles in advertising budget. Higher demand is reflected through an upward shift of the demand curve from D_1 to D_2. Without changing the price, P, the demand has increased.

Figure B - Shifts of the demand curve



A monopoly exists when there is only one firm in the industry. But whether an industry can be classed as a monopoly is not always clear. It depends on how narrowly the industry is defined. For example, a textile company may have a monopoly on certain types of fabric, but it does not have a monopoly on fabrics in general. The consumer can buy fabrics other than those supplied by the company. A rail company may have a monopoly over rail services between two cities, but it does not have a monopoly over public transport between two cities. People can travel by coach or air. They could also use private transport. When you went to an adventure playground as a child, your parents may have refused to buy you an ice cream, because they were too expensive. The ice cream seller had a local monopoly, but it was obviously not the only seller of ice creams in the country.

To some extent, the boundaries of an industry are arbitrary. What is more important for a firm is the amount of monopoly power it has, and that depends on the closeness of substitutes produced by rival industries. The Post Office in the UK, before 2006, had a monopoly over the delivery of letters, but it faces competition in communications from telephone, faxes, and e-mail.

Barriers to Entry

For a firm to maintain its monopoly position, there must be barriers to the entry of new firms. Barriers must be high enough to block the entry of new firms.

Economies of scale

If the monopolist's costs go on falling significantly up to the output that satisfies the whole market, the industry may not be able to support more than one producer. This case is known as natural monopoly. It is particularly likely if the market is small. For example, two bus companies might find it unprofitable to serve the same route, each running with perhaps only half-full buses, whereas one company with a monopoly of the routes could make a profit. Electricity transmission via a national grid is another example of a natural monopoly.

Even if a market could support more than one firm, a new entrant is unlikely to be able to start up on a very large scale. Thus the monopolist, which is already experiencing economies of scale, can charge a price below the cost of the new entrant and drive it out of business. If, however, the new entrant is a firm already established in another industry, it may be able to survive this competition.

Economies of scope

A firm that produces a range of products is also likely to experience a lower average cost of production. For example, a large pharmaceutical company producing a range of drugs and toiletries can use shared research, marketing, storage and transport facilities across its range of products. These lower costs make it difficult for a new single-product entrant to the market, since the large firm will be able to undercut its price and drive it out of the market.

Product differentiation and brand loyalty

If a firm produces a clearly differentiated product, where consumer associates the product with the brand, it will be very difficult for a new firm to break into that market. Rank Xerox invented, and patented, the plain paper photocopier. After this legal monopoly (see below) ran out, people still associated photocopier with Rank Xerox. It was not unusual to hear someone say they are going to "Xerox the article" or, for that matter, "Hoover their carpet". Other examples of strong brand image include Guinness, Kellogg's Cornflakes, Coca-Cola, Nescafé and Sellotape.

Lower costs for an established firm

An established monopoly is likely to have developed specialised production and marketing skills. It is more likely to be aware of the most efficient techniques and the most reliable and/or cheapest suppliers. It is likely to have access to cheaper finance and is thus operating on a lower cost curve. New firms would therefore find it hard to compete and would be likely to lose any price war.

Ownership of, or control, key input or outlets

If a firms governs the supply of vial inputs (say by owning the sole supplier of some component part, through "backward vertical integration"), it can deny access to those input to potential rivals. On a world scale, the de Beers company has a monopoly in fine diamonds because all diamond producers market their diamonds through de Beers.

Similarly, if a firm control the outlets through which the product must be sold, (through "forward vertical integration"), it can prevent potential rivals from gaining access to consumers. For example, Birds Eye Wall's used to supply freezers free to shops on the condition that they stocked only Wall's ice cream in them.

Legal protection

The firm's monopoly position may be protected by patents on essential processes, by copyright, by various forms of licensing (allowing, say, only one firm to operate in a particular area) and by tariffs (i.e., custom duties) and other trade restrictions to keep out foreign competitors. Examples of monopolies protected by patents include most new medicines developed by pharmaceutical companies (e.g., anti-AIDS drugs), Microsoft's Windows operating systems and agro-chemical companies, such as Monsanto, with various genetically modified plant varieties and pesticides.

Mergers and takeovers

The monopolist can put in a takeover bid for any new entrants. The sheer threat of takeovers may encourage new entrants.

Retained profits

An established firm is likely to have some retained profits behind it. If a new firm enters the market, the established firm could reduce prices and thus start a price war, or start a massive advertising campaign, knowing that it could sustain losses until the new entrant leaves the market. The threat of this can act as a barrier to entry. Alternatively, a firm could begin aggressive advertising.

Source: Sloman & Jones (2011) Economics and the Business Environment, Third Edition, Prentice Hall.

The success of an individual business depends not only its own particular market and its own particular decisions. It also depends on the whole macroeconomic environment in which it operates.

If the economy is booming, then individual businesses are likely to be more profitable than if the economy is in recession. It is thus important for businesses to understand the forces that affect the whole business climate.

One of these forces is the level of confidence, both consumers and business. If business confidence is high, then firms are likely to invest. Similarly, if consumer confidence is high, spending in the shops is likely to be high and this will increase business profitability. The result will be economic growth. If however, people are predicting a recession, firms will hold off investing and consumer spending may well decline. This could tip the economy into recession. Various forces will affect the performance of the economy.

Another key ingredient of the macroeconomic environment is government policy and the actions of the central bank (e.g., the Bank of England, in the UK). If the government raises taxes or the central bank raises interest rates this could impact directly on business profitability and on business confidence. This refers to as domestic macroeconomic policies.

Next, international trade plays a role in the international macroeconomic environment. It indicates how countries and firms can gain from trade and why. Despite this, governments sometimes choose to restrict trade.

The flows of finance across international exchanges indicate how exchange rates are determined and how changes in exchanges rates affect business.

Last but not least, governments worldwide attempts to coordinate their macroeconomic policies.

Source: Sloman, J. and Jones, E. (2011) Economics and The Business Environment, Third Edition, Prentice Hall, p.267

Whatever the aims of firms, if they are to be successful in pursuing them, they must take account of the environment in which they operates. That is, the market conditions that firms faces in their particular industry.

Most firms are not price takers; they can choose the prices they charge. But in doing so, they must take account of the reactions of their rivals. We look at pricing and output decisions and see how firm's aims affect these decisions.

However, it is not just in terms of pricing and output decisions that firms must take account of rivals. They must also do so in planning out their longer-term strategy – in making decisions about developing and launching new products, how quickly and how much to expand, the methods of production to use, their supply chain, the balance of what should be produced in-house and what should be 'outsourced', i.e., bought in from other firms, their sources of finance, and whether to target international markets or to confine themselves to producing and selling domestically.

Source: Sloman & Jones (2011) Economics and the Business Environment, Third Edition, Prentice Hall.