Contemporary management accounting practices in UK manufacturing

By

David Dugdale, University of Bristol
Colwyn Jones, University of West of England
Steve Green, Home Group Limited
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1. Overview
Prevailing wisdom in management accounting research suggests that absorption-costing methods are widespread in manufacturing companies. However, some of our previous investigations revealed a number of companies using contribution margin methods of internal reporting. Now our findings from a document-based interviewing study of 41 manufacturing companies show that there is a rich diversity of contemporary UK reporting practices, that are constrained neither by the financial accounting requirements of SSAP9, nor by any sense of general management accounting trends. Instead, Financial Directors choose from a toolkit of ‘traditional’ and ‘innovatory’ practices in constructing reporting systems appropriate to their varied commercial needs. Within this diversity there is a strong leaning towards contribution margin approaches. These diverse reporting practices cover a wide range of management accounting techniques in relation to contribution, margin, profit, variances, budgets and forecasts.

2. Objectives
The project had three specific objectives:
• To investigate whether internal management accounting policies and reporting are currently dominated by the requirements of financial reporting.
• To establish the nature of innovatory forms of management information and begin to explore where and why they have been introduced.
• To disseminate innovative practice in management accounting.

3. Methods
We devised a document-based interviewing method for the study. This required a disclosure of each company’s Profit and Loss Account format currently in use in their internal reporting system followed by telephone interviews, usually with Financial Directors/Controllers. From the taped interviews, summaries were made for each company and supplied to the respondents for verification.

This method has a number of research advantages. Firstly, the information presented is more likely to be faithful to reporting practice in participating companies than undocumented verbal descriptions. Secondly, companies often use terms such as gross profit, gross margin and contribution margin rather loosely so it is not always obvious what techniques are actually in use. The P&L format gives a good guide to actual usage and meaning. Third, the combination of documentary evidence and interviews helps to avoid the imposition of researchers’ meanings and aids the discovery of those intended by practitioners. Fourthly, where interesting accounting methods are adopted in companies, these can be pursued and set out in greater depth.
A disadvantage of document-based interviewing is the commitment required from firms and only about 9% of companies contacted were willing to participate in the study. Thus, validity is achieved at the expense of representativeness but, in our view, the results strongly justify this trade-off. A second disadvantage is the labour intensive nature of the research method; it involves transcribing interviews, summarising the transcripts and analysing the mass of qualitative data that results. This was a factor in limiting the number of companies interviewed to 41.

4. Findings

4.1 Costing techniques

The study reveals that virtually all the techniques developed since the late nineteenth century, and evident in the historical literature, are still in use today. There are examples of 'traditional' techniques such as absorption costing, standard costing and marginal costing as well as 'contemporary' techniques such as activity-based costing and throughput accounting. New techniques are often marketed by denigrating existing methods, identifying them as 'problems' before unveiling new techniques as the 'solution'. For example, standard costing was once hailed as more effective and much less expensive than the 'job-order cost plans' of the early twentieth century. Direct costing was sold as simpler and more informative than absorption costing. Activity-based costing promised to be more accurate and to avoid the misleading signals of traditional costing methods. However, 'old' methods have not died: they are still taught, examined and used.

4.2 Prevalence of contribution statements in internal financial reporting

In the report participating companies are broadly categorised as 'contribution companies' or 'gross margin companies'. This was not easy because of ubiquitous references within companies to 'gross profit', 'gross margin' and 'manufacturing margin' applied to P&L lines that textbooks would refer to as 'contribution margin'. However we conclude that 28 (approximately 68%) of the survey companies employ contribution statements. All these companies treat material cost as variable and 21 companies (75%) treat labour as a variable cost. Other 'variable' costs appear less frequently: variable production overhead in 12 companies; transport/distribution costs in 7 companies and variable selling costs in 3 companies.

4.3 Prevalence of standard costing but limited variance analysis

Most (29) of the 41 companies employ standard costs and, of those that do not, 8 have only limited manufacturing operations or are engaged in contract work. Therefore only 4 companies (less than 10%) do not employ standard costing where this might be expected. All (29) 'standard costing companies' set standards for materials, most (26) set standards for labour and about two-thirds (20) set overhead recovery rates. However, standard cost variances often do not appear as part of P&L information. Over half of these 'standard cost companies' base P&L reports on actual costs; some 'add back' variances while others frequently update material standards so that they approximate actual costs.

Although not necessarily appearing in the P&L most of these companies calculate some material and labour variances for control purposes. Overhead variances are less prevalent and only one company reports subdivisions of both variable and fixed overhead variances. No company subdivides the fixed overhead volume variance into capacity and efficiency elements. Variance reporting is therefore very selective.

4.4 Inter-relationships between financial presentation and costing systems

Financial reporting presentation and costing methods are inter-related and most of the 28 'contribution companies' make a P&L adjustment for 'overhead in stock' that allows 'bottom line' profit or loss to be reported on a full cost basis. Surprisingly, 11 of these 'contribution companies' establish 'full' standard costs in order to value stock consistent with financial reporting requirements. In these companies a contribution orientation is loosely coupled with a full standard cost system. In 'gross margin' companies systems are usually more tightly coupled: 7 companies adopt a gross margin approach and, consistently, adopt full standard costing.

Contribution companies can trace variable costs to products or product groups and, in some companies, this analysis provides the starting point for further analysis of segment profitability, attributing overhead to products, markets or distribution channels. This is reminiscent of activity-based ideas and several companies had experience of activity-based costing, usually intended to establish more accurate product costs. However, although one-off ABC exercises had provided some valuable insights, none of the survey companies were currently using the technique.
4.5 Choice of financial reporting and costing systems

Senior managers could influence the choice of policy and it was clear that, in some companies, the finance director or financial controller had sufficient influence to determine the choice of system. The choices of these managers were influenced by their experiences and two senior managers ensured that conservative (marginal) methods were employed for stock valuation. Financial controllers tended to prefer marginal methods because of their simplicity and utility. In several companies parent company policies could be very important either directly or through their influence on technology choice; several companies had harmonised their systems with the wider group and/or planned to update their MRP systems. The nationality of the parent company could also be a factor and, for example, we noted some similarity in the reporting adopted by companies under Gallic ownership.

4.6 Budgeting and forecasting

All but one of the companies sets budgets and reports budget variances and most companies make regular forecasts. Most forecasts are for the financial year, typically referred to as, for example, ‘3+9’ or ‘6+6’ forecasts. The concentration on financial year reporting reveals the influence of external pressures and, at one company, current and previous year results are compared: “…because that’s the way the stock market seems to work”. One company is exceptional in developing its forecasts to include the remainder of the current financial year and the whole of the following year.

This development, including innovative graphical presentations, is set out in detail in the Appendix on the CD-ROM supplied with the main publication.

4.7 Incentive schemes

Most of the companies operate either executive or staff incentive schemes and 13 operate both.

The executive schemes have a heavy reliance on financial performance measures and over half of the companies (10 from 18) use profit versus budget or target in their schemes. The most important non-financial item in these schemes is ‘personal performance’.

The staff schemes also rely heavily on financial measures. Although non-financial measures such as on-time delivery, customer feedback and quality are occasionally employed, relatively few companies use these measures.

About half of all incentive schemes are based on a single performance measure. The remainder use combinations of measures and, in a few schemes, there are as many as four measures in combination. Although financial measures are prevalent these are not particularly sophisticated, only three of the executive schemes use return on capital employed and none use residual income or its more modern version, economic value added.

4.8 The ‘relevance lost’ debate

A loud critique of management accounting over the last 20 or so years is that it has lost its managerial relevance through subservience to the requirements of external financial accounting. If so, in the UK, this would mean that SSAP 9 acts as a strong constraint on internal financial reporting. This survey undermines this view. Instead, we find a wide range of practices that are constructed in response to the particular commercial circumstances of individual companies and not imposed by an external financial accounting regime. Thus there are very varied practices in UK manufacturing companies. The survey companies employ:

- marginal costing and contribution ideas
- standard costing but often combined with reports based on actual costs
- variance analysis but limited use of overhead variances
- segmental reporting
- budgeting, forecasting and incentive schemes.

Companies have a wide range of options in order to ensure that their systems are ‘relevant’ and the majority of the survey companies had opted for direct or marginal costing.

The number of companies employing contribution methods and, to a greater or lesser extent, marginal costing, suggests that manufacturing companies in general are not dominated by the (full cost) requirements of financial reporting standards. However, matters are not quite this simple. We note that the bottom line profit or loss in most companies is reported in accordance with SSAP 9 and although, technically, it is easy to report both marginal and full cost profit or loss, only one company does this. Additionally, companies employ cycles of budgeting and forecasting that are clearly influenced by external financial reporting requirements. We conclude that, in many companies, financial reporting does not lead to the inappropriate use of full product costs. However, internal financial reporting is often influenced by external reporting cycles and managers are conscious of the need to meet external expectations.
5. Conclusions and recommendations

There is considerable interest in contribution analysis in the companies studied. Although there has been a widespread presumption that absorption costing systems dominate manufacturing practice, this study reveals that companies often follow long-standing academic advice in structuring their internal Profit and Loss reporting on contribution lines. However, the analysis is sometimes not very systematic - for example, only one company derives both marginal and full-cost profit on a month-to-month basis.

**Recommendation 1**: that, if contribution presentations are adopted internally, these should be designed systematically and the presentation of both absorption cost and marginal cost profits should be considered. This need not involve an excessively onerous calculation.

Manufacturing companies usually employ standard costing systems. However, they tend to be selective in their use of variance analysis and especially reticent in their use of overhead variances. Analysis of fixed overhead variances was very limited. These practices may reflect the widespread criticism that the (mis)use of variance analysis has received, especially in JIT and TQM environments.

**Recommendation 2**: that the value and, possibly unfortunate, consequences, of variances be carefully assessed before they are used.

**Recommendation 3**: in view of the limited use of overhead variances the syllabus weighting of this topic be reviewed by professional accounting bodies.

Interviewees were generally very conscious of the arguments for and against the apportionment and allocation of overhead to cost objects such as divisions, responsibility centres, products and services. However, some companies employed quite sophisticated segmental profitability analysis based on the thoughtful attribution of overhead. This was especially so in contribution companies because the contribution line provides a sound starting point for such analysis.

**Recommendation 4**: that companies adopting contribution style presentations can add value to the presentation by identifying levels of contribution. Contribution calculated after variable costs and after sales and marketing costs by market, distribution channel or customer can be especially valuable for some companies.

There is extensive use of budgeting, forecasting and incentive schemes but the methods adopted are, typically, relatively unsophisticated. For example, most companies make forecasts only to the end of the financial year and employ a very limited range of performance criteria in their incentive schemes.

**Recommendation 5**: that, where practicable, forecasting systems be extended so that a rolling twelve forecast is routinely available.

**Recommendation 6**: that graphical presentations of performance and forecasts of performance might be more widely adopted.

**Recommendation 7**: that research into the impact of incentive schemes, especially the use of a wider range and sophistication of performance measures would be worthwhile.

Details of all the Profit and Loss formats together with summaries of the practices employed by each company are available on the CD-ROM that accompanies the Elsevier-CIMA book based on this project.
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