

# Management Accounting

## Responsibility Accounting

### Responsibility Accounting- Concept

- It is used to measure performance of divisions of an organisation rather than organisation as a whole.
- Responsibility Accounting is a system of control where responsibility is assigned for the control of costs. The persons are made responsible for the control of costs.
- Proper authority is given to the persons so that they are able to keep up their performance. In case the performance is not according to the predetermined standards then the persons who are assigned this duty will be personally responsible for it. In responsibility accounting the emphasis is on men rather than on systems.
- Responsibility Accounting collects and reports planned and actual accounting information about the inputs and outputs of responsibility centres”
- Responsibility Accounting must be designed to suit the existing structure of the organization.
- Responsibility should be coupled with authority. An organization structure with clear assignment of authorities and responsibilities should exist for the successful functioning of the responsibility accounting system. The performance of each manager is evaluated in terms of such factors.

### Responsibility Accounting- Meaning & Definition

- Responsibility accounting is a system of management accounting under which accountability is established according to the responsibility delegated to various levels of management and a management information and reporting system instituted to give adequate feedback in terms of the delegated responsibility.
- Under this system, divisions or units of an organisation under a specific authority in a person are developed as responsibility centres & evaluated individually for their performance.
- **Horngreen:** defines “Responsibility accounting is a system of accounting that recognizes various responsibility centres throughout the organisation and reflects the plans and actions of each of these centres by assigning particular revenues and costs to the one having the pertinent responsibility. It is also called profitability accounting and activity accounting”. According to this definition, the organisation is divided into various responsibility centres and each centre is responsible for its costs. The performance of each responsibility centre is regularly measured.
- **Institute of Cost and Works Accountants of India** defines Responsibility accounting as “a system of management accounting under which accountability is established according to the responsibility delegated to various levels of management and a management information and reporting system instituted to give adequate feedback in terms of the delegated responsibility. Under this system divisions or units of an organisation under a specified authority in a person are developed as responsibility centres and evaluated individually for their performance.”

## **Essential Features of Responsibility Accounting**

### **1. Inputs and Outputs or Costs and Revenues:**

- The implementation and maintenance of responsibility accounting system is based upon information relating to inputs and outputs.
- The physical resources utilized in an organisation such as quantity of raw material used and labour hours consumed, are termed as inputs. These inputs expressed in the monetary terms are known as costs.
- Similarly, outputs expressed in monetary terms are called revenues.
- Thus, responsibility accounting is based on cost and revenue information.

### **2. Planned and Actual Information or Use of Budgeting:**

- Effective responsibility accounting requires both planned and actual financial information.
- It is not only the historical cost and revenue data but also the planned future data which is essential for the implementation of responsibility accounting system.
- It is through budgets that responsibility for implementing the plans is communicated to each level of management.
- The use of fixed budgets, flexible budgets and profit planning are all incorporated into one overall system of responsibility accounting.

### **3. Identification of Responsibility Centres:**

- The whole concept of responsibility accounting is focused around identification of responsibility centres.
- The responsibility centres represent the sphere of authority or decision points in an organisation.

In a small firm, one individual or a small group of individuals, who are usually the owners may possibly manage or control the entire organisation.

- However, for effective control, a large firm is, usually, divided into meaningful segments, departments or divisions. These sub- units or divisions of organisation are called responsibility centres.
- A responsibility centre is under the control of an individual who is responsible for the control of activities of that sub-unit of the organisation.
- This responsibility centre may be a very small sub-unit of the organisation, as an individual could be made responsible for one machine used in manufacturing operations, or it may be very big division of the organisation, such as a divisional manager could be responsible for achieving a certain level of profit from the division and investment under his control.
- However, the general guideline is that “the unit of the organisation should be separable and identifiable for operating purposes and its performance measurement possible”.

#### 4. Relationship between Organisation Structure and Responsibility Accounting System:

- A sound organisation structures with clear-cut lines of authority—responsibility relationships are a prerequisite for establishing a successful responsibility accounting system.
- Responsibility accounting system must be so designed as to suit the organisation structure of the organisation.
- It must be founded upon the existing authority- responsibility relationships in the organisation.
- In fact, responsibility accounting system should parallel the organisation structure and provide financial information to evaluate actual results of each individual responsible for a function.

#### 5. Assigning Costs to Individuals and Limiting their Efforts to Controllable Costs:

- After identifying responsibility centres and establishing authority-responsibility relationships, responsibility accounting system involves assigning of costs and revenues to individuals.
- Only those costs and revenues over which an individual has a definite control can be assigned to him for evaluating his performance
- The following guidelines should be followed while assigning of costs
  - If the person has authority over both the acquisition and use of the services, he should be charged with the cost of these services.
  - If the person can significantly influence the amount of cost through his own action, he may be charged with such costs.
  - Even if the person cannot significantly influence the amount of cost through his own direct action, he may be charged with those elements with which the management desires him to be concerned, so that he will help to influence those who are responsible.

#### 6. Performance Reporting:

- A control system to be effective should be such that deviations from the plans must be reported at the earliest so as to take corrective action for the future. The deviations can be known only when performance is reported.
- Responsibility accounting system is focused on performance reports also known as ‘responsibility reports’, prepared for each responsibility unit.
- Unlike authority which flows from top to bottom, reporting flows from bottom to top. These reports should be addressed to appropriate persons in respective responsibility centres.
- The reports should contain information in comparative form as to show plans (budgets) and the actual performance and should give details of variances which are related to that centre.
- The variances which are not controllable at a particular responsibility centre should also be mentioned separately in the report.

- To be effective, the reports should be clear and simple. Use of diagrams, charts, illustrations, graphs and tables may be made to make them attractive and easily understandable.

### **Pre-requisites of Responsibility Accounting**

- It should be a big company with divisionalised organisation structure
- The organisation should have clearly set goals and targets
- Managers should actively participate in establishing budgets against which their performance is measured
- Managers are held responsible only for those activities over which they exercise significant degree of control
- Performance reporting should be timely and contain significant information relating to the responsibility centres

### **Responsibility centre**

- The main focus of responsibility accounting lies on the responsibility centres.
- A responsibility centre is a sub unit of an organization under the control of a manager who is held responsible for the activities of that centre.
- It is like a small business to achieve the objectives of a large organisation

#### **1. Cost Centre**

- A cost or expense centre is a segment of an organisation in which the managers are held responsible for the cost incurred in that segment but not for revenues.
- According to CIMA, London a cost centre is “a location person or equipment , for which costs maybe ascertained and used for purposes of cost control”
- Responsibility in a cost centre is restricted to cost.
- For planning purposes, the budget estimates are cost estimates; for control purposes, performance evaluation is guided by a cost variance equal to the difference between the actual and budgeted costs for a given period.
- Cost centre managers have control over some or all of the costs in their segment of business, but not over revenues.
- In manufacturing organisations, the production and service departments are classified as cost centre. Also, a marketing department, a sales region or a single sales representative can be defined as a cost centre.
- Cost centre may vary in size from a small department with a few employees to an entire manufacturing plant. In addition, cost centres may exist within other cost centres.
- E.g. accounting department, repairs & maintenance department

## **2. Revenue Centre**

- It is a segment of the organisation which is primarily responsible for generating sales revenue.
- A revenue centre manager does not possess control over cost, investment in assets, but usually has control over some of the expense of the marketing department.
- The revenue centre manager will control the selling price, promotion mix and product mix
- The performance of a revenue centre is evaluated by comparing the actual revenue with budgeted revenue, and actual marketing expenses with budgeted marketing expenses.
- E.g. sales department

## **3. Profit Centre**

- Also called business centre
- It is a segment of an organisation whose manager is responsible for both revenues and costs.
- In a profit centre, the manager has the responsibility and the authority to make decisions that affect both costs and revenues (and thus profits) for the department or division.
- The managers are encouraged to act as if they were running their own separate business
- The main purpose of a profit centre is to maximise profit by making decisions relating to production volume, product mix, selling price, marketing strategy.
- Profit centre managers aim at both the production and marketing of a product.

## **4. Investment Centre**

- It is responsible for both profits and investments.
- The investment centre manager has control over revenues, expenses and the amounts invested in the centre's assets.
- He also formulates the credit policy which has a direct influence on debt collection, and the inventory policy which determines the investment in inventory.
- The manager of an investment centre has more authority and responsibility than the manager of either a cost centre or a profit centre.

- Besides controlling costs and revenues, he has investment responsibility too. 'Investment on asset' responsibility means the authority to buy, sell and use divisional assets.
- E.g. a new hotel being developed

**Steps for Achieving Goals of Responsibility Accounting:**

1. The organisation is divided into various responsibility centres each responsibility centre is put under the charge of a responsibility manager. The managers are responsible for the performance of their departments.

2. The targets of each responsibility centre are set in. The targets or goals are set in consultation with the manager of the responsibility centre so that he may be able to give full information about his department. The goals of the responsibility centres are properly communicated to them.

3. The actual performance of each responsibility centre is recorded and communicated to the executive concerned and the actual performance is compared with goals set and it helps in assessing the work of these centres.

4. If the actual performance of a department is less than the standard set, then the variances are conveyed to the top management. The names of those persons who were responsible for that performance are also conveyed so that responsibility may be fixed.

5. Timely action is taken to take necessary corrective measures so that the work does not suffer in future. The directions of the top level management are communicated to the concerned responsibility centre so that corrective measures are initiated at the earliest.

The purpose of all these steps is to assign responsibility to different individuals so that the performance is improved. In case the performance is not up to their targets set, then responsibility may be fixed for it. Responsibility accounting will certainly act as control device and it will help in improving the overall performance of the business.

## **Advantages of Responsibility Accounting**

- Some responsibility is given to each individual and he is held accountable for his performance. No person can assign his responsibility to others. In this system, responsibility is fixed individually
- Facilitates stricter control on costs & revenue along with helping in planning and decision making
- When responsibility is fixed for each department, managers consider themselves important part of the organisation. It helps in developing spirit of initiative among employees and increases their motivation
- A mechanism for presenting information is provided. A framework for managerial performance appraisal systems can be established on that basis, besides motivating managers to act in the best interest of the enterprise
- Relevant and up to the minute information is made available which can be used to estimate future costs &/or revenue and fix up standards for departmental budgets.

## **Problems in Responsibility Accounting**

- For responsibility accounting to be effective, a proper classification between controllable and non-controllable costs is a prime requisite. But practical difficulties arise while doing so on account of the complex nature & variety of costs.
- Separate departmental pursuits may lead to inter-departmental rivalry and it may be prejudicial to the interest of the enterprise as a whole. Managers may act in the best interest of their own, but not in the best interest of the enterprise
- Can't be relied upon completely as a tool for management control. It is a system just to direct the attention of management to those areas of performance which require further investigation
- Preparation of an organisation chart which clearly delineates lines of responsibility and authority is a difficult task
- Responsibility accounting reports may be overloaded with all available information

## **Divisional Performance- Concept**

- The whole organisation is divided into separate divisions and each divisional manager has great deal of independence.
- The manager of each division is accountable for performance of its operations as also the nature of operations undertaken.

- It leads to creation of a decentralised organisation structure and each division is treated as a separate responsibility centre. The performance of each responsibility centre will be separately measured and compared with other responsibility centres for managerial decisions.
- However, authority can't be exclusive one, implying that full autonomy can't be fully granted to the divisional head as no unit can be independent of other units within one organisation.
- The performance of each division has to be separately and independently evaluated only to place responsibility for effective management so that those who are doing the jobs don't shrink from their duties and the operations which they are bound to perform.

### **Merits of Divisional Performance**

- Promotes quick decision making and avoids red tape and delays
- Motivates divisional managers to perform better. It also helps to improve their job satisfaction and self-fulfilment
- Makes top management free from detailed involvement in the day to day operations and enables them to devote themselves to important policy matters.

### **Demerits of Divisional Performance**

- Various divisions may compete with each other and in that divisional managers may try to increase their own profits at the expenses of other divisions
- There may be lack of coordination and cooperation between divisions. This results in lack of harmony in achieving overall goals of the business

### **Measurement of Divisional Performance**

#### **1. Variance Analysis**

- Actual performance is compared with standard or budgeted performance and any variance between the two is analysed to know the causes so that responsibility can be established and corrective actions taken.
- Should be undertaken at each cost centre & revenue centre.

#### **2. Profit**

- The absolute amount of profit earned by a profit centre

#### **3. Return on Investment**

- ROI addressed divisional profit as a percentage of the assets employed in the division. Assets employed can be defined as total divisional assets, assets controllable by the divisional manager, or net assets.

$$\text{ROI} = (\text{Divisional Profit} / \text{Divisional investment}) * 100$$

$$= (\text{EBIT} / \text{capital employed}) * 100$$

$$= (\text{Profit/ sales}) * (\text{Sales/ capital invested}) * 100$$

- An organisation can improve the ROI either by improving the net profit margin or by increasing the turnover with the same amount of investment. It implies that the performance of a firm/ segment can be improved either by increasing the profit margin per rupee of sales or by generating more sales volume per rupee of investment
- Advantages
  - Is easy to understand & interpret
  - It Is a measure of relative performance and therefore can be used to compare the firms of different sizes.
  - Helps in ensuring good congruence between the different divisions and the firm
  - Is widely accepted measure of performance because it relates net income to investments made in the division
  - Motivate divisional managers to improve their performance by optimum utilisation of the capital invested in the divisions.
- Limitations
  - Satisfactory definition of profit & investment on which ROI is based are difficult to find
  - There are different methods of valuation of assets such as book value, original cost, current replacement cost etc which of these valuations is to be taken for calculating ROI remains a difficult question to answer
  - There may be some practical difficulties in calculating the divisional profit which in turn will make calculations of ROI difficult.

#### 4. Residual Income

- Also known as Economic value added (EVA) method
- Was developed by consulting firm Stern Stewart & co.
- Residual income is excess income generated more than the minimum rate of return

Residual Income = Divisional Profit- Cost of capital

$$= \text{Divisional Profit} - (\text{Divisional Investment} * \text{rate of interest})$$

- Advantages
  - It leads to better decisions than ROI
  - It has the advantage of showing division's ability to earn more than the cost of capital
  - Divisional managers are made to realise that there is an opportunity cost of funds used by the divisions in the form of cost of capital

- Disadvantages
  - Cannot be used to compare the performance of divisions of different size
  - This method is difficult to understand and apply
  - It may be difficult to determine the rate of calculating cost of capital