

Responsibility Accounting: An Innovative Technique of Managerial Control.

Dr. Santanu Das.
Asstt. Professor in Commerce.
Srikrishna College.
Bagula, Nadia, West Bengal.
E-mail-100santanudas@gmail.com
Mob-9477557784

Abstracts:

The most important element of every organization is “people” as they can easily influence the other elements (technology, goals, tasks etc). Every organization is a social system or social unit. A system may be defined as an entity consisting of a number of interrelated and interdependent components of parts which are generally known as subsystem. One of the important features of organization is that it is always engaged in goal directed activities. Like other organization business organization are also engaged in goal directed activities.

In every organization there are a number of managers in various levels of management. They perform jointly to fulfill their organizational objectives. Every manager has particular responsibilities. They worked under the supervision of top management to fulfill their individual responsibilities. The overall success of the organization largely depends upon the fulfillment of the responsibilities of the managers.

From this viewpoint, the concept of “Responsibility Accounting” is emerged. It means a system which makes every-one conscious and responsible for the job that is entrusted to him by his supervisor. That is a control by delegating and locating responsibility for costs. In this article an attempt has been made to discuss all the significant areas of “Responsibility Accounting” in an analytical view for a better understanding of this important managerial tool.

Keywords: *Responsibility Centre, Cost centre, Divisional Performance measurement , Revenue Centre, Investment Centre. Profit Centre.*

Introduction:

According to Karl Marx, an organization is a collective activity for production and distribution. Every organization is a social system or social unit. A system may be defined as an entity consisting of a number of interrelated and interdependent components of parts which are generally known as subsystem. One of the important features of organization is that it is always engaged in goal directed activities. Like other

organization business organization are also engaged in goal directed activities. There are so many goals of a business organization which they try to achieve in their normal course of activities. Like-wise other organization, the prime goal of Business organization is to maintain their existence for indefinite period of time. The other goal of every business organization is generated from this prime goal.

As a goal oriented system, business organizations always try to fulfill their goal. In order to fulfill the goal business organization needs a structure. Structure is a mean to accomplish the goal. Structure is a frame work within which different components (peoples, goals,tasks) interact with each other for the accomplishment of the organizational goals.

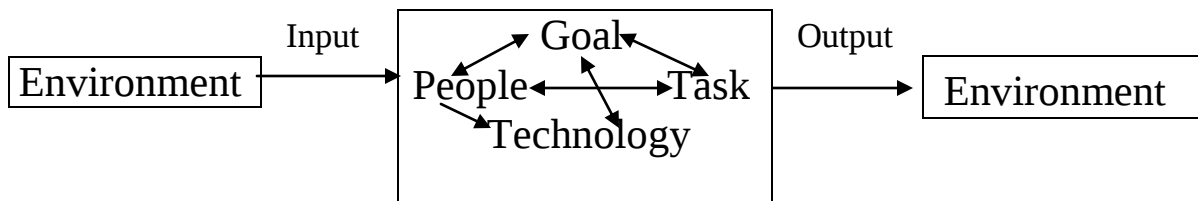


Exhibit – I Organization Structure

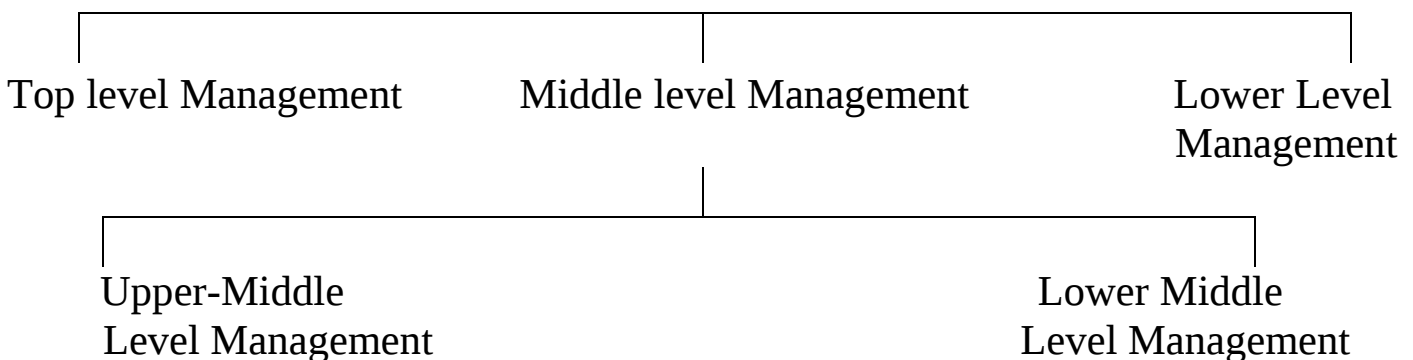
So, people are very important factor of business structure. Achievement of business goals very much depends upon them. They can normally influence the other factor or elements of organization structure.

There are a number of people in every business organization. They perform jointly in a systematic and predetermined way to fulfill objectives of their organization. But, according to McGregor’s “Theory X” peoples are basically lazy, they dislike their works. They will avoid their responsibilities if it is possible. So, the controller of the business enterprise has to direct the various employees in a proper and systematic manner. From this viewpoint the concept of Responsibility accounting developed means a system which makes everyone conscious and responsible for the job entrusted to him by his supervisor.

Management means: MANAGE – MEN-T (TACT FULLY)

According to E.F.L. Brech, there are three levels of management in every business organization which is popularly known as hierarchy of management. These are as follows:

Hierarchy of Management



So, in every organization there are a number of managers in various level of management. They perform jointly to fulfill their organizational objectives. Every manager has particular responsibilities. They worked under the supervision of top management to fulfill their individual responsibilities. The overall success of the organization largely depends upon the fulfillment of the responsibilities of the managers.

From this viewpoint, the concept of “Responsibility Accounting” is emerged. It means a system which makes every-one conscious and responsible for the job that is entrusted to him by his supervisor. That is a control by delegating and locating responsibility for costs.

Divisional performance measurement is one of the significant roles that the management has to play to achieve the overall goals of a firm. The objectives of divisional performance measurement are:

- i) To determine the contribution that a division makes to the total organization.
- ii) To provide a basis for evaluating the quality of the divisional manager’s performance. And
- iii) To motivate the divisional manager to operate his division in a manner consistent with the basis goals of the organization.

Responsibility accounting as a control device is relevant to divisional performance measurement. It is a fundamental tool of managerial control. This tool plays a key role in measuring actions and outcomes and in defining the rewards to be received by individuals.

Responsibility Accounting emphasizes division of an organization among different sub-units in such a way that each submit is the responsibility of an individual manager, this approach recognizes cause and effect relationship between a manager’s decision action and it seeks to relate cost and revenue results of this decision and actions. This approach should be used exclusively to assist top management in planning and controlling the organizational activities effectively and effectively.

Review of Literature:

Bettner and Whittington (1996) and Morse and Zimmerman (1997) identified different types of responsibility accounting centres such as Cost Centres, Profit centres and Investment Centres. Arya et al (1998) illustrated some subtleties related to the system They provided the suitable conditions under which responsibility accounting system works more efficiently. Ogonnu (2000) stated that organizing a business in this manner enables managers and employees to specialize in specific types of business activity.

Though the issue of “Responsibility Accounting” as a control device has got huge attention in last few decades, there is no doubt that most of the studies related to this issue were done in the context of developed countries of the world. Very few studies were done related to the developing countries.

Background:

Responsibility Accounting also classifies the cost assigned to each Responsibility centre according to whether they are controllable costs are classified by items. The aim is to show up result of operation by each section or division having control over resources and their use.

Responsibility Accounting requires that costs be classified:

- 1) By responsibility centre.
- 2) Within each responsibility centre whether controllable and non-controllable, and within the controllable classification by cost elements in sufficient detail to provide useful basis for analysis.

Responsibility Accounting is an approach to cost control whereby every item of expenditure is made the responsibility of that individual who can best influence it by his actions.

Responsibility centre is a personalized group of control centre under the control of an individual. Responsibility Accounting is a concept aims to help achieve a fit between planning and control system and managerial responsibilities. It is a system of accumulating and reporting both actual and budgeted costs and revenues by individual responsible for them. In Responsibility Accounting concept persons are made responsible for the execution of plans and the evolution of actual performance for determining whether actual operations have gone according to what was planned and if the actual are not according to plan, what is the extent of deviation, what is the reason for deviation. What action can be taken to bring in the future actions more in line with the plan?

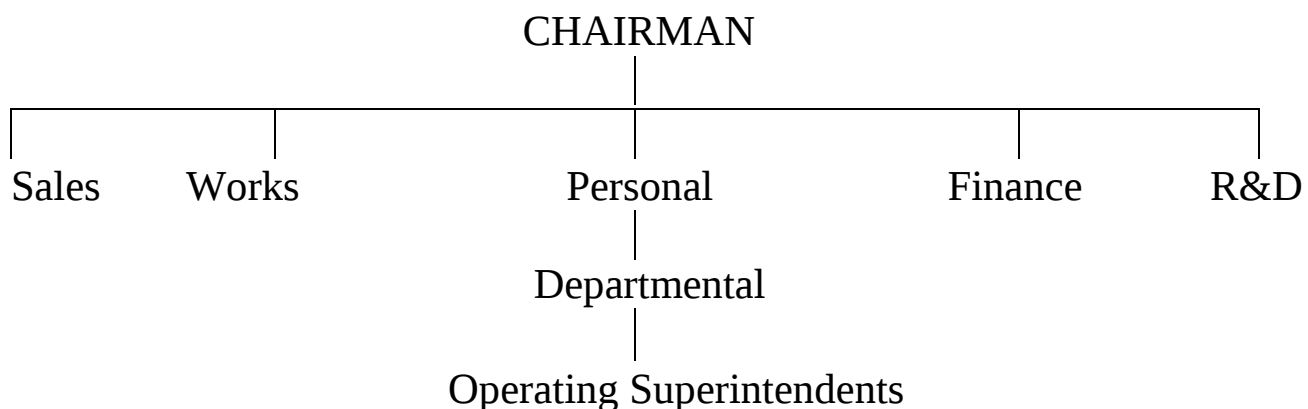
So, it is quite clear that application of Responsibility Accounting system is very significant to exercise control over a firms operation so that its objectives are achieved.

Objectives of the Study:

1. To find out the benefits that can be derived from the system.
2. To analyse the various techniques of the system.
3. To Study the factors that makes the Responsibility Accounting more efficient.
4. To identify the drawbacks of the system.

Levels of Responsibility and Flow of Information

The organization structure and needs will decide the levels of responsibility for each individual business unit which will vary in case. At each level responsibility, there may be several responsibility centers. We may take the following example:



The line of responsibility starts with operating Superintendent, department heads and the Works Manager to the Chairman. These are levels of responsibility. The flow of information's upward from the lowest to the highest level in each responsibility centre.

Fourth Level of Responsibility Centre (Operating superintendents):

Variance statement showing budgeted / actual variable cost in terms of material, Labor and overhead will be reported to the third level, i.e. the department head.

Third Level of Responsibility Centre (Department Head) :

The responsibility centers will be, say, standing operation, wiring operation and assemble operation. The summarized variances for each operation will be prepared and communicated to the second level of responsibility, i.e. the works Manager.

Second level of Responsibility Centre (Works Manager):

The responsibility centers at this level may be, say, cutting department, matching department, fishing department, and packaging department – again variance reporting of each responsibility centre is prepared and communicated upward, i.e. to the chairman.

First Level of Responsibility Centre (The Chairman):

The responsibility centers will be sales manager, finance manager, personnel manager and R & D. Again, variance statements of each responsibility centre will be ascertained with favorable and unfavorable dimensions.

The variance statement is basically reporting design of the Management information system in Responsibility Centre. However, the flow of information from the corporate office to the divisional head and vice-versa can include contribution margin, net income and variance analysis to reflect overall performance and also performance by divisional heads.

Pre-Requisites of Responsibility Accounting:

- i) The area of Responsibility and authority of each centre should be well defined.
- ii) Each Responsibility centre should have a clear set of goals for the Manager.
- iii) Only the revenues, Expenses, profits and investments that are controllable by the manager of a Responsibility centre should be included in the performance report for that centre.
- iv) Performance report for each Responsibility centre should be prepared highlighting variances, the item requiring manager's attention.
- v) The manager of each Responsibility centre should participate in establishing the goals that are going to be used to measure their performance.

Advantages of Responsibility Accounting:

- i) It introduces sound system of control.
- ii) It facilitates decentralization of decision making.
- iii) It ensures budgeting in order to compare the results of an operation between the budgeted figures and the actual one.

- iv) It helps the management to make an effective delegation of authority and required Responsibility as well.
- v) It fosters a sense of cost consciousness among managers and their subordinates.
- vi) It compels the management to set realistic plans and budgets.
- vii) It measures the Performance of individuals in an objective manner.

Limitations of Responsibility Accounting:

- i) The manager may find it difficult to fix responsibility.
- ii) Individual interest may conflict with Organizational interest and serious problem of implementation may occur.
- iii) The traditional way of classification of expenses should be subjected to a further analysis which becomes difficult.
- iv) The system faces passive resistance, if not active and it will lose its purpose, till it is judiciously applied.

Responsibility Centers:

Responsibility Accounting focuses on Responsibility Centers. A Responsibility centre is a sub unit of an organization under the control of a manager who is responsible for the activities of that responsibility centre. A small firm can possibly be managed by an individual or a small group of individuals, however, for effective control a large firm is divided into meaningful segments or departments. Each subunit has certain activities to perform and its manager is assigned the responsibility authority to carry out those activities. These subunits of an enterprise for the purpose of control are called Responsibility centers. The important criterion for creating a Responsibility centre is that the unit of the organization should be separable and identifiable for operating purpose and its performance measurement should be possible.

In Responsibility Accounting system, Responsibility Centers form the decentralized unit of organization. Each Responsibility centre has a defined executive head to control operations. The other features are:

- Defined Authority
- Defined Responsibility
- Defined Input
- Defined Output
- Defined criteria of measuring executive performance.

For control purpose Responsibility centers are divided in five categories. Such as:

- i) Cost or expenses centre.
- ii) Revenue Centre.
- iii) Profit centre.
- iv) Investment Centre.
- v) Contribution Centre.

i) Cost or expenses centre:

Costs centre is a location, function or items of equipment in respect of which costs may be ascertained and related to cost units for control purpose.

CIMA define cost centre as “a Production or Service, function, activity or item of equipment whose cost may be attributed to cost unit”.

A cost centre is a smaller segment of activity or area of responsibility for which cost can be accumulated. Responsibility in a cost centre is measured in terms of cost. Since the Performance of a cost centre is measured in terms of cost. Since the Performance of a cost is measured by financial measure of cost only, an essential requirement is that the cost of operating the division be directly traceable to it. This means that the relevant costs are the incremental or avoidable cost of operating that division. The incremental cost would include both variable and fixed costs but would exclude costs common to several divisions and allocated among them on some arbitrary basis.

From the view Point of the measurement of Performance of the divisional manager, the implication of the cost centre is that his performance will be judged on the basis of the cost incurred in his department or division. What is done in the division (output/Revenue) will be of no consequence. The analysis of performance is restricted to the consumption of resources in the division and there is no reference to what the division has achieved as a consequence of consuming those resources.

ii) Revenue Centre:

Revenue centre is the smallest segment of activity or an area of responsibility for which only revenues are accumulated. A revenue centre is a part of that organization whose manager has the primary responsibility of generating sales revenues.

CIMA defines Revenue centre as “a centre devoted to rising revenue with no responsibility for production”. In a revenue centre the manager is only held responsible for the level of Revenue or output of a centre but not responsible for the cost of goods or services that the centre sells.

iii) Profit Centre:

Profit centre is a division of an organization in which financial performance is measured on the basis of profit. In this context profit may be defend as excess or revenues over expenses.

CIMA defines, Profit centre as “a part of business accountable for cost and revenues.”

The structural shape of a profit centre may be as below:

A profit centre’s performance report measured in absolute terms would show profit on the bottom line. If a share of “head office” overheads is charge to the profit centre, these non controllable costs should be shown separately and kept distinct from directly attributable costs. A Profit centre’s Performance report might look as shown in Exhibit IX below:

iv) Investment Centre:

Investment centre is a segment of activity or area held Responsibility for both profit and investment. Objective of investment centre is to maximize the centre’s return on investment. CIMA defines investment centre as “a profit centre whose performance is measured by its return on capital employed.”

The return of an investment centre can be measured by the use of either ROI (Return on Investment) or RI (Residual income).

$$ROI = \frac{\text{Sales}}{\text{Capital Invested}} \times \frac{\text{Net Income}}{\text{Sales}}$$

Return on Investment (ROI) depends upon two ratios:

- i) Net Profit Ratio and
- ii) Capital turn over ratio.

If those two ratios changes, there is a consequent change in ROI since these ratios depends on many factors which may change frequently.

V) Contribution centre:

Contribution centre is a segment of activity of area of responsibility for which both revenues and variable cost are accumulated. CIMA defines contribution centre as “a Profit centre whose expenditure is reported on a marginal or direct cost basis.” The main objective of contribution centre manager is to maximize the centre contribution.

Contribution = Revenue – Variable Cost

The responsibility of a contribution centre’s manager is to rising sales revenue as well as to control variable cost of production.

Manager’s Control over Responsibility centre:

The manager’s control over different responsibility centre and criteria for measurement of performance can be summarized with the help of the following table –

Type of Responsibility Centre	Managers has control Over	Principal Performance measurement

Cost Centre	Cost (only Controllable cost items)	Variance analysis Efficiency measures
Profit Centre	Costs (Controllable Cost), Sales Price (Including Transfer Prices) Output volumes.	Profit
Investment centre	Costs (Controllable Cost), Sales Price (Including Transfer Price) Output volumes. Investment in fixed And current Assets	Return on investment (R.O.I) Residual Income (R.I) Other Financial Ratios

Responsibility Reporting:

Responsibility Reporting is an accounting and management reporting system directed towards controlling cost according to Responsibility centre.

It involves in defining and grouping responsibilities within an organization structure, determination and assignment of costs to appropriate levels of activities and strong emphasis and controllability. It emphasizes control on person who made responsible for executing of the plan entrusted to them and performance evaluation is done by evaluating of results in a responsibility report.

A SPECIMEN RESPONSIBILITY REPORT IS GIVEN BELOW:

Responsibility Report

Department:				
Foreman :			Month:	
Production (in u	Budgeted (Rs)	Actual (Rs)	Variance (Rs)	Remarks

<u>Controllable Costs:</u>				
Direct Materials	***	***	***	
Direct Labour	***	***	***	
Indirect Material	***	***	***	
Maintenance	***	***	***	
Indirect Labour	***	***	***	
Total (a)	***	***	***	
<u>Non Controllable Costs:</u>				
Depreciation	***	***	***	
Building Maintenance	***	***	***	
Other Allocated Cost	***	***	***	
Total (b)	***	***	***	
Total Cost (a + b)	***	***	***	

Financial Responsibilities of Centre's Managers:

The various Responsibility Centre's Managers financial responsibilities on various aspects can be summarized as under –

Type of centre	Manager Responsibility for			
	Costs	Revenue	Profit/Loss	Investment
Cost centre	Yes	No	No	No
Revenue Centre	No	Yes	No	No
Profit centre	Yes	Yes	Yes	No
Investment Centre	Yes	Yes	Yes	Yes

Conclusion:

It may be concluded that the main requirement of a system of Responsibility accounting is that the organization should be such that the responsibility of each individual should be clearly defined. Each executive would know what he is required to do and what performance is expected from him with regard to the cost which is controllable by him. The system of accounting and reporting is fitted into the various responsibility areas so that the performance of each area is evaluated and reported for improvement. Thus,

Responsibility Accounting lays stress on planning and cost control rather than cost ascertainment and its main advantage lies in the prompt reporting of performance or executives of various levels of management. For follow-up action in a befitting way that leads to the achievement of organization goals.

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