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Lecture 2: *Responsibility accounting, structure and the organisational sub-unit*

Explain alternate responsibility centres

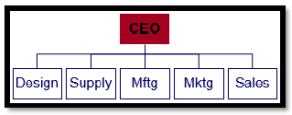
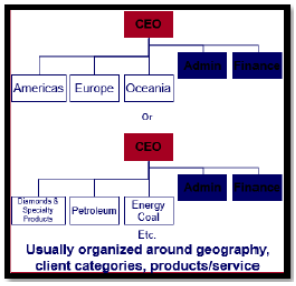
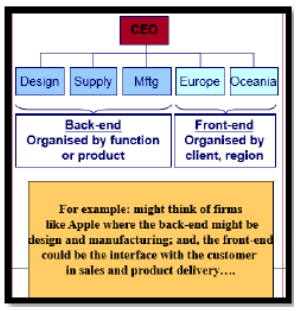
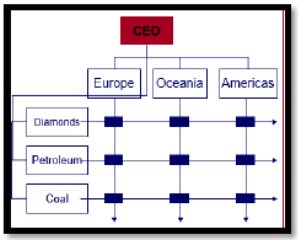
1. Hold divisions **accountable** for the financial performance corresponding to their **scope of control**
    a. Based on the **controllability principle**: "*the evaluation of a manager's performance should be based only on factors that are under their control*"

Level of control

	Cost centre	Revenue centre	Profit centre	Investment centre
Control	Manager has significant control over **costs**, but not matching revenue or investment decisions	Manager has significant control over **revenue**, but not matching costs or investment decisions	Manager has significant control over both **revenue** and **costs**, but not investment decisions	Manager has significant control over all **revenue**, **costs** and **investment** decisions
Accountability	Manager may be held accountable for cost, quality etc.	Manager may be held accountable for revenue, sales volume, pricing etc.	Manager is held accountable for profit	Manager is held accountable for return on assets employed

Explain alternate organisational structures

1. Fit under two basic work types:
    a. **Function oriented**: focused on work-process to attain economies of scale and scope (**efficiency**)
        i. Divisions of people with similar, specialised skills, e.g. accounting, design, supply functions (**economies of scale and scope focus**)
    b. **Market-oriented**: focused on market-segment to enhance organisation's ability to respond quickly and effectively to opportunities and threats in the market (**market responsiveness**)
        i. Divisions split by groups such as geography, different products and customer etc (**cx focus**)
    c. There is a **trade-off**: a business work-unit an be efficient as possible or responsive as possible
        i. Need to see if benefits of market responsive or economies of scale are higher

Basic types of organisational structure				
	Functional	**Divisional**	**Hybrid**	**Matrix**
Description	Dominated by **functional work-units** (efficiency). Hence, focus on specialisation, expertise, economies of scale and scope	Dominated by **market**-oriented work-units. Hence, focus on responding to specific needs of each market segment	Includes both **market-oriented** and bigger centralised **functional** work-units	Work-units are organised in two dimensions with **dual hierarchy** (team members have two superiors). Hence, focus is on **both market-responsiveness and specialisation**
Structure				
Benefits	• **Economies of scale and scope** – the teams can work together to achieve **high efficiency** (lower cost, higher quality) as they have specialised skills	• **Market responsiveness** – enhanced ability to respond to specific needs of differing market segments • Each division tends to be self-contained,	• Can achieve a **balance** between market responsiveness and economies of scale • Front end (market-oriented units) and back end (functional	• **Market responsiveness** whilst **preserving some economies of scale** • **Greater flexibility and innovation** - as teams work together, across functions and market segments, there is

a. **Sourcing autonomy**:
    i. Do unit managers have (1) the autonomy to make the decision to sell (buy) internally? And (2) do they have the incentive?
b. **Pricing method**:
    i. How is the transfer price determined? See below

Calculating transfer prices using different methods

Internal transfer pricing methods				
Pricing method	Market-based	Cost-based	Negotiated	Dual-price
Description	Transfer recorded at **market price**	Transfer recorded at **cost** of production – can use different measures of cost Most common	When autonomy is encouraged, managers between divisions can **negotiate** the price, and share the profits	Two pricing methods are used – buyer and seller **record transaction at different values** – the difference is recorded in a corporate cost account
Limitations	Market price **not always readily available/accurate:** • requires efficient, competitive market Goods must resemble that on the market	**Reduces selling division's incentive to reduce costs:** • As they just pass the costs on to the buying division Can result in **unfair distribution of profits** between divisions: • Selling divisions only covering costs (or small margin), whereas selling division make a (larger) profit	**Goal displacement**: • Managers negotiate a price which is optimal for them, and not necessarily the firm as a whole	
When to use	When market price is available	When market price not readily available	When market price not readily available Costs are unstable	To influence 'make' or 'buy' decision • Can impose a tax or levy on internal transactions i.e. to make cheaper or more expensive for the divisions
Decision rule	$\max P_{buyer} > \max P_{seller}$ $ceiling\ price > floor\ price$			

- That is, the seller will only sell if the transaction yields a **net benefit** – where the internal transfer price > relevant cost:
    - Relevant cost w/ idle capacity: seller will sell if $RC = MC$ of producing the good is greater than price
    - Relevant cost w/o idle capacity: seller will sell if $RV = MC + OC$ of producing the good is greater than price
        - OC is the profit $(SP - MC)$ of the alternate transaction foregone

Steps to determine if 'make' or 'buy' summary	
Map potential transactions between parties	To analyse each potential transaction in isolation
Work out RC of seller to determine **floor price**	MC if idle capacity $MC + OC$ if no idle capacity MC can differ between internal/external sale
Work out **ceiling price** of buyer	Price of buying externally
Determine if transaction will occur internally or externally	$ceiling\ price > floor\ price = 'make'$ $floor\ price > ceiling\ price = 'buy'$

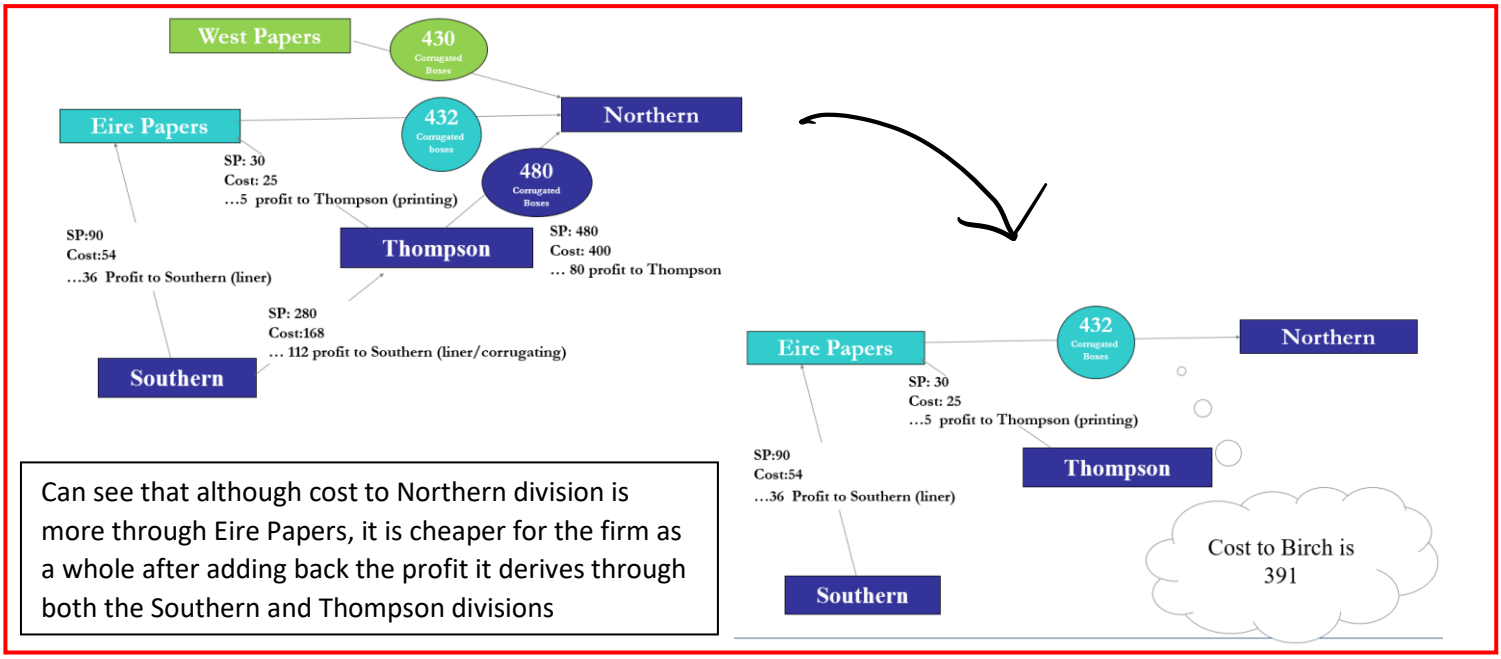
Which transfer price is most suitable?

1. Factors to consider include:
    a. Availability of market price
    b. Cost function and existence of idle capacity
    c. Context of transaction
        i. One-off vs recurring
        ii. Magnitude
        iii. Level of autonomy
    d. Effect on cost structure of firm as a whole
        i. The seller's fixed cost becomes the buyers variable cost, being captured and transferred via the internal transfer price
            1. Impacts on firm's CVP analysis decisions
2. Cannot consider internal pricing policy in **isolation** – need to consider along with:
    a. Organisational structure
        i. Is the structure [cost/profit/investment centre] optimal?
    b. Decentralised decision making
        i. Is autonomy encouraged or are decisions make centrally at head office?

Which transfer price is optimal for firm as a whole?

1. Need to break down each potential transaction
    a. If transactions include profit to different divisions of the same firm, then you need to **add back the profit** to derive the **cost to the firm** and not the individual division
    b. Then need to decide whether to intervene or not to achieve desired outcome

e.g.:



Can see that although cost to Northern division is more through Eire Papers, it is cheaper for the firm as a whole after adding back the profit it derives through both the Southern and Thompson divisions

- It is in the best interests of the firm as a whole to 'make', hence, should **intervene**, as if they don't, Northern will buy from West Papers which will incur the greatest cost to the firm, despite being the cheapest to Northern division
    - Although also need to consider the impacts this will have:

Decision to intervene or not		
Decision	Intervene	Not intervene
Benefits	• Acquire desired decision to minimise costs to firm	• Acquire fair allocation of profit