Handle with care

Traditional management accountancy methods are not always the best solution to the problems facing small and medium-sized businesses. Keith Cleland highlights the risk of killing the patient not the illness.

For good reasons, management accountants are being urged to become more involved in the decision-making process. But how does this work for small business? A recent book, *Management Accounting*[1], which has been compiled by four highly reputable academics, describes an accountant's involvement in the area of cost allocation in a particular company. Unfortunately, the ideas it puts forward merely highlight the inadequacy of much management accounting methodology as taught by tertiary institutions and advocated by the profession.

The authors use a case study of a US-based auto-service company, which has been in business for 20 years but is experiencing strong competition from a "quick service" competitor. The auto shop has five bays, two highly skilled mechanics earing $60,000 a year each and three other mechanics earning $25,000 each.

When asked to explain the deteriorating financial performance to his accountant, the proprietor complains that the competitor is "taking away most of my simple repair business with low prices. How can they price their jobs so low and still make a profit?"

The accountant asks to look at the job order costing system to try and find an answer. He finds that the proprietor has developed his charge rate by adding the cost of parts to an hourly labour rate. The hourly rate is based on total expenses (less parts) divided by total billable hours: $459,000/9,000 x 20 per cent mark up = $61.20 per hour.

The authors point out that "the present job costing system fails to distinguish between the expert and regular types of labour and does not recognise some of the support activity costs. - including $54,000 for depreciation and maintenance of special tools and machines".

They recommend that two prices be developed, one for the lower-paid work and one for the more expert work. Wages and overhead costs should be apportioned accordingly so that the hourly charge for non-expert works out at $44.67 and for experts and $86, both inclusive of a 20 per cent mark up. Presumably to simplify the example, the authors avoided adding a mark up percentage on top of the cost of parts and accessories.

The final recommendation is that the new charge rates be applied in the proportions of 5,400 hours at $44.67 and 3,600 at $86 (amounting to 9,000 hours at $61.20).

If the proprietor takes this advice and drops the rate from $61.20 to $44.67 for non-expert work, and there is insufficient work at the $85 rate to compensate, we can only guess at the outcome.

So what approach should the accountant take? The client's belief that he is losing business to a competitor may or may not be the prime cause of decline in the business. An important initial step would be to pinpoint the level of activity (productivity) by identifying how may of the 9,000 hours were actually billed in the preceding period.

A close approximation of hours billed can be obtained in a matter of minutes by analysing a representative sample of billings, in which the average rate achieved is compared with the quote. For example, if a job had been accomplished in half the time quoted, the achieved rate would have been $120.40, not $61.20. Conversely, if the job had blown out to double the time quoted, the achieved rate would have been closer to $30.60.

And there are many jobs where the proprietor applies "feelings" which have the effect of adding or, in the case of some long-standing customers, subtracting from the $61.20 In the case of insurance work (how much of that was done?), he would have been trying to improve on the insurer's estimates of time and rate.

Suppose the average hourly rate of the billing sample was $75. Dividing the gross profit (sales less parts) of $550,818 by $75 would indicate that 6,877 hours were billed - which is around 2,123 hours short of the 9,000 billing hours available. If this was the case, the underlying cause could be as much to do with inadequate supervision of jobs as it is to do with increased competition.

Whatever hours were actually billed, an attempt to differentiate the "expert" hours from the "non-expert" would probably fail because of a lack of relevant detail in the job cards. Given the size and type of business, it is inevitable that experts would work on non-expert jobs and vice versa. It is probably because of this that the proprietor developed the inclusive average rate.

Before making any recommendation for change, the accountant should request a weekly copy of all billings for several weeks ahead, on which the proprietor agrees both to note the quote rate and to differentiate the quoted expert and non-expert hours involved. He should also note the actual hours recorded against each job.

Without such analysis, any attempt to advise the application of differing rates would be foolhardy to say the least. It would be more than likely to kill the patient, rather than cure the cause.

In advocating the need for management accountants to become more involved in the decision-making process, this case study illustrates why much of our professional input has little relevance to the real world of SMEs.

1.A Atkinson, R Banker, R Kaplan and S Mark Young, *Management Accounting*, Prentice Hall, 2nd Edition 1997

Keith Cleland is professor of small business enterprises in the distance-learning MBA programme of the Institute of International Business Relations