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Responsibility Centres Under IAS 2/ IFRS

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Abstract

The worldwide implementation of IFRS to a larger extend impacts financial statements more and more. On one side, the internal reporting struggles to provide accurate and insightful information for decision-making process and liquidity management. On the other side, the legal requirements of accounting standards influence not only the external reporting but also the internal one.

In this paper, we discuss the impact of international financial reporting standard for inventory (IAS2) on the cost accounting system. In this line of thought, we conclude that the direct costing is wildly worldwide used for internal reporting, although it doesn't comply with IAS2.

Keywords*: responsibility centres, cost accounting, inventories, IAS2, IFRS*

JEL classification: *F15, F63, M41*

1. Introduction

Harmonizing accounting systems is a big challenge of our days. Business leaders need to take the time to understand the rules and regulations and develop practices that meets standards without huge costs. The aim is to level the playing field for global businesses through providing uniform information, based on the same accounting methodologies. In this way, the international risks shall reduce and the information for economic policy decision- making shall enhance.

2. Cost approach under inventory standard IAS2

IAS2 requires that those assets, considered inventory, should be stated at the lower of cost and net realisable value. Cost not only includes the purchase cost but also the conversion costs, which are the costs involved in bringing inventory to its present condition and location. In other words, there is a need for implied direct costs identification, such as, for example direct labour and direct material.

Direct costs can be directly attributed to a cost object and thus assimilated to a finished product (or service) and is generally associated with a profit center. The cost object can be a product, a service, a project or an order. The project, mainly in the manufacturing sector, is also known under the abbreviation PSP, which stands for Plan of Project Structure. It includes all project activities, as detailed bottom in this paper, at responsibility centers. These costs are visible through the expense report at the contract, order or profit center level, as the cost items within the company have been defined. These directly costs are the part of total costs that remain constant irrespective of the change in output (negative or positive).

Direct costing, also called variable or marginal costing is the practice of charging all direct costs to operations, process or products, leaving all indirect costs to be written off against profits in the period in which they arise. According to Horngren et.al.(2012) this method is largely used in internal reporting worldwide - 30-50% of the worlds' companies- in order to create a model to answer a question about what actions management should take. We add to the figures of Horngren study the percentage of implicit using of variable costing in Germany, according to Kilger et.al.(2012).

Table 1: International Use of Direct costing in internal reporting

	SUA	Canada	Australia	Japonia	Suedia	UK	Germania*
Folosesc metoda							
Costurilor variabile	31%	48%	33%	31%	42%	52%	70%
Folosesc metoda							
Costurilor absorbante	64%	52%	67%	69%	58%	48%	30%
Folosesc o altă metodă	4	0					

Source: Horngren et.al. 2012, ro p. 334 and Kilger et.al., 2012; *DB

Although direct costing is widely used, as shown in Fig.1, it is not a costing methodology for constructing financial statements – in fact, **accounting**

standards specifically exclude direct costing from financial statement reporting. Thus, it does not fill the role of a standard costing, process costing, or job costing system, which contribute to actual changes in the accounting records, thus necessitating year-end adjustments for the preparation of financial disclosure. Instead, it is used to extract pertinent information from a variety of sources and aggregate the information to assist management with any number of tactical decisions. It is most useful for short-term decisions, unhand **contribution margin** and least useful when a longer-term time frame is involved - especially in situations where a company must generate sufficient margins to pay for a large amount of overhead. Contribution (selling price less variable costs) is an excellent tool for decision-making. Though useful, direct costing information is problematic in situations where incremental costs may change significantly, or where indirect costs may be pertinent to the decision.

According to the studies presented by Horngren et.al.(2012), many companies using the direct costing method for internal reporting purposes are also using the absorption cost method for external and tax reporting, as shown in Fig.1. **Absorbing costing** is the practice of charging all costs both variable and fixed to operation, process or products or process. It is a method of apportioning all the production costs to a unit. Historically, this was a very common costing method in the manufacturing industry.

The difference between the two methods is in the treatment of fixed manufacturing overhead costs. Under the direct costing method, fixed manufacturing overhead costs are expensed during the period in which they are incurred. Under the full costing method, also called absorption costing, fixed manufacturing overhead costs are expensed when the product is sold.

IAS 2 also allows the capitalisation of variable overheads and fixed overheads also, so long as the **fixed overheads are allocated on a systematic and consistent basis and in respect to usual output levels**. Not only that there is a need for overheads classification between fixed and variable ones but the defined allocation rules gain a big importance under IFRS. Where output is lower than expected, the resultant excessive overhead should be considered a period expense and be not capitalised. In case output is abnormally high the fixed overhead allocated to each unit must be decreased so as not to overvalue the inventory.

Overhead costs cannot be attributed directly to a cost object, because they are indirect costs, which include indirect materials and indirect labour such for example rent, insurance, heat, light, supervision costs, facilities maintenance (Webster, 2004). Therefore, they are assigned to a cost centre.

As the marginal costing refers to the ascertainment of marginal costs by differentiating between fixed costs and variable costs and the effect on profit

of the changes in volume or type of output, it doesn't include overheads in unit costs instead charging them to the income statement in full. Thus, inventory is valued at variable cost of production. Therefore, we keep in mind that marginal costing doesn't comply with IAS2.

On the other hand, **absorption costing** complies with IAS2 on accounting for inventory, whereby the value of inventory must include an appropriate amount of fixed production overhead. Furthermore, it recognises that selling price must cover all costs. Problems may issue because it assumes that overheads are volume related, and also profits can be manipulated by simply changing production levels.

The deficiencies mentioned above are put aside by an extension of absorbing costing, the **ABC method**, that assumes that many overheads are complexity and diversity related, not only volume related. In ABC case, overheads are grouped into activities, which are called cost pools. The item that causes the costs to incur is the cost driver and on its basis are overheads absorbed into products. Due to high levels of overheads and the diversity of product ranges, ABC is becoming a much more appropriate tool for businesses to use.

IFRS does not permit direct costing methods that expense all overheads. Therefore, inventories should not include administrative overheads unrelated to production, selling costs, abnormal waste and storage costs, where the storage is not part of the production process, as well as foreign exchange differences arising directly on the recent acquisition of inventories invoiced in a foreign currency and interest cost when inventories are purchased with deferred settlement terms[1] (IFRS).

Selling, general and administrative expenses are, consequently reported on the income statement in the accounting period in which they incur. They are referred to as period costs because they are **not assigned to products**, and therefore cannot be included in the cost of items held in inventory (Horngren, Datar, Foster, 2012, p.43).

Period costs are deducted from revenues without ever having been included as part of inventory, whereas in the financial accounting they are assigned to the accounting period. They are extremely important for financial disclosure because they are running directly in the P&L account, having an immediately impact on income statement, and thus on financial performance.

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[1] IAS 2 , available at [https://www.iasplus.com/en/standards/ias/ias2], accessed on 21 st of January 2019

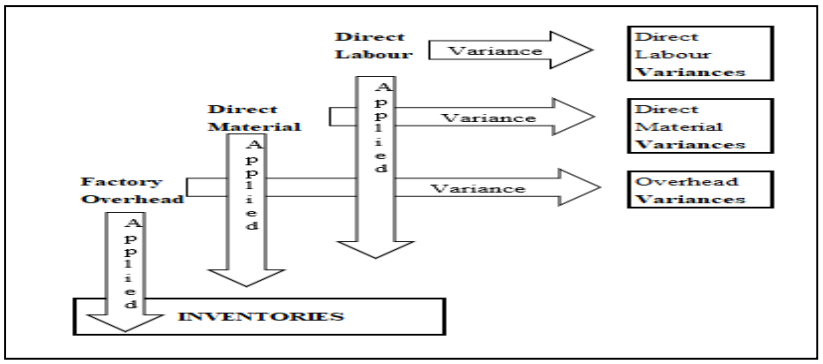
Ebbeken, Possler and Ristea (2000, p.19) declares that period costs are respective period related expenses that have nothing in common with inventories. Regarding period costs is of paramount importance the value of expense in any given period and not the detailed structure of it (Hoitsch& Lingnau, 2004, p.14).

According to Horngren, Datar and Foster (2012, p.42) the following mistake is frequently made in relation with indirect costs, such as rent, telephone and depreciation, when assuming they are always costs of the period in which they are incurred, being not associated with inventories. When these costs are incurred in marketing or in corporate headquarters, they are period costs. However, when these costs are incurred in manufacturing, they are manufacturing overhead costs and are inventoriable. Moreover, manufacturing overhead costs impact work in process (WIP) inventory as part of total manufacturing costs incurred and furthermore as cost of goods manufactured.

In large companies, Research and Development (R&D) costs are treated as period costs due to the fact that although these costs may benefit revenues in a future period, if the R&D efforts are successful, it is highly uncertain if and when these benefits will occur. Expensing period costs as they are incurred best matches expenses to revenues. (Horngren, Datar, Foster, 2012, p.42, p.38). Some other usual period costs in large companies are interdivisional charges and customer service costs as for example bids costs, that simply flow into the financial result.

Furthermore, IAS 2 impose the following two costing methods for cost measurement: the standard one and the retail technique. In the following, we focus on standard costing, which is merely used in manufacturing sector.

Figure1.Standard costing



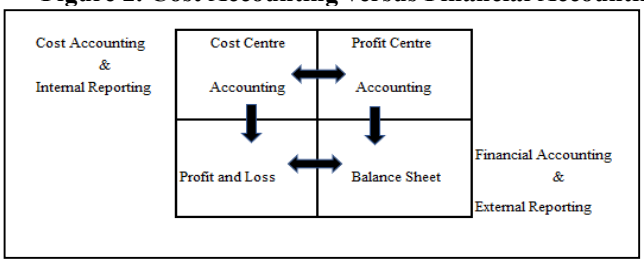
Source: adapted after https://www.assignmenthelp.net/assignment_help/standard-costing , accessed on 21st of January 2019

Standard costing is a particular concept that involves[2] setting up predetermined standards for each element of cost and each product, comparison of actual with standard to find variation and last but not least causes identification of variances by breaking down the differences between standard and actual cost, for taking remedial action.
Given the prerequisites above, one may analyse the types of variance for every type of cost: material, labour, variable and fixed overhead. Variance analysis refers to the investigation of the reasons for deviations in the financial performance from the standards set by an entity in its budget in order to keep a control on its operational result. Thus, standard costing is an excellent system control of costs and of measuring efficiency. When standard costs are used to create an inventory valuation, there will inevitably be some differences between standard and actual costs that will create variances that appear in the cost of goods sold (Bragg, 2005).

3. Elements of costs within responsibility centers

Responsibility center is defined as a part, segment, or subunit of an organization whose manager is accountable for a specified set of activities. Depending on the type of center, there are the following ways to track cost in Horngren acceptance: Profit Center and Cost Center, aside Investment Center. The cost center is responsible for controlling and minimizing costs, while the profit center is responsible for maximizing revenue and profits.

Figure 2. Cost Accounting versus Financial Accounting



Source: adapted from Friedl et.al. 2010, Horngren et.al.2012, Friedler 2014

In the figure above are shown the interdependencies among cost and financial accounting based on the way they interact. Cost accounting is different from costing in the sense that the former provides only the basis and information for ascertainment of costs, according to The Chartered Institute of

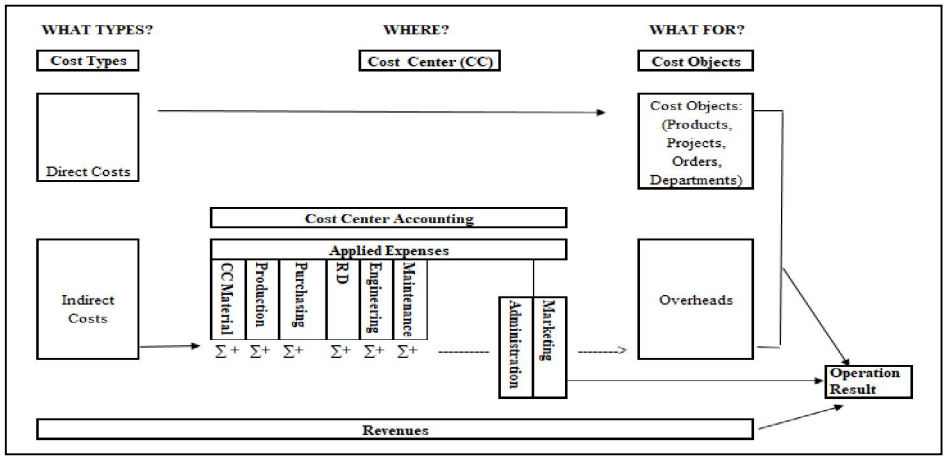
Management Accountants in England (CIMA). Once the information is made available, costing can be carried out. Cost accounting principles evolved over the years to fulfil needs of management, who are the primary users of cost (and revenue) information.

Starting from the paradigm presented by Horngren (14th, p.199), Briciu (2006 ,p.81) and many others - Different costs for different purposes, the collection of costs in a logical pattern is actually by IFRS imposed. In this way, one entity may fulfill the requirement of IAS2 regarding allocation of fixed overheads on a systematic and consistent basis, taking into consideration the usual output levels.

Cost center is a location or function of an organization where management is primarily responsible for controlling costs (Webster,2004). It answers the question WHERE the costs incur (Horngren,2012).

There are many classifications for the cost centres in speciality literature, but from responsibility point of view significant is the delimitation between auxiliary cost centres, where collected resources and costs are distributed and afterwards allocated with defined rules to the final ones, where primary costs are finally, as well as other directly applied expenses settled. Furthermore, certain cost centres that show only their plan figures are blocked for posting actual costs, while cost centers that collect actual costs will be associated with the same burden center or profit center.

Figure 3. Traditional Cost Accounting



Source: adapted after Eșanu (2002) and Friedel, Hoffmann, Pedell (2010)

Regarding the expenditure reports they may declare costs vertically according to the cost type (Ebbeken et al., 2000) and horizontally on each

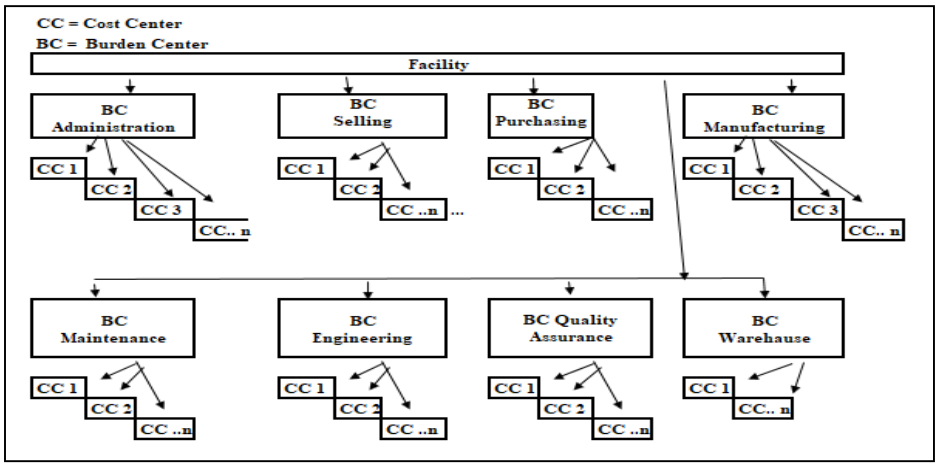
given burden center. The vertical collection and settlement report tables may be developed on three levels: for each financial cost/expenditure account (first level) shall be assigned a cost type (second level) so that total costs on cost objects (third level) will be shown. Direct costs as well as applied expenses of cost center accounting and further on the allocated overheads distributed on cost drivers base become visible on cost objects only after the internal distribution of indirect costs in cost center accounting and overheads costs in profit center accounting is done, at the end of the given period.

Cost centers usually form a hierarchical tree structure because **costs come in a hierarchy of levels.** Cost hierarchy is a tool for organizing costs in collection centers, with great importance in the allocation process. While the hierarchical structure depends on the nature of the individual business, in many situations, an entity adopts a hybrid of two or more costing methodologies (Webster, 2004, p.137). Several cost centers can form a **sector** linking cost centers to burden cost centers. For example, in the production cost center, painting can be a sector. Sectors can be defined for selected manufacturing phases to facilitate full cost calculations with phase method or on sub-processes within process cost calculation method. As a result of cost hierarchy, cost centers can be assigned to cost pools for certain processes respectively responsibilities, called **burden centers (BC)**. These pools collect expenditure and then, according to the agreed settlement methods, established at management level, allocates them according to the allocation keys for the different types of indirect costs in certain collection basins, such as material and production.

Burden centers are relatively modern cost elements that have emerged along with the development of process costing by Germans Horvath and Mayer. These can be associated with the processes of an enterprise and, to a certain extent, with the process-based system. They have appeared in German cost accounting, in order to reduce the deepest weakness of marginally flexible accounting (GPK Grenzplankostenrechnung): higher fixed costs. Therefore, the German literature analyzes and continuously improves the integration of the ABC system into the marginally flexible system (GPK) through the process-based calculation system since 1989.

Each burden center may have its share of cost allocation according to the cost allocation criterion set at the company level. For example, in the case of maintenance costs, the method of allocating indirect production costs may be based on hours worked. Actual direct work hours are for example a very common basis for allocation process costs, thus being a cost driver.

Figure 4. Burden Centers by Responsibility



Source: inspired from Loitsch 2009

A **profit center** is the place or function in the organization, where the manager is responsible for both revenue and expenditure, so for the resulting profit. It collects both revenue and expense for the purpose of calculating the result, associating cost objects (Ebbeken et al., Horngren et al). According to Webster's definition (2004, p.88), the cost object is any activity, unit or operation for which management wishes to measure costs. A cost object answers the question WHAT FOR the costs arise. Examples of cost objects are a product, a service, a project, a customer, a brand, a department or a program, namely a car, boat, train, tram or plane.

For each project, at least one PSP element (plan of the project structure) is implemented. The PSP is a cost element that directly collects contract or product actual costs and for which the project activities are developed by type of activity into a network or a tree structure.

The Project Structure Plan (PSP) is part of the project's accounting, usually used in controlling to collect actual expenditures and to estimate time, cost and risk (also previously budgeted). It consists in the hierarchical detailing of the entire project by activity and, furthermore, in establishing the existing relationships between individual activities by establishing a rank for each. The smallest unit of planning PSP is the work package and corresponds to the last defined rank, according to DIN 69901.

Preparation of monthly reporting should ensure financial reporting accuracy. Up to reporting activities, closing ones impose review of the month-end adjustments of accruals and diverse provisions, reconciliation of balance

sheet accounts as well as review of the accounting transactions in order to ensure proper classification of transactions according to the profit- respectively cost- centers. Inventory valuation addresses usually the biggest expenditure that flows into the result in any given period.

4. Conclusions

In order to accomplish the harmonisation of the financial information, arise the need for understanding the requirements of the globally comparable accounting standards promoted. In the name of transparency and accountability, there are challenging decision-makings to be met by management on basis cost accounting information and financial disclosure requirements under IAS2 and IFRS, on one hand, as well as other local GAAPs, on the other hand.

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