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e-Mag of the Institute of Certified Management Accountants

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Global Investment: The US – still the least of our problems

Risk and uncertainty defined the 2012 global economy. Daniel Parasol and Paul Benveniste of investment advisory and portfolio management company Evans and Partners review the investment outlook for 2013.

Despite broader global risks, which on balance look to be no greater next year than what has unfolded in 2012, the US economy appears well-placed heading in to 2013 for the following reasons.

- Monetary policy is clearly working, with the low government bond yields flowing through into lower long term corporate funding costs and lower fixed rate mortgages (refer Chart 1). The Federal Reserve's decision to proceed with QE3 – totally unnecessary – provided further impetus to the step-down in long term borrowing costs
- The latest round of stimulus will ensure that the housing recovery continues to unfold in all likelihood moving from first gear to at least third over the next year. This will create a meaningful multiplier effect through jobs, (the construction sector lost 2.25 million jobs during the recession), and further household balance sheet repair. The encouraging trends across the US housing sector are evident in Chart 2.
- Over the past three years, household consumption in the US has been subdued but resilient – holding at an annual growth rate of two per cent approx. A stronger private sector job market will assist in 2013, but not to the extent that our 'thriving' expectation is beholden on the consumer.

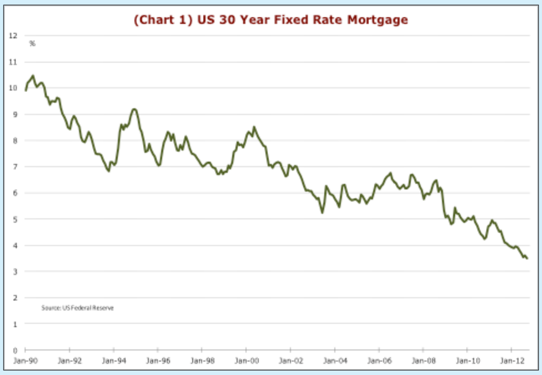

chart 1

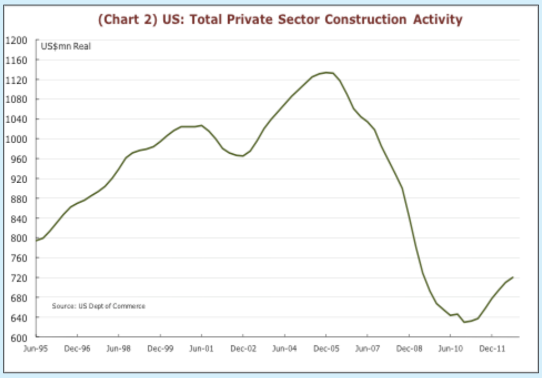

chart 2

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Corporate *spending* in the US has certainly *cooled* over the past six months

- Contrary to the strength of profits, cash flows and balance sheets, corporate spending in the US has certainly cooled over the past six months. We suspect companies are holding back awaiting resolution of the 'fiscal cliff' risk (highly likely) and greater clarity on Europe (less likely). Once these issues pass, balance sheet capacity and low funding costs point to another leg-up in business investment – which still remains soft relative to long term averages. The main risk to this outlook sits with Congress which may have to look to the flush US corporate sector to assist with the task of fiscal repair. Given the long term decline in the effective tax rate of US companies – from 40 per cent approx. in the 1970s to 22 per cent approx. of late – we will not be critical if such an impost were to eventuate.

- The public sector in the US is contracting and will remain a drag on the economy over the next two to three years. As such, GDP growth will struggle to breach 3 per cent. The state/local government sector, which is 40 per cent approx. larger than the Federal sector (including defence), has already contracted by 5 per cent. As such, state/local austerity should be easing as Federal austerity picks up over coming years.

What will all this mean for investment outcomes?

- From a relative growth perspective, the US economy is now pulling away steadily from Europe and Japan. The performance gap is likely to widen further in 2013. As such, the US Dollar is well-placed to continue its steady appreciation. On the margin, this will be to the detriment of the Australian Dollar, USD-denominated commodity prices and US corporate profits. The appreciation will be more dramatic if the interest rate implications discussed below come to pass.

- The Federal Reserve continues to tell us that the Federal Funds Rate will remain around 0 percent until 2015. Over the past year, the unemployment rate in the US has fallen from 9 per cent to 7.8 per cent. By this time next year it will most likely be in the 6 per cent range. With the US economy responding to low interest rates and core inflation comfortably holding around 2 per cent p.a., we struggle to see why the Federal Reserve would prolong a zero-interest rate regime and/or quantitative measures into 2015. The market will start to question the viability of this forecast and begin

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to price-in an earlier tightening phase. The US yield curve will steepen and in doing so trigger a painful rout across the government bond markets of Germany, France, UK, Japan and Australia.

- We expect that by this time next year the 'end-game' for Europe will be well-advanced, at least to the point where risks have been ring-fenced or realised. If so, the willingness of investors to pay an irrational price for 'safety' will also be receding and with it dissipates another source of support for ultra-low nominal and real long bond yields.

What does this mean for investors?

- From an asset allocation perspective, many investors are still underweight global equities. Our view is that with a 5 year plus investment horizon, the split between investors' domestic and global equities should be approaching 50 / 50 subject to individual circumstances.

- In the current environment, Australian investors have the unique opportunity to buy relatively cheap global assets with an historically over-priced currency. A combination highly conducive to positive outcomes.

- Whilst Global equities have the disadvantage of lower headline yields and no franking benefits, the growth in both income and capital, we believe, presents adequate compensation.

- Global investment is far easier now than it has ever been. Investors can access highly liquid, listed exchange-traded funds covering global markets, sectors or geographies, plus direct equities in addition to an ever growing menu of traditional managed funds. There is also much more research available on global stocks. Just ask your advisor.

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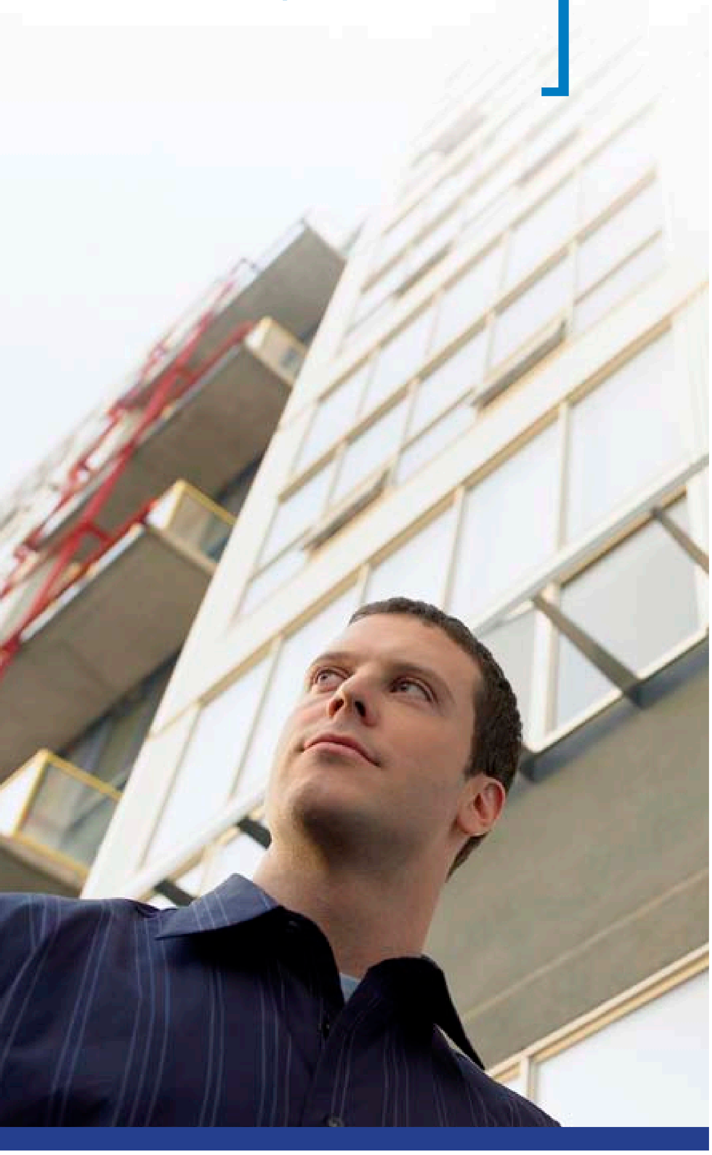
[Global investment is far *easier* now than it has ever *been*]

> [A ***primary*** focus was to **maintain** the Management Accountant category on the Australian Government's *Skilled* Occupation List]



President's report to the Annual General Meeting

Michael Vincent, ICMA President

The seventeenth Annual General Meeting of the Institute was held on 13 December 2012 at CMA house.

The president, Michael Vincent, commenced his report by listing the main projects that the executive committee focused on during the year and commented on any progress made.

A primary focus was to maintain the Management Accountant category on the Australian Government's Skilled Occupation List (SOL) for General Skilled Migration (GSM) for a third year, and the president was pleased to report that the ICMA was successful in this endeavour. A further submission with respect to the need for retaining the category on the list was lodged recently with the relevant government department, and the Institute awaits the outcome due in June 2013.

The Institute continues its campaign to attain the status of a migration assessment authority for Australia, and dialogue with the relevant federal government departments will continue next year.

The formation of a strategic alliance with Navitas for the delivery of the CMA programs in Australia was another important project that came to fruition in 2012. Plans are currently being finalised for the launch of the programs early in 2013.

Our first Year Book published early in the year was very well received and the editorial team is currently working on the 2012/3 edition.

The president also announced that an organisation originally set up by the ICMA, the Institute of Certified Carbon Analysts and Auditors (ICCAA) received full admission recently as an observer organisation of the United Nations Framework Convention on Climate Change (UNFCCC). This is a significant achievement in terms of global recognition.

The president concluded his report by thanking the professional staff of the Institute for its tireless work during the year, the editorial teams responsible for the Institute's three publication, *On Target Online*, *Journal of Applied Management Accounting Research* (JAMAR) and the *ICMA 2011/2 Year Book*, and the members of the Executive Committee.

He particularly thanked council member John Donald for his efforts in promoting the benefits of ICMA membership to his Deakin University students.

Finally, the President acknowledged the efforts of the overseas branches for the marvellous progress they had made in growing the membership numbers outside Australia.

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The Return of Open Book Management

by Leon Duval

[Our **responsibility** as management accountants is to make *effective* decisions within the parameters of the information ***available*** at the time]

Management teams are often driven by external hype to embrace the latest fad rolled out by the management consulting industry as the ultimate solution "that will revolutionise the way you do business". Unfortunately (or possibly fortunately), managing organisations is not an exact science because outcomes are fashioned by the actions of people, and the behaviour of people is never totally predictable. Ultimately the revolution fails to deliver its promised outcomes and is unceremoniously dumped as another failed project, often after absorbing massive resources for little profitability or efficiency gain.

Open Book Management (or OBM), a phrase coined by consultant John Case in 1993, was a case in point. Launched by a successful 'how to' book and promoted by a number of consultants who jumped on the bandwagon, OBM was embraced as a New Age management philosophy by many organisations. Case's most successful disciple was Jack Stack, CEO of SRC Holdings, who implemented OBM as the driving philosophy shaping his organisation's culture and in the process became a proselyte and a missionary for internal transparency and information sharing across all levels.

OBM may be simply explained as the creation of a culture that allows employees at all levels to understand how their particular task fits in with the company's financial plan. In order to build this understanding, the communication of information previously considered as 'for the eyes of top management only' is constantly channelled to employees in a form they can readily understand. This prising open of the information black box shapes a corporate culture based on transparency and creates an empowered work force with an ownership attitude.

The Case and Stack methodology is based on three cornerstone concepts. (1) Every employee should be given the measures of business success and taught to understand them. (2) Every employee should be expected and enabled to use their knowledge to improve performance. (3) Every employee should have a direct stake in the company's success and in the risk of failure.

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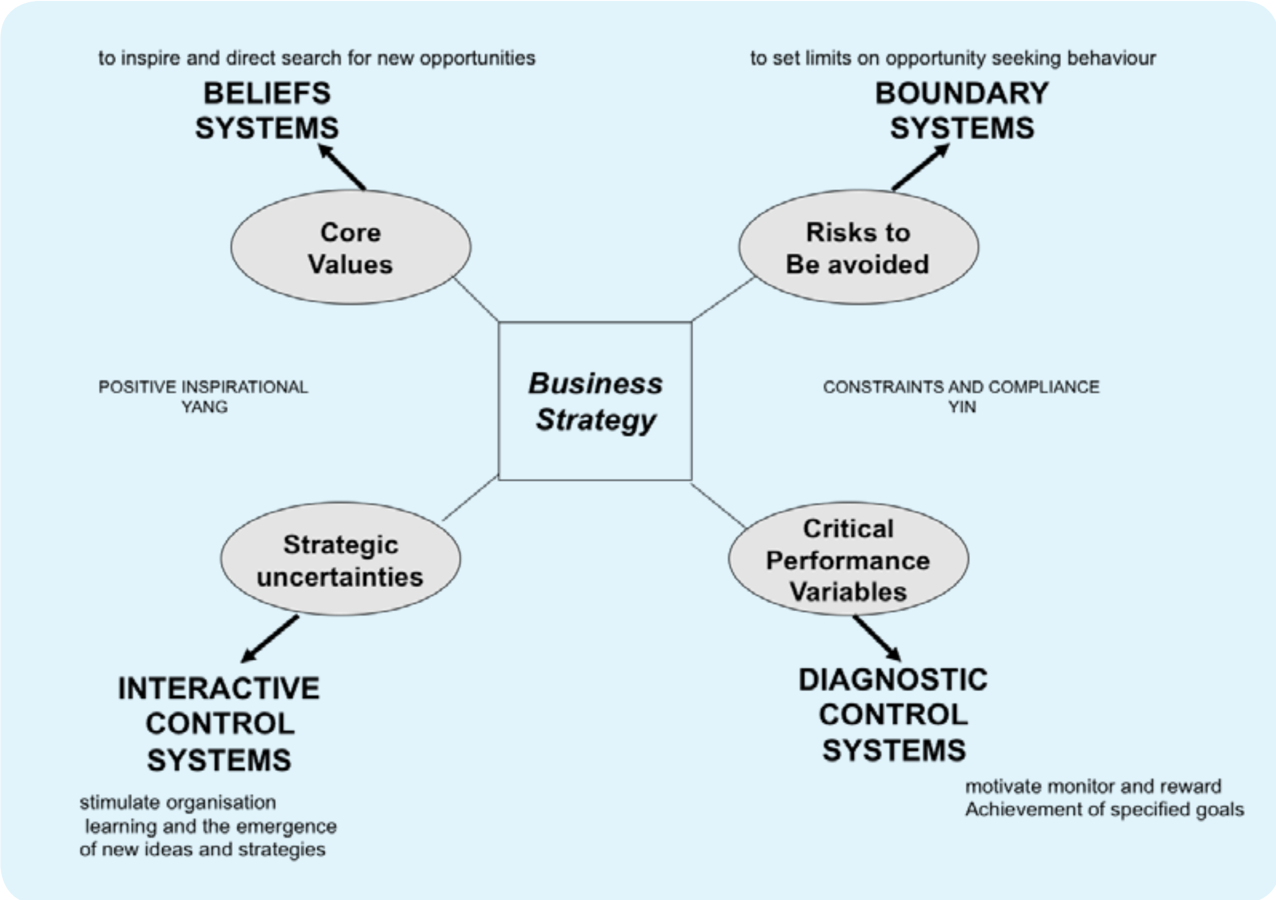

After its heyday in the mid to late nineties, OBM appeared to have receded into the annals of management history, but it has surprisingly re-emerged, in fact on 13 November when the philosophy was the subject of a regular management column in *The Economist* written under the Schumpeter nom de plume. Referring to OBM as a process of "creative disrobing" Schumpeter surprisingly asserts that today the most fervent adopters are small private firms. This is a claim that seemingly flies in the face of popular perception in Australia where closely held family businesses are considered to be notoriously secretive, reserving all critical information for the exclusive use of the ruling clan. The reasons given by Schumpeter are twofold and may potentially provide some insight into why the philosophy has re-emerged after a fallow period.

First, it is suggested that transparency calms internal jitters in uncertain times. Fully informed employees are not influenced by rumour and misinformation; the availability of sensitive information effectively brings them into the privileged confines of the corporate board room. Given the current level of uncertainty dominating the external environment it is perfectly understandable that top management would embrace measures with potential for stabilising their internal capability and protecting it against irrational forces that stimulate even further uncertainty.

Schumpeter's second reason for the rising popularity of OBM is that the possession of information inspires fresh thinking and this has the potential to nurture new ideas, different approaches and ultimately the power of innovation to take advantage of strategic windows. This is a very important insight and it implies that an OBM philosophy can become the catalyst for nurturing a culture that encourages a process of emerging strategic initiatives emanating not only from the apex of the organisation but also from the bottom up.

Management theory has long recognised that the formulation of strategy is not necessarily a formal deliberative process which is the exclusive role of top management. Strategy has the potential to emerge from the trenches as well, from the perceptions and impressions formulated by employees working in operations and in sales and in the multitude of support roles now characterising our complex structures. These front line personnel accumulate critical first-hand intelligence as they perform their tasks and many have the ability to internalise the information and in so doing develop recommendations for realigning existing strategy or for formulating new strategy. What is mandatory for this potential to become reality is a process where the intelligence gathered and the knowledge derived from it can reach the strategic apex of the organisation because unless it does so there is no potential for influencing strategic direction.

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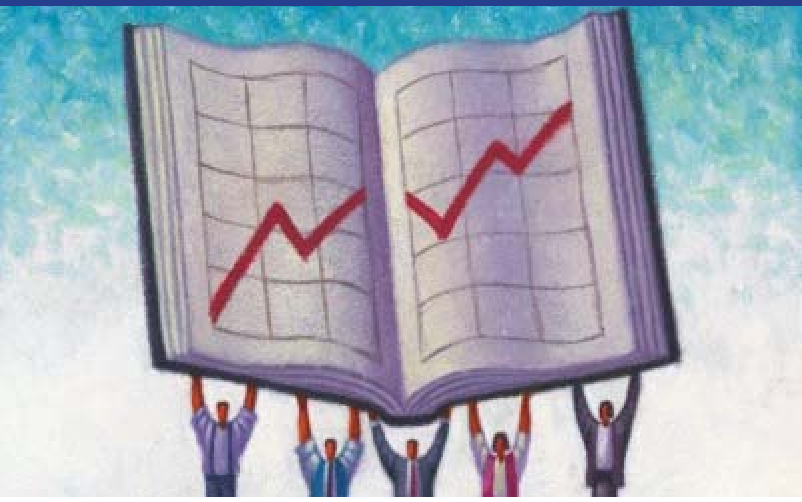

> Importantly, the **staff**, a key organisational resource, is *encouraged* to develop a level of ***commitment***

In 1995, Robert Simons suggested a model with the required feedback loop that provided the potential for communicating strategic information into the strategic apex of the organisation while simultaneously maintaining the focus on core competencies and control over extant facilities. The Simons model is illustrated in Figure 1. It is based on harnessing two opposing forces, the yin and the yang, the positive inspiration coming from the new ideas emerging from active learning always constrained by recognised boundaries and systems that prescribe mandatory levels of compliance.

The active participation of all levels of the personnel resource in contributing to the emerging strategic process is through what Simons refers to as an interactive control system (ICS). This describes the processes that both stimulate learning and facilitate the emergence of new ideas and strategic initiatives. For the ICS to operate effectively and achieve its objectives it must be embedded in a culture of transparency that allows information transmission upstream and downstream. It would seem that the three cornerstone principles of Open Book Management are an ideal philosophical framework into which the Simons model could be dropped resulting in a capability that can open up strategic windows while remaining focused on areas of core competency. Importantly, the staff, a key organisational resource, is not only encouraged to develop a level of commitment usually reserved for an ownership class; it is also empowered through the information it possess to both maintain extant capabilities and to innovate. These are fundamental requirements for remaining competitive and relevant in dynamic global environments, and it would appear that combining Simons' Levers of Control with the cornerstone principles of OBM may offer the structure to achieve those objectives.

Simons, R (1995) *Levers of control.* Boston Massachusetts, Harvard Business School Press

What's the Scenario?

By Matthew Schott, ICMA (Australia)

Dealing with the multiple scenarios required by management is a common daily issue for many of us. Trying to limit the scenarios is certainly one approach to handling complexity, but no matter how many required a process is needed. This article provides an example using scenarios and a neat way to keep control of the inputs and outputs.

One situation is where a set of assumptions are used to calculate a forecast for an investment, e.g. new plant equipment. This example would involve a comparison between how much the current equipment costs to run versus the capital costs and running costs of new equipment. When forecasting the operating costs of the current equipment there is more certainty due to historical records. As per the simplified example in table 1 there are four major cost drivers and these are split into two categories:

1. Common elements to the old and new options (green): Labour Cost per Hour, Cents per Kw

2. Elements with more uncertainty for the new option (orange): Minutes per Unit, Kw per Hour

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Daily Operating Model	Old	New
No. Of units to produce	300	300
Mins per unit	4	3
Total Operating Minutes	1200	900
Total Labour Hours to operate equipment	20	15
Labour Cost per Hour	$40.00	$40.00
Labour Cost per Day	$800	$600
Cost per Kw	$0.08	$0.08
Kw Per Hour	200	400
Electricity Cost	$320	$480
Total Cost of Production	$120	$1080

table 1

Now we have a very simple cost model setup for both the current and new equipment. For the purposes of our analysis there are a number of assumptions that can be considered in this simple model and these are shown in table 2. The red font 'live' cells are those currently used in table 1. This 'live' set of assumptions is chosen via a scenario selector; in this case scenario 1 has been selected (yellow). Using the lookup function to achieve this is the preferred method.

Scenario Selector	*Selected: 1*	*Scenario*			
Scenario Inputs	LIVE	1	2	3	4
New: Mins per Unit	3	3	3	2.5	3
Both: Labour Cost per Hour	$40.00	$40.00	$40.00	$40.00	$40.00
Both: Cents per Kw $	0.08	$0.08	$0.10	$0.10	$0.10
New: Kw Per Hour	400	400	400	400	450

table 2

The 'live' cells need to be linked to the cost model (table 1) as per the colour coding. With this dynamic model set up the power to change assumptions becomes apparent. The key assumptions can be changed in a controllable table and there is virtually no limit to the number of scenarios you can set up.

There is a final piece of work to make the results easier to compare and view which involves setting up a data table that can show the outputs of all the different scenarios at the same time and in the same format as the assumptions they are derived from. Table 3 shows what this output looks like.

Scenario Outputs	LIVE	1	2	3	4
Total Cost - Old	$1120	$1120	$1200	$1200	$1200
Scenario Outputs	LIVE	1	2	3	4
Total Cost - New	$1080	$1080	$1200	$1000	$1275
Difference +/-	$40	$40	$-	$200	-$75

table 3

In this example I have built the data tables to show the cost under the Old and New equipment for each of the scenarios with the final line comparing the cost between both under these various scenarios. Although this example uses a small number of cost drivers the outputs show a range of possible outcomes for 300 units:

- Scenario 1 – The new equipment is $40 a day cheaper
- Scenario 2 – Both cost the same to run
- Scenario 3 – The new equipment is $200 a day cheaper
- Scenario 4 – The old equipment is $75 a day cheaper

Note, to add further complexity the number of units could be variable and part of the assumptions list.

This method of controlling scenario inputs and outputs is a great tool to assist with decision making, but it still requires management to have a good understanding of what drivers it can influence and by how much. Its main benefit is that the model does not have to be constantly manipulated and possibly corrupted in the process. Once the assumptions are linked up to the scenario selector it can be manipulated from there - with the added benefit of seeing the results at the same time. I hope you find it as useful as I do.

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[The key **feature** of job costing is that each job is readily *identifiable* as a ***separate*** cost object]

Product Costing Systems (Part 2)

by John Donald, Lecturer, School of Accounting, Economics and Finance, Deakin University.

In the last set of Student Notes, you were introduced to the concept of job costing and the journal entries it requires. You will recall that this type of costing system is used by manufacturers producing either single unique items or batches of identical items. These firms generally make things according to their customer's specifications. Examples of this type of producer include manufacturers of specialised equipment, construction contractors and commercial printers. Job costing is also used by service firms that provide customised advice or activities as required by their clients e.g. legal or accounting firms. The key feature of job costing is that each job is readily identifiable as a separate cost object. How job costing operates is demonstrated by the following example.

Job costing at Timbercraft Pty Ltd

A manufacturer of pleasure boats – Timbercraft Pty Ltd – builds only custom-made boats using all-wood construction. The company employs ten people for assembly work and rents a factory building. Timber and marine plywood for the boat hulls are purchased locally, and all other materials are obtained by special order to be assembled into the boats according to the specifications in each customer's order. Thus purchases of items such as motors, window glass, plumbing equipment, upholstery and various stainless steel or brass attachments, are made only after a customer's order is received. All the boats are finished to the highest level of quality. Job costing is used by Timbercraft for pricing and cost control purposes.

As at 1 March 2012, the company had four boats under construction:

Job 221, a 6-metre speedboat

Job 222, a 10-metre cabin cruiser

Job 223, a 15-metre cabin cruiser

Job 224, a 15-metre houseboat

The company's job cost sheets showed that the following costs were incurred during March:

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Jobs	221	222	223	224
Direct material	$4 580	$ 6 800	$11 250	$15 660
Direct labour	2 250	8 420	6 900	8 460
*Manufacturing overhead**	1 125	4 210	3 450	4 230
Total	$7 955	$19 430	$21 600	$28 350

*Management decided that overhead costs are primarily labour-driven, so overhead is applied to work in process using a predetermined overhead rate of 50 per cent of direct labour cost.

The balances in the inventory accounts at 1 March were:

Raw materials	$15 430
Work in process	77 335
Finished Goods	0

The following transactions in summary provide the manufacturing cost information for March:

1. Purchases of direct material and factory supplies (indirect material) during March totalled $17 900.

2. During March, direct materials were issued to jobs in process as follows:

Job 221	$ 2 300
Job 222	3 000
Job 223	7800
Job 224	11 000
	$24 100

3. The summary of labour timesheets for March showed that the direct labour costs for the various jobs were:

Job 221	$ 3 840
Job 222	5 650
Job 223	11 980
Job 224	18 950
	$40 420

4. Jobs 221 and 222 were completed during March, and the boats were delivered to the customers (at their expense).

5. Customers were billed during March as follows: for Job 221, $20 000; for Job 222, $38 630.

6. By the end of March, the following information had been compiled concerning actual manufacturing overhead costs for the month:

Factory supplies consumed	$ 2 490
Indirect labour shown on timecards	3 580
Monthly rent on factory building	9 000
Monthly depreciation of machinery	5 200
Utilities (gas, electricity, water, phone)	800
	$21 070

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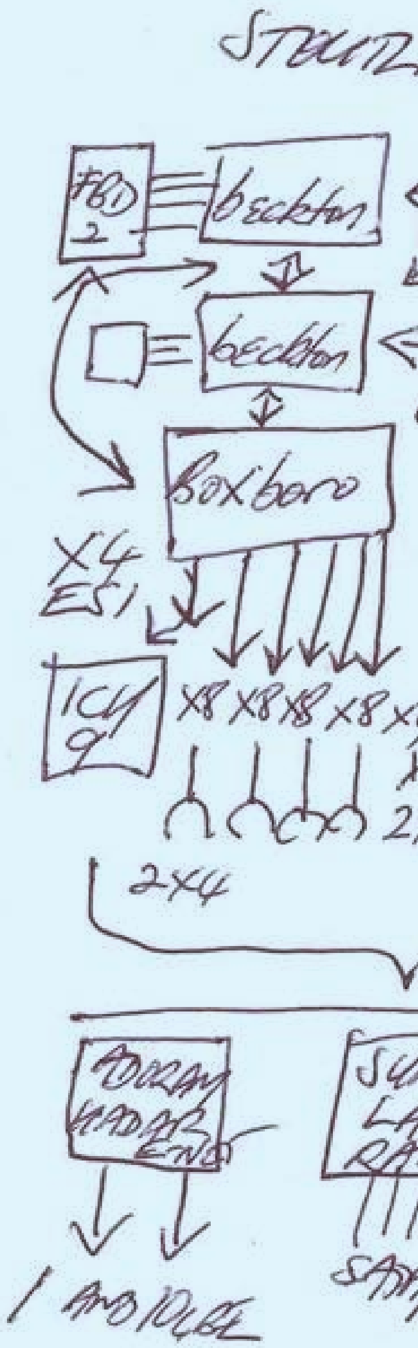

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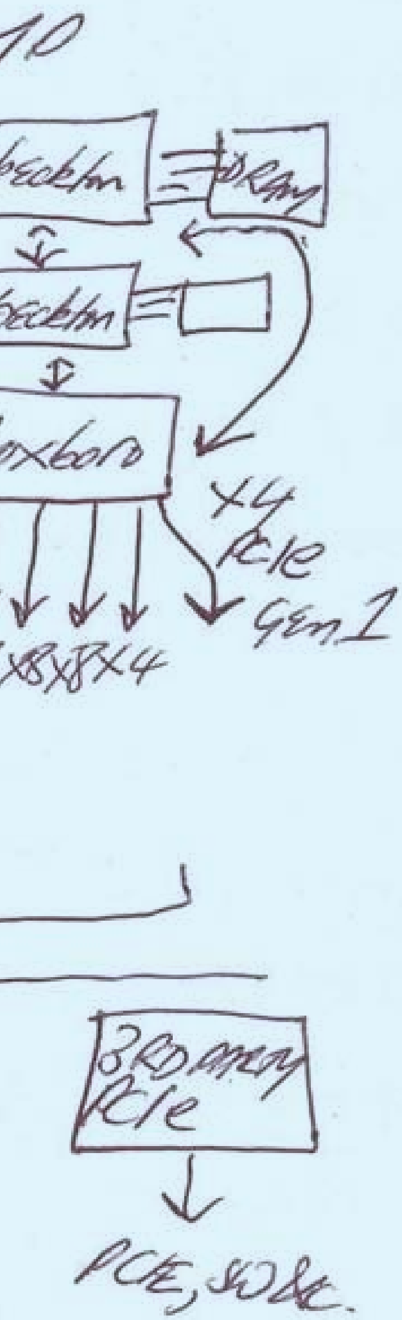

The following journal entries would be needed to record the activities of the company during March. These entries are numbered in the same sequence used in the last set of Student Notes. You may like to refer back to those notes for further explanations of the entries.

(1) Raw Materials Inventor	$17 900
Accounts Payable	$17 900

To record purchases of direct materials and factory supplies.

(2) Work in Process Inventory	$24 100
Raw Materials Inventory	$24 100

To record the issuing of direct materials to jobs, and to update job cost sheets as follows:

Job 221	$ 2 300
Job 222	3 000
Job 223	7,800
Job 224	11 000
Total	$24 100

(3) Work in Process Inventory	$40 420
Wages Payable	$40 420

To record direct labour costs incurred on jobs, and to update job cost sheets as follows:

Job 221	$ 3 840
Job 222	5 650
Job 223	11 980
Job 224	18 950
	$40 420

Note: Labour on-costs such as superannuation are omitted for the sake of simplicity. In reality, these would need to be added to the wages paid to employees to get the total cost of labour.

(4) Work in Process Inventory	$20 210
Manufacturing Overhead	$20 210

To record manufacturing overhead applied to jobs, at a predetermined rate of 50 per cent of direct labour cost, and to update job cost sheets as follows:

Job 221	$ 1 920
Job 222	2 825
Job 223	5 990
Job 224	9 475
	$20 210

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(5) Manufacturing Overhead $21 070

Raw materials Inventory $2 490

Wages Payable 3 580

Prepaid Factory Rent 9 000

Accumulated Depreciation of Machinery 5 200

Accounts Payable 800

To record the actual manufacturing overhead costs for March.

(6) Finished Goods $46 920

Work in Process Inventory $46 920

To transfer the costs of Jobs 221 and 222, completed in March, and to close out job sheets as follows:

Job 221	$16 015
Job 222	30 905
Total	$46 920

The costs of the two completed jobs were calculated as follows:

Job 221

Total of costs incurred as at 1 March	$ 7 955
March costs:	
Material	2 300
Labour	3 840
Manufacturing overhead applied	1 920
	$16 015

Job 222

Total of costs incurred as at 1 March	$19 430
March costs:	
Material	3 000
Labour	5 650
Manufacturing overhead applied	2 825
	$30 905

(7) Accounts Receivable $58 630

Sales Revenue $58 630

To record the sale of two boats: Job 221for $20 000, and Job 222 for $38 630.

(8) Cost of Goods Sold $46 920

Finished Goods $46 920

To transfer the costs of jobs completed and sold in March.

At the end of each accounting period, which for most firms is usually 30 June, the balance in the Cost of Goods Sold account is transferred to the Profit and Loss account so that profit for the period can be calculated. However, taking the month of March on its own, Timbercraft's gross profit was $11, 710 as shown below:

	Job 221	Job 222	Total
Sale revenue	$20 000	$38 630	$58 630
Total manufacturing costs	16 015	30 905	46 920
Gross profit	$ 3 985	$ 7 725	$11 710
Percentage mark-up on cost	24%	24%	

Because of the very high quality of its boats, Timbercraft's customers are prepared to sign cost-plus contracts incorporating a mark-up for profit equal to 24 per cent of total manufacturing costs. This pricing policy transfers the risk of unexpected materials or labour cost increases from the company to its customers and, of course, ensures that the company makes a profit on each job.

The balances in the company's inventory accounts at 31 March were:

Raw materials	$ 6 740*
Work in process	115 145*
Finished Goods	0

* You should test your understanding of job costing by confirming the accuracy of these two amounts. The next set of Student Notes will introduce you to the other main type of costing system i.e. process costing.

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In the October issue, Leon Duval reported in his CEO Snapshot on the debate among council members as to whether or not *On Target Online* should be restricted to members only or remain freely available and of benefit as a marketing tool.

Members were invited to express their opinions and as promised, we publish a selection of responses below. To date they have been overwhelmingly in favour of maintaining the status quo.

Dear Mr Duval

I fully support the idea that the magazine should reach out to a wider audience providing access to and awareness of the CMA brand,

Regards,

Deopaul Lakeram CMA (Australia)

Mississauga, ON, Canada

Dear Mr Duval,

I personally feel that On Target is an excellent and quick snapshot summary provider for management accounting professionals. The sharing of information is extremely useful through the electronic media. ICMA can certainly market itself better through this option. Presently I use On Target and being a member of ICMA I have also passed on certain articles at my workplace. Being in New Zealand I am trying to convey the benefits of the Institute and also encourage members of other professional institutes at my work to become ICMA members,

Regards,

Roopak Haridasan

Wellington, NZ

Dear Mr Duval,

I agree with your opinion concerning the potential benefit of attracting sponsorship by retaining unlimited access,

Regards,

John Wright,

Australia

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