Chapter 1

Management Accounting and the Business Environment

Lecture Notes

A. Management vs. Financial Accounting. It is a good idea to begin the course by contrasting management with financial accounting. At minimum, you may want to point out that financial accounting is concerned with reports to owners, accounts payable, and others outside of the firm. Management accounting is concerned with reports prepared for the internal use of management. You may want to go into more detail concerning the differences between management and financial accounting at this time, but we personally prefer to defer this discussion until after students have a better understanding of what managers do.

B. Organizations. A review of the work of managers and the organizations in which they operate is useful. You may want to take a few moments and discuss some organizations that students are familiar with. Examples of organizations that students may mention include: sole proprietorships, partnerships, corporations, churches, cities, military units, social clubs, foundations, and families. With the various types of organizations listed, focus on two points.

1. An organization consists of people who are brought together for some common purpose. It is a group of people working together that is the essence of any organization, not the particular assets used by these people.

2. People work together in an organization in order to attain some goals. The objectives or goals may be clearly stated, but often they are not. The financial objectives for most organizations, even if not articulated, are fairly straightforward. In commercial enterprises, a goal is ordinarily to maximize profits or to at least earn a 'satisfactory profit.' In nonprofit organizations, avoiding losses is more of a constraint than a goal. Nevertheless, managers need virtually the same information to avoid losses that they need to maximize profits. While we usually talk about profit-making firms in the course, almost everything we say applies as well to nonprofit organizations.

C. The Work of Management and the Planning and Control Cycle. While it is clearly a simplification, the work of managers can be usefully classified into four major categories: planning, directing and motivating, controlling and decision making.

1. Planning The first step in planning is to identify alternatives and then select from among the alternatives the one that does the best job of furthering the organization's objectives. All important alternatives considered by management in the planning process have some effect on revenues and costs, and management accounting data are essential in estimating those effects. When a decision is made, it is translated into short-term plans. The plans of management are often expressed formally in budgets (i.e. in specific, quantitative terms).

2. **Directing and motivating** involves mobilizing people to implement the plan. This requires the ability to motivate and effectively direct people.

3. **Control** is concerned with ensuring that the plan is followed. Emphasize that the accounting function plays a major role in the control phase. Accountants maintain the databases and prepare reports of various types that provide feedback to managers. One of these reports, which compares budgeted to actual results, is called a performance report. The feedback provided by these can be used to reward particularly successful employees, but more importantly the feedback can be used to identify potential problems and opportunities that were not anticipated in the plan. Based upon feedback, it may be desirable to modify the plan. The feedback can also be used to identify parts of the organization that need help and those parts that can provide advice and assistance to others.

4. **Decision making** is an integral part of the other three management activities. It involves selecting a course of action from competing alternatives. Many decisions revolve around the following three questions: *What* should we be selling? *Who* should we be serving? *How* should we execute?

SUGGESTION: You may want to point out to students that they already use (consciously or unconsciously) the steps of the planning and control cycle. Most students have established long-term educational goals (e.g. graduation and future employment). Short-term planning involves deciding which courses to take the next term or perhaps over the next few terms. Students implement their plans by enrolling in classes and (hopefully) studying diligently. Performance is measured by grades. At the end of each term, students evaluate their performance to decide on the appropriate courses for the next term, or perhaps even reevaluate their long-term objectives (e.g. major).

E. **Comparison of Financial and Management Accounting.** Both financial and management accounting rely on the same basic accounting database. However, there are important differences between the two disciplines:

1. **Financial Accounting.**
- Is concerned with reports made to those outside the organization.
- Summarizes the financial consequences of past activities.
- Emphasizes precision and verifiability.
- Summarizes data for the entire organization.
- Must follow IFRS since the reports are made to outsiders and are audited.
- Is required for publicly-held companies and by lenders.

2. **Management Accounting.**
- Is concerned with information for the internal use of management.
- Emphasizes the future.
- Emphasizes relevance and flexibility of data.

- Places more emphasis on non-monetary data and timeliness and less emphasis on precision.
- Emphasizes the segments of an organization rather than the organization as a whole.
- Is not governed by IFRS.
- Is not required by external regulatory bodies or by lenders.

F. Organizational Structure. Organizational structure refers to the way in which responsibilities and authority are distributed within an organization.

1. Centralization vs. decentralization. At one extreme is a totally centralized organization in which the 'boss' makes all decisions. The opposite extreme is a totally decentralized organization where decisions are made at the lowest possible level in the organization. Centralization tends to be favoured in situations where information is centralized and control is important. Decentralization tends to be favoured in situations where information is dispersed and centralized control is less important.

2. Organization charts. Exhibit 1-4 is useful in discussing the structure of an organization. Informal communication links are particularly important.

3. Line and staff relationships. Exhibit 1-4 is also useful for discussing line and staff positions. A line manager is directly engaged in attaining the organization's objectives. People in staff positions provide support to the line positions. Especially important to note here is that the accounting function is a staff position.

~~**G. International diversity in management accounting traditions.**~~
~~Management accounting is based on different traditions in different countries. For example, although we might expect to find basic economic calculations on costs and revenues to be of interest to managers in any system of competitive capitalism, these calculations may be the province of different professional groupings (such as engineers or business economists) in different countries. This point may also be used to emphasize that management techniques including management accounting are influenced by cultural, institutional and historical factors.~~

G~~H~~. Expanding Role of Management Accounting. An understanding of the history of management accounting is important for several reasons. First, it helps students to understand later in the course why some prevailing management accounting practices are less than optimal (e.g. allocating overhead on the basis of direct labour). Second, students should be aware that management accounting is evolving in response to changes in the business environment. There is not a single right way to do things or a single formula that will always provide the best answer. This often comes as a surprise to students who expect management accounting to be a subject like physics where there are immutable laws.

H. Sources of Management Accounting Knowledge.~~:~~ Management accounting knowledge draws from practice (e.g., General Motors pioneered budgets), academia (e.g., business schools, research published in accounting and management journals), professional bodies (e.g., CIMA), professional interest groups (e.g., Beyond Budgeting roundtable) and others. Managerial fashions and fads constantly influence management accounting practices, which is why a critical understanding of management accounting principles is required to mitigate risky and/or faulty practices. *Suggestion: you may wish to pick up on 'Business Gurus', inquire how trustworthy their insight is, and why.*

I. International diversity in management accounting traditions. Management accounting is based on different traditions in different countries. For example, although we might expect to find basic economic calculations on costs and revenues to be of interest to managers in any system of competitive capitalism, these calculations may be the province of different professional groupings (such as engineers or business economists) in different countries. This point may also be used to emphasize that management techniques including management accounting are influenced by cultural, institutional and historical factors.

J~~I~~. The Changing Business Environment. Over the last two decades, competition in many industries has become global and the pace of innovation in products and services has accelerated. While this has generally been good news for consumers, it has resulted in wrenching changes in business. Many companies now realize that they must continuously improve in order to remain competitive. This revolution is having a profound effect on the practice of management accounting. Many companies have gone through several waves of improvement programmes, starting with just-in-time (JIT) and passing on to total quality management (TQM).

K~~J~~. Deregulation and Privatization. The historical and institutional factors introduced above may be illustrated by looking at the effects of deregulation and privatization. It is also worth noting that the increased competition in the airline industry was not possible until the de-regulation effects of 'open skies' policies. De-regulation and privatization of former state-owned monopolies has a significant impact in Europe, especially in the UK, which pioneered these policies. The changes in ownership and increased competition have not only affected the huge public utilities that were privatized, such as British Telecom or British Rail, but they also had a knock-on effect on the companies that supplied these giants.

L~~K~~. The increased importance of service industries and changing approaches to public sector management. Management accounting has expanded its influence from its traditional base in manufacturing to service sectors, which themselves have become increasing sources of employment and income in many economies. Students may be able to relate to their own experiences here as part-time and holiday jobs are often found in the service sector. They should also be able to relate easily to changes in the public sector with new information available on the performance of organizations that they are familiar with, such as universities and hospitals. It should be relatively easy to provoke debate about the use of measurements in areas such as health care.

Suggestion: you may wish to pick on area where performance indicators have been used and discuss their likely consequences, e.g. problems of league table mentality; focus on the indicators at expense of what is not measured (e.g. hospital waiting lists).

M. ESG, CSR, and Environmental MA. These are very topical areas in the modern business landscape (e.g., mitigating carbon emissions, climate change). When discussing the integration of CSR and ESG roles into company strategies, it should be highlighted how these components may further enhance shareholder value, customer value, and attract investors. The role of CSR and ESG could be further linked in demonstrating ethical business practices, which can mitigate risks and serve as powerful tools for recruitment and employee retention. Regarding EMA, it should be noted that both physical and monetary information on environmental costs and benefits are usually gathered to make informed, environmentally sensitive decisions. It should be noted that companies increasingly adopt green business policies to comply with policies and regulations, reduce costs, and meet societal demands.

N~~L~~. **Professional Ethics.** This is also an extremely topical area with high-profile scandals such as Enron. In the UK, the problems have been particularly acute with ~~a number of~~several examples of mis-selling in the financial services industry. Students may be invited to debate about the role of ethics, professional standards and regulation. Some may argue that this area is more a matter of financial accounting. Yet apart from emphasizing the general importance of business ethics to the operation of a successful market economy, there are specific areas of management accounting that affect issues such as international transfer pricing. Some students tend to equate legal and ethical behaviour. That is, if an action is legal, they consider it to be ethical. We believe it is important to dispel this notion.

1. In the text we use a utilitarian approach in arguing for the importance of maintaining ethical standards. We argue that ethical standards are necessary for the smooth functioning of an advanced market economy. Basically, if you could not trust anyone, you would be unwilling to transact in the marketplace without ironclad guarantees. Such guarantees are expensive to write and enforce even when they are feasible. See Eric Noreen (1988), ‘The economics of ethics: a new perspective on agency theory’, *Accounting, Organizations and Society*, 13 (4), for further development of these ideas.

2. One advantage of approaching ethical issues in the management accounting course is that there is a code of ethics promulgated by a professional body (the Chartered Institute of Management Accountants) that can be used as a framework. You might wish to compare the situation of professional associations that do not have special monopolies with those that have the statutory right to audit and verify financial statements.