

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, creditors, and others outside of the firm. Management accounting is concerned with reports prepared for the internal use of management. Since these are internal reports, there is no requirement that management accounting reports conform to GAAP. Indeed, there are instances in which it is desirable to depart from GAAP. 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. Organisations. A review of the work of managers and the organisations in which they operate is useful. You may want to take a few moments and discuss some organisations that students are familiar with. Examples of organisations that students may mention include: sole proprietorships, partnerships, corporations, churches, cities, military units, social clubs, foundations, and families. With the various types of organisations listed, focus on two points.

1. An organisation 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 organisation, not the particular assets used by these people.

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

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 three major categories: planning, directing and motivating, and controlling. All of these activities involve making decisions.

1. **Planning** consists of strategic planning and developing more detailed short-term plans. Most of what we refer to below is with reference to the more detailed short-term plans.

2. **Directing and motivating** involves mobilising people to implement the plan.

3. **Control** is concerned with ensuring that the plan is followed. Emphasise that the accounting function plays a major role in the control phase. Accountants maintain the databases and prepare the reports that provide feedback to managers. The feedback 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 be also used to identify parts of the organisation 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.

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).

D. Need for Information. Accurate and timely accounting information helps management plan effectively and to focus attention on deviations from plans. In the planning stage, managers make decisions concerning which alternatives should be selected. Financial information is often a vital component of this decision-making. Once the alternatives have been selected, detailed planning is possible. These detailed plans are usually stated in the form of budgets. The control function of management is aided by performance reports that compare actual performance to the budget. This feedback mechanism directs attention to activities where management attention is needed.

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 organisation.
- Summarises the financial consequences of past activities.
- Emphasises precision and verifiability.
- Summarises data for the entire organisation.
- Must follow GAAP 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.
- Emphasises the future.
- Emphasises relevance and flexibility of data.
- Places more emphasis on non-monetary data and timeliness and less emphasis on precision.
- Emphasises the segments of an organisation rather than the organisation as a whole.
- Is not governed by GAAP.
- Is not required by external regulatory bodies or by lenders.

F. 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.

G. 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 realise that they must continuously improve in order to remain competitive.

H. Organisational Structure. (Exercise P1-2) Organisational structure refers to the way in which responsibilities and authority are distributed within an organisation.

1. Centralisation vs. decentralisation. At one extreme is a totally centralised organisation in which the 'boss' makes all decisions. The opposite extreme is a totally decentralised organisation where decisions are made at the lowest possible level in the organisation. Centralisation tends to be favored in situations where information is centralised and control is important. Decentralisation tends to be favored in situations where information is dispersed and centralised control is less important.

2. Organisation charts. Exhibit 1-3 is useful in discussing the structure of an organisation. Informal communication links are particularly important.

3. Line and staff relationships. Exhibit 1-3 is also useful for discussing line and staff positions. A line manager is directly engaged in attaining the organisation'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.

4. The controller. The controller is the manager in charge of the accounting department. The controller is a member of the top-management team and should be an active participant in the planning, control, and decision-making processes.

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 emphasise that management techniques including management accounting are influenced by cultural, institutional and historical factors.

J. Deregulation and Privatisation

The historical and institutional factors introduced above may be illustrated by looking at the effects of deregulation and privatisation. 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. Deregulation and privatisation 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 privatised such as British Telecom or British Rail; they also had a knock-on effect on the companies that supplied these giants.

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 organisations 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).

L. Professional Ethics. This is an extremely topical area with high profile scandals such as Enron. In the UK, the problems have been particularly acute with a number of 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 emphasising 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, 'The economics of ethics: a new perspective on agency theory,' *Accounting, Organisations and Society*, vol. 13, no 4, 1988 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.