

# Part 1

## DEFINING, REPORTING AND MANAGING COSTS

Management accounting takes us inside an organisation. It could be a private-sector business organisation, or it could be a public-sector service provider. The common feature is that managers need information to help them with planning, decision making and control. Management accounting will provide information that directs attention, keeps the score and solves problems. Chapter 1 explains these functions of management and of management accounting.

Inside the business there is information available in great detail. Costs of all types are recorded and analysed to evaluate performance. Chapter 2 explains how costs can be classified according to how they behave in relation to activity levels. It also shows that some costs relate to products and output while other costs relate to the passage of time. The type of classification used depends on the purpose for which costs are needed.

The costs of manufacturing goods or providing a service can be grouped as costs of materials, costs of labour and other costs of output. The costs that are not directly identified to a unit of output are called overhead costs. Chapters 3 and 4 explain how costs of materials, labour and overhead are recorded and analysed.

The definitions explained in Chapters 2, 3 and 4 are applied in Chapter 5 to show that different treatments of overhead costs give different measures of profit when inventory levels are changing. Absorbing all costs into products means that unsold inventory carries its share of overheads to the profit of the period when it is eventually sold. Treating overheads as a cost of the period means that these costs fall into the profit of the period of manufacture or service provision.

Chapter 6 explains how the cost of a job is calculated. Chapter 7 shows the system for recording job costs. Chapter 8 describes the approach to be used when a process is continuous so that separate jobs cannot be distinguished.

### Part 1 DEFINING, REPORTING AND MANAGING COSTS

<b>LEVEL 1</b>	<b>Chapter 1</b> What is management accounting?	<b>Chapter 2</b> Classification of costs	<b>Chapter 3</b> Materials and labour costs	<b>Chapter 4</b> Overhead costs
<b>LEVEL 2</b>	<b>Chapter 5</b> Absorption costing and marginal costing	<b>Chapter 6</b> Job costing	<b>Chapter 7</b> Recording transactions in a job-costing system	<b>Chapter 8</b> Process costing

# Chapter 1

## What is management accounting?

### Real world case 1.1

#### What is management accounting?

Management accounting combines accounting, finance and management with leading edge techniques needed to drive successful businesses. It combines technical skills with business management skills.

Management accountants:

- advise managers about the financial implications of projects;
- explain the financial consequences of business decisions;
- formulate business strategy;
- monitor spending and financial control;
- conduct internal business audits;
- explain the impact of the competitive landscape.



Source: CIMA website, 2009. <http://www.cimaandme.com/#/iscimaforme/whatis/>.

#### Discussion points

- 1 Imagine that you are working as a management accountant in a company that is planning a project to establish a 'wind farm' to generate renewable electricity. What kind of work might you contribute to the project?
- 2 Imagine that you are working as a management accountant in a company which is unprofitable because its labour costs are higher than those of its competitors. How might you contribute to improving the profitability through controlling the labour costs?

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## Learning outcomes

After studying this chapter you should be able to:

- Explain how the definition of ‘accounting’ represents the subject of management accounting.
- Explain the needs of internal users of accounting information.
- Describe the management functions of planning, decision making and control, and show how these are related within a business activity.
- Describe the roles of management accounting in directing attention, keeping the score and solving problems.
- Analyse simple cases where management accounting may contribute to making judgements and decisions.
- Understand that the terminology of management accounting is less well defined than that of financial accounting and therefore you will need to be flexible in interpreting the use of words.
- Describe and discuss examples of research into work based on management accounting.

## 1.1 Introduction

**Accounting** has been defined as follows:

### Definition

**Accounting** is the process of identifying, measuring and communicating financial information about an entity to permit informed judgements and decisions by users of the information.<sup>1</sup>

Many would argue that those who manage an organisation on a day-to-day basis are the foremost users of accounting information about that organisation. The description **management** is a collective term for all those persons who have responsibilities for making judgements and decisions within an organisation. Because they have close involvement with the business, they have access to a wide range of information (much of which may be confidential within the organisation) and will seek those aspects of the information which are most relevant to their particular judgements and decisions. **Management accounting** is a specialist branch of accounting which has developed to serve the particular needs of management.

### Activity 1.1

*Imagine that you are in charge of a cycle hire business in a holiday resort. You have 50 cycles available for hire. Some customers hire cycles for one day; others take them for up to one week. Write down any three decisions that you might make as a manager, where accounting information would be helpful in making the decision.*

### 1.1.1 Applying the definition

Consider the following three scenarios which are typical of comments in the 'Management' section of the financial press. As you read each scenario, think about how it relates to the definition of 'accounting' given at the start of this section. Then read the comment following the scenario and compare it with your thinking.

#### Scenario 1.1

In the 12 months to June 30, net profits dropped from £280m to £42m, depressed by hefty investments, increased paper costs and poor advertising spending . . . The chief executive has explained the company's plans for improving its margins to the average level for the industry. The directors are also committed to getting the assets to work creatively together. *[Report on a magazine publishing company]*

Scenario 1.1 indicates decision making related to **profit margins** and the effective use of **assets**. The profit margins will be improved either by improving **sales** or by controlling **costs**, or through a mixture of both. Assets will be used more effectively if they create more **profit** or higher sales. Achieving these targets requires a range of managerial skills covering sales, **production** and asset management. Identifying the relevant costs and **revenues**, measuring the achievement of targets and communicating the outcomes within the organisation are all functions of management accounting. The chief executive will need to form a judgement on whether the decisions taken are likely to satisfy investors and maintain their confidence in the management team.

### Scenario 1.2

Salespersons at a car manufacturer's dealership noticed business was slow in April. They reacted by encouraging customers to take more time in deciding whether to buy a car. What was the reason? They were paid a monthly bonus when sales exceeded a specified target. They could see that the April sales would not reach the target and so encouraged customers to wait until May, to increase the likely volume of May sales. In a brewing company the sales manager set a low sales target, in the hope of exceeding it easily. This caused the company to reduce production, so that when demand for beer rose to a higher level because of good weather, the company could not provide adequate supplies. [*Journalist's comment on how unrealistic targets can distort achievement of company objectives.*]

Scenario 1.2 shows that at some point in the past a decision was taken to create employee incentives by setting quantifiable targets. Unfortunately this has led to a narrow focus on measuring the achievement of the targets. There was a problem in allowing the employees too much freedom to influence either the setting of the target or the achievement of the target. There was no judgement about the best interests of the company. A further decision is now required to balance the motivation of the employees against the best interests of the company. Communication is an important feature of getting the decision right.

### Scenario 1.3

Engineers are challenging the assumption that companies are run by 'number-crunchers' . . . The hidden skill of engineers is their ability to be analytical and numerate. As someone who has to evaluate and sit on the boards of information technology and software development companies, I have the ability to understand the basics of their business. [*Managing director of a venture capital company, qualified engineer.*]

The term 'number-cruncher' tends to be used as a somewhat uncomplimentary description of an accounting specialist. The engineer quoted in Scenario 1.3 has related to the measurement aspect of accounting and has identified the need to make judgements ('evaluate') using analytical skills. However, this quotation has made no mention either of communication or of decision making. There is an increasing expectation that the management accountants in an organisation will work with the engineers or other technical specialists, try to understand the nature of the business and ensure that the judgements are communicated to the experts so that cost-effective decisions can be made.

## 1.1.2

### A contingency approach

The word 'contingency' means 'condition'. The contingency theory of management accounting describes the process of creating a control system for a given set of purposes. This is sometimes described in terms of a '**contingency theory**' of management accounting. The management accounting approach is conditioned by ('contingent upon') the situation.

The idea for thinking about management accounting in terms of contingency theory comes from a study of management and the ways in which management structures are created. Researchers have shown that management structures depend on factors such as the size of the organisation, the production technology and the competitiveness of the industry. These are the contingencies (conditions) that shape the management structure.

In management accounting, control systems have been shown to depend on the external environment of the business, the production technology, the size of the organisation and the corporate strategy.<sup>2</sup>

Management accounting methods have been developed within particular industries. In the UK economy, approximately 75 per cent of output is provided by service industry with only 25 per cent of output being provided by manufacturing industry. However, management accounting began to develop in the twentieth century at a time when manufacturing industry dominated. As the service sector has grown, management accounting has developed to meet its particular needs. What remains of the manufacturing sector has moved from being labour intensive to being capital intensive. In some parts of the world, manufacturing remains labour intensive. The agricultural sector may be stronger in developing economies. All these differences lead to different judgements and decisions, and hence different approaches to identifying, measuring and communicating accounting data. The following chapters will explain management accounting techniques that have been developed to meet particular needs in making judgements and decisions.

### 1.1.3 Strategic management accounting

The traditional approach to management accounting has been to regard internal decision makers as inward looking. This has led to developing techniques for identifying, measuring and communicating costs where only internal comparisons have been thought relevant. Those techniques remain useful in some cases and are sufficiently widely used to justify studying them in an introductory course. However, the later years of the twentieth century brought an increasing awareness that company managers must be outward looking. They must form a strategy for their business that has regard to what competitors are achieving. This requires management accounting to identify, measure and communicate data on the company relative to data for other similar companies. Managers must consider competitive forces such as the threat of new entrants, substitute products or services, rivalry within the industry and the relative bargaining strength of suppliers and customers. Managers must also consider how their organisation adds value in creating its product. There is a flow of business activity from research and development through production, marketing, distribution and after-sales support. This chain of activities creates costs which must be compared with the value added by the organisation. The term '**strategic management accounting**' applies to the identification, measurement and communication of cost data in all these situations where the organisation is being judged against the performance of competitors.

## 1.2 Meeting the needs of internal users

Although the definition of accounting remains appropriate for internal reporting purposes, its application will be different because internal users need to form judgements and make decisions that are different from those of external users. External users form judgements on the overall performance of the entity and make decisions about their relationship with it. Their decisions are of the type: 'Shall I invest money in this business?', 'Shall I continue to be an investor in this business?', 'Shall I supply goods to this business?', 'Shall I continue to supply goods to this business?', 'Shall I become a customer of this business?', 'Shall I continue to be a customer of this business?'

The internal users make different types of judgement and different types of decision. They may have to judge the performance of the various products of the organisation as compared with those of competitors. They may have to judge the performance of different divisions within the organisation. Their decisions are of the type: 'Shall I invest in manufacturing more soap powder, or do I switch resources into toothpaste?', 'Shall I continue offering a television repair service as support for my sales of

televisions?', 'Is it cost effective to have three separate locations at which my tenants can pay their rent?', 'Will this investment in a new factory pay for itself over the next 10 years?' There is great variety in the judgements and decisions made by those who manage the business. Their needs are so wide ranging that management accounting has developed as a separate discipline, within the overall 'accounting' umbrella, in order to serve the particular needs of management.

The use of accounting as a tool which will assist in the management of a business raises two significant questions:

- 1 What types of informed judgement are made by management and about management?
- 2 What types of decision are made by management?

It is presumed that many of those reading this text for the first time may not have a great deal of experience of the types of judgement and decision made in business. This chapter therefore devotes space to four case study illustrations of management situations where management accounting will have a contribution to make. The case studies are uncomplicated so that the management accounting applications are intuitively obvious. After each case study outline there is a comment on the management accounting aspects. You will then meet Fiona McTaggart, a management accounting consultant, who explains how she sees the management accountant's contribution to the management issues raised in each of the four case studies.

Before exploring the case studies, this chapter sets out, in section 1.3, some basic categories of management functions and then outlines, in section 1.4, the role of management accounting in helping to meet the information needs of those management functions.

## 1.3 Management functions

This section describes three management functions: planning, decision making and control.

To be effective, each of these functions requires the application by management of communication and motivation skills. To ensure that the entity's operations are effective, those who work in the entity must be persuaded to identify with its objectives. Managers require the skills to motivate those for whom they are responsible, creating a sense of teamwork. The communication process is a vital part of creating a sense of teamwork and ensuring that all the players understand the role they play in achieving targets. They must also be motivated to want to achieve the targets. Management accounting has a particularly important role in that process of communication and motivation.

### 1.3.1 Planning

'**Planning**' is a very general term which covers longer-term strategic planning and shorter-term operational planning. These two types of planning differ in the time scale that they cover. **Strategic planning** involves preparing, evaluating and selecting *strategies* to achieve objectives of a long-term plan of action. **Operational planning** relates to the detailed plans by which those working within an organisation are expected to meet the short-term objectives of their working group.

Strategic planning is based on objectives set by those who manage the entity at a senior level. If the entity is a legal entity such as a limited liability company or a public-sector corporation, objectives will be set for the corporate entity which will require high-level **corporate strategic planning**. Within the company or corporation there will be major divisions of activities into key business areas, each with their own objectives

requiring **business strategic planning**. The corporate entity may contain many different businesses and those who manage the corporate entity as a whole must manage the entire collection of businesses. They must decide which businesses to develop in the corporate interest, which to support when in temporary difficulties, and which to dispose of as no longer contributing to the corporate well-being. Business strategic planning focuses on each of the separate businesses, which have to consider not only their position within the corporate group of businesses but also their position within the industry or sector to which the business belongs.

Shorter-term operational planning is also referred to as **functional strategic planning**. It concentrates on the actions of specific functions within the business. Although these functions may have a longer-term existence, they must also plan their activity in shorter-term periods so that achievement of targets may be monitored regularly.

At a practical level, managers find that they have to plan ahead in making major decisions on such things as sales, production and **capital expenditure**. Such planning is required for the immediate future and for the longer term. Businesses will typically make a detailed plan for the year ahead and a broader plan for a two- to five-year period. Plans for sales require decisions on which products to sell, which markets to target and what price to charge. Plans for production require decisions on the mix of resources, including labour, the source of raw materials or component parts, the level of stock of raw materials and finished goods to hold and the most effective use of productive capacity. Plans for capital expenditure require a longer-term perspective, taking into account the expected life of the capital equipment acquired. As well as investing in **fixed assets**, the business will need **working capital** as a base for a new project. Decisions will be required on the level of working capital which is appropriate. If the enterprise is to move ahead, plans must lead to decisions.

Scenario 1.4 shows some of the planning stages for Media Advertising Ltd. This is a company which earns profit by selling advertising space on television, the internet and mobile phone texts. Each of these three businesses is organised separately. The managing director of the company has a corporate strategy of achieving returns for shareholders based on all three businesses. The managing director has worked with the business managers to set an overall strategy for each of the three businesses which will help to meet the corporate strategy. If any one of the businesses does not meet its strategic target, it might be restructured or even closed down. The managers of each business then put in place their own operational planning to ensure that they meet the business strategy. The scenario shows the operational planning for the television sales business. The managers of the other two businesses will set similar operational plans.

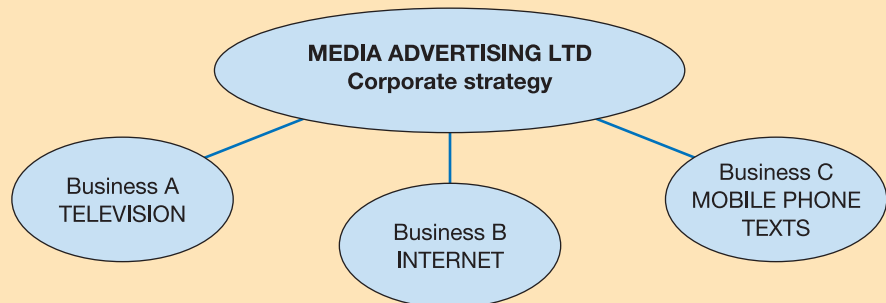
### 1.3.2 Decision making

**Decision making** is central to the management of an enterprise. The manager of a profit-making business has to decide on the manner of implementation of the objectives of the business, at least one of which may well relate to allocating resources so as to maximise profit. A non-profit-making enterprise (such as a department of central or local government) will be making decisions on resource allocation so as to be economic, efficient and effective in its use of finance. All organisations, whether in the private sector or the public sector, take decisions which have financial implications. Decisions will be about resources, which may be people, products, services or long-term and short-term investment. Decisions will also be about activities, including whether and how to undertake them. Most decisions will at some stage involve consideration of financial matters, particularly cost. Decisions may also have an impact on the working conditions and employment prospects of employees of the organisation, so that cost considerations may, in making a final decision, be weighed against social issues. Where the owners are different persons from the manager (e.g. shareholders of



a company as separate persons from the directors), the managers may face a decision where there is a potential conflict between their own interests and those of the owners. In such a situation cost considerations may be evaluated in the wider context of the responsibility of the managers to act in the best interests of the owners.

### Scenario 1.4 Planning



#### Corporate strategic planning

*Prepared by: managing director, Media Advertising Ltd*

We intend to operate in three business areas with an overall return of 12% per annum on shareholders' funds for the next 3 years

#### Business strategic planning

*Prepared by: managing director in consultation with business managers A, B and C*

We will expand profits of all three businesses by 15% over three years

We will maintain profit margins in A and B at 40% but increase margin in C to 45%

We will increase the sales of business A to 12% of the industry sector total

We will reduce labour costs in business B by outsourcing all administrative work.

#### Operational planning – Business A

*Prepared by: business manager, A*

We need £2m capital expenditure in new equipment over 3 years

Our sales mix will be 60% home and 40% export

We will reduce overtime working to 5% of total wages cost

We will hold stock levels to cover 10 days' sales

### Scenario 1.5 Decision Making

In Media Advertising Ltd the manager of business A has a problem. The sales mix was planned as 60 per cent home and 40 per cent export. The export sales have not met expectations because the home currency has become stronger during the year and overseas buyers now think the advertising charges are too high. The manager has two choices:

- 1 Reduce the price charged to overseas buyers and risk complaints from home customers.
- 2 Accept the lower volume of export sales and try to increase home sales by reducing the price charged to home customers.

Scenario 1.5 shows how business managers have to make decisions. The decision taken by the manager of business A will require a knowledge of the market and an understanding of the competition. The manager of business A may also be concerned about personal job security. The managing director of Media Advertising Ltd needs to be sure that the manager of business A makes the best decision for meeting the corporate strategy.

### 1.3.3 Control

Once a decision has been taken on any aspect of business activity, management must be in a position to **control** the activity and to have a view on whether the outcome is in accordance with the initial plans and with the objectives derived from those plans. This might involve identifying areas in the business where managers are in a position to control and account for costs and, in some cases, profit. To implement the control process, individual managers will require timely, relevant and accurate information about the part of the business for which they are responsible. Measurement, including cost measurement, is therefore an important ingredient in carrying out the control function.

To carry out the control function, a management control system is needed. A useful definition of a management control system is the following:

#### Definition

A **management control system** is a system involving organisational information seeking and gathering, accountability and feedback designed to ensure that the enterprise adapts to changes in its substantive environment and that the work behaviour of its employees is measured by reference to a set of operational sub-goals (which conform with overall objectives) so that the discrepancy between the two can be reconciled and corrected for.<sup>3</sup>

This definition points to some of the aspects of control which will be encountered in later chapters. It acknowledges the process of seeking and gathering information but emphasises the importance of adaptation and meeting operational goals. Later chapters will refer to feedback processes and also to techniques for measuring differences between actual performance and sub-goals set for that performance.

The information provided to individual management is an essential part of the communication process within a business. For effective communication, there must be an organisational structure which reflects the responsibility and authority of management. Communication must cascade down through this organisational structure and the manner of communication must have regard for the motivation of those who are part of the control process. For control to be effective there must also be a reverse form of communication upwards so that management learn of the concerns of their staff. Motivation, expectations and personal relationships are all matters to be considered and to be harnessed effectively by the process of control.

#### Scenario 1.6

The manager of business A has discovered that sales agent X has failed to meet a monthly target. Fortunately, sales agent Y has exceeded the monthly target. This means that overall the results of business A have met the target set by the managing director at head office. The manager of business A is aware that the poor result for sales agent X was due to problems created with a customer who was dissatisfied with the service provided by business B. The manager of business A reports this in the monthly control report to head office and asks for a meeting with the manager of business B so that action can be taken to control any future problems with this particular customer.

Scenario 1.6 gives an example of a problem requiring action that results from collecting information about the performance of individuals and finding the cause of the problem. In this case it would not be sensible to blame sales agent X directly, but it is important to take action that will limit any further damage in the best interests of the company as a whole.

### Activity 1.2

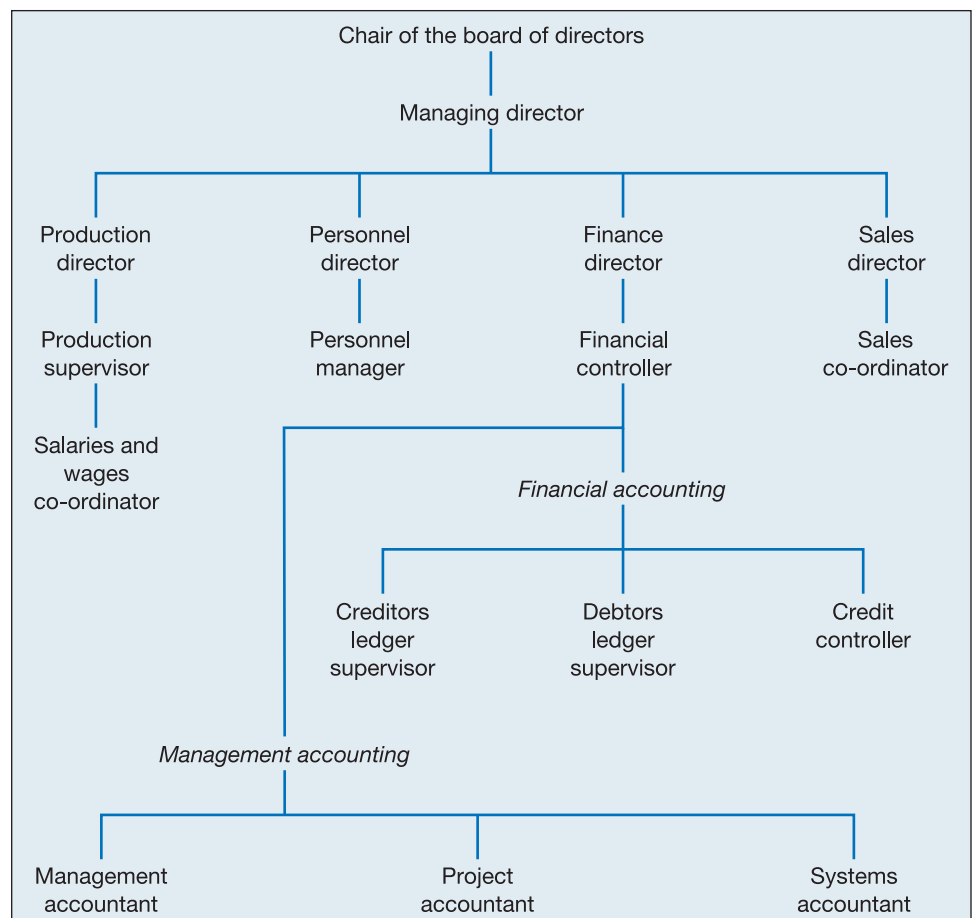
*Think of an organised activity in which you participate at college or at home. To what extent does this activity involve planning, decision making and control? Who carries out the planning? Who makes the decision? Who exercises control?*

## 1.3.4 An organisation chart

Figure 1.1 presents a simple organisation chart showing various types of relationships in a manufacturing company. It illustrates line relationships within the overall finance function of the business, showing separately the management accounting and financial accounting functions. In most medium to large companies, the management accounting function will be a separate area of activity within the finance function. The term 'management accountant' is used here as a general term, but a brief perusal of

**Figure 1.1**

Part of an organisation chart for a manufacturing company, illustrating line relationships within the overall finance function of the business



the 'situations vacant' pages of any newspaper or professional magazine advertising accountancy posts would indicate the range of titles available and the versatility expected. Two other functions have been shown in the chart as 'project accountant' and 'systems accountant'. Such specialists have specific roles in the internal accounting process within the enterprise which are relevant, although not exclusive, to the management accounting function.

The organisation chart shows individual people, each with a different job to do. Each person has a specialisation indicated by the job title, but he or she also has responsibilities to others higher in the structure and authority over others lower in the structure. In the interests of the business as a whole, individuals must communicate up and down the line relationships and also across the horizontal relationships.

Taking one line relationship as an example, the finance director must make plans for the year ahead which are communicated to the financial controller. The financial controller must consult the systems accountant to ensure that the accounting systems are in place to record and communicate these plans within the organisation. The financial controller must also consult the project accountant to ensure that there is an evaluation of any capital investment aspects of the finance director's plans. The management accountant will prepare accounting statements showing how the plans will be implemented. The financial controller will bring together the details supplied by each person, summarising and evaluating the main factors so that the results may be relayed to the finance director.

Horizontal relationships can be more difficult when communications channels are being planned, because there are so many potential combinations. It is a responsibility of management to decide which horizontal relationships have the greatest communication needs. Continuing the planning theme, the finance director will be expected to communicate the financial plan to the other members of the board of directors, who in turn will want to see that it fits the board's overall strategy and that it is compatible with the capacity of their particular areas of activity in the business. The financial plan will depend on the projected level of sales and will reflect strategy in production and personnel management. The plan will therefore need to be communicated to the sales co-ordinator, the production supervisor and the personnel manager. The sales co-ordinator, production supervisor and personnel manager will in turn provide feedback to the financial controller. The detailed analysis of the plans for the period, and the expected impact of those plans, will be evaluated by the management accountant, project accountant and systems accountant. They will report back to the financial controller who in turn will channel information to the finance director and the rest of the board of directors.

### Activity 1.3

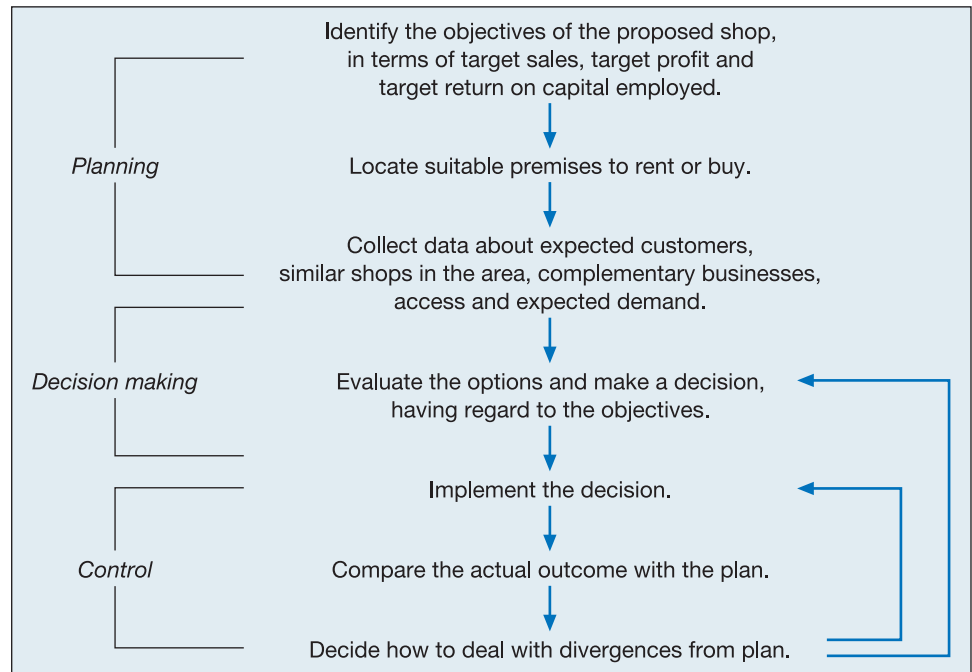
*Think again about the organised activity which you identified in Activity 1.2. Prepare an organisation chart to include all the persons involved in the activity. Draw green lines with arrows to show the direction of communication. Draw red lines with arrows to show the direction of responsibility. What does the pattern of red and green lines tell you about communication and co-ordination in the organisation? What is the mechanism for motivation? Does it use the green lines of the communication network?*

### 1.3.5 Illustration of the interrelationships

The three management functions of planning, decision making and control are all interrelated in the overall purpose of making judgements and decisions. Figure 1.2 shows how a company owning a chain of shops supplying motorcycle spares might go about the business of planning to open a new shop in the suburbs of a city. The shop will sell motorcycle spares and will also provide advice on basic repair work which motorcyclists can safely undertake themselves.

Figure 1.2

## Managing a decision on the location of a new business



The shop's objectives will be concerned with achieving target sales and profit, and with making an adequate return on the capital invested in establishing the shop. Because of the desire to offer an advice service as well as selling spare parts, there will be non-financial objectives expressed in terms of customer satisfaction. These non-financial objectives will have indirect financial implications because satisfied customers will lead to increased sales and increased profits. The location of the shop, other types of shop close by, hours and days of opening and approach to stock control are all factors which are considered in the planning process. The choice of shop premises will depend upon the rent to be paid, any costs associated with the property, such as refurbishment and repairs, access for delivery and collection, and security. If the shop is to trade successfully, there will need to be parking facilities, good access by road and preferably public transport backup for those who need spare parts but whose motor cycles are too much in need of repair to be used as transport to the shop. Location requires careful consideration. Is it preferable to have the shop in a neighbourhood where a high proportion of residents own motor cycles or to locate it on a main road along which they travel to work? Evaluation for decision-making purposes will require information about planned costs and revenues, although non-cost factors may also influence the decision.

Knowing the objectives and planning to meet those objectives will result in a decision, but the decision to start up the shop is not the end of the story. There has to be a continuing judgement as to whether the shop is successful and, eventually, there may be another decision on expanding or contracting the shop's activity. The continuing exercise of judgement will require a management accounting information outcome of the judgement. Any future decision to expand or contract will similarly include a requirement for information on planned costs and revenues.

Planning, decision making and control are shown on the diagram in Figure 1.2 as separate parts of the total activity. Communication is shown by arrows from one stage to the next. Motivation is not easily shown on a diagram, so there is no attempt to do so, but it remains an important part of the communication process. The greater the

number of communication trails built into the process, the more effective will be the understanding and motivation of those who carry out the work of the business at various levels of management. Ideally, the diagram would be criss-crossed with communication trails so that all participants are well informed.

### Activity 1.4

*Imagine that you want to set up a business as a travel agent booking low-cost holidays with the emphasis on good value. List two activities that you might carry out in each of the stages of planning, decision making and control.*

## 1.4 Role of management accounting

In the previous illustration of planning where to open a new shop, there is work for the management accountant: first, in **directing attention** to accounting information which is relevant to making plans and taking the decision; second, in **keeping the score** for making judgements on the effectiveness of decisions; and third, in helping to **solve problems** which arise when the results of decision making do not work out as expected. So there are three roles that management accounting could play in this exercise that will be found to be general features of any decision-making situation encountered by management. These are: directing attention, keeping the score and solving problems.

### 1.4.1 Directing attention

*Directing attention* is a matter of being able to answer questions such as 'Who should take action?' or 'Whose responsibility is this loss?' or 'Who is to be congratulated on this favourable result?' Managers are busy people. They do not always have time to consider every detail of cost information about the operation or process they control. They look to the management accountant to direct their attention to the exceptional points of interest, be these good or bad. One way of carrying out that function is to highlight those costs which have departed from expectations – provided that everyone understands at the outset what the expectations are. Words such as *fairness* and *timeliness* are almost bound to be involved in attention-directing processes.

Managers are also sensitive people. They do not like being blamed unjustly for something they see as being beyond their control. So the management accounting information has to be presented in such a way as to relate to the level of responsibility and degree of authority held by the manager concerned. On the other side of the coin, managers enjoy being praised for achievements and may welcome management accounting information which helps them to demonstrate their accountability for the resources entrusted to them.

In any organisation emphasising strategic management, it will be part of the role of management accounting to direct the attention of management towards information about competitors. Competitive forces include: the threat posed by new entrants to the industry, the emergence of substitute products or services, the relative strength of suppliers and customers in controlling prices and conditions in the industry, and the intensity of rivalry within the industry. Such information is often well known on an anecdotal basis. The management accountant may be required to collect and present information in a useful and focused manner.

The role of management accounting in directing attention will therefore depend on how managers wish their attention to be directed. A business which retains an inward-looking approach to management will expect management accounting to direct attention inwards. A business which is thinking strategically about its position in the market for goods and services will expect management accounting to include an outward-looking perspective.

Strategic management accounting has been defined as follows:

### Definition

**Strategic management accounting** is the provision and analysis of financial information on the firm's product markets and competitors' costs and cost structures and the monitoring of the enterprise's strategies and those of its competitors in these markets over a number of periods.<sup>4</sup>

The practical effects of the different types of management accounting approaches are summarised in Table 1.1 which contrasts the potential limitations of an inward focus with the benefits claimed for an outward focus.

**Table 1.1**  
Contrasting an inward and outward focus of management

<i>Possible limitations of an inward focus for management</i>	<i>Benefits of an outward focus for management</i>
A risk of placing too much emphasis on evaluating past actions.	Management accounting includes a prospective element evaluating the potential outcomes of various strategies.
A risk of focusing on the business entity alone.	Management accounting sets information about the business entity in the context of other businesses in the sector.
A tendency to focus on a single reporting period.	Management accounting sets the results of one period in a longer-term analysis.
Directing attention towards separate single issues of decision making.	Management accounting directs attention towards sequences and patterns in decision making.
Directing attention to the outcome of the manufacturing or service activity of the particular organisation.	Management accounting directs attention to the competition for the manufacturing or service activity.
A tendency to concentrate on existing activities.	Management accounting is expected to look also to prospective activities.
Risk of not considering linkages within the organisation or potential for effective linkages beyond.	Management accounting is expected to direct attention to effective linkages which will improve competitive position.

### 1.4.2 Keeping the score

*Keeping the score* is very much a case of being able to answer the questions 'How much?' or 'How many?' at any point in time. It requires careful record keeping and a constant monitoring of accounting records against physical quantities and measures of work done. The emphasis is on *completeness* but also on *fairness*. Questions such as 'How much?' may involve sharing, or allocating, costs. Accounting is concerned with allocations of various types, all concerned with aspects of *matching*. That could require matching costs to a time period, matching costs to an item of output, or matching costs against revenue for the period. For this matching process to be effective, information must be complete and the basis of allocation must be fair.

For the business which has a strong emphasis on strategic management, score keeping will include being able to answer questions such as 'How much of the market share?' or 'How many compared to our competitors?' Questions of fairness of

allocation within the business may be important but it may be even more important to understand the performance of the business in relation to others. Such questions will be answered by both financial and non-financial measures.

### 1.4.3 Solving problems

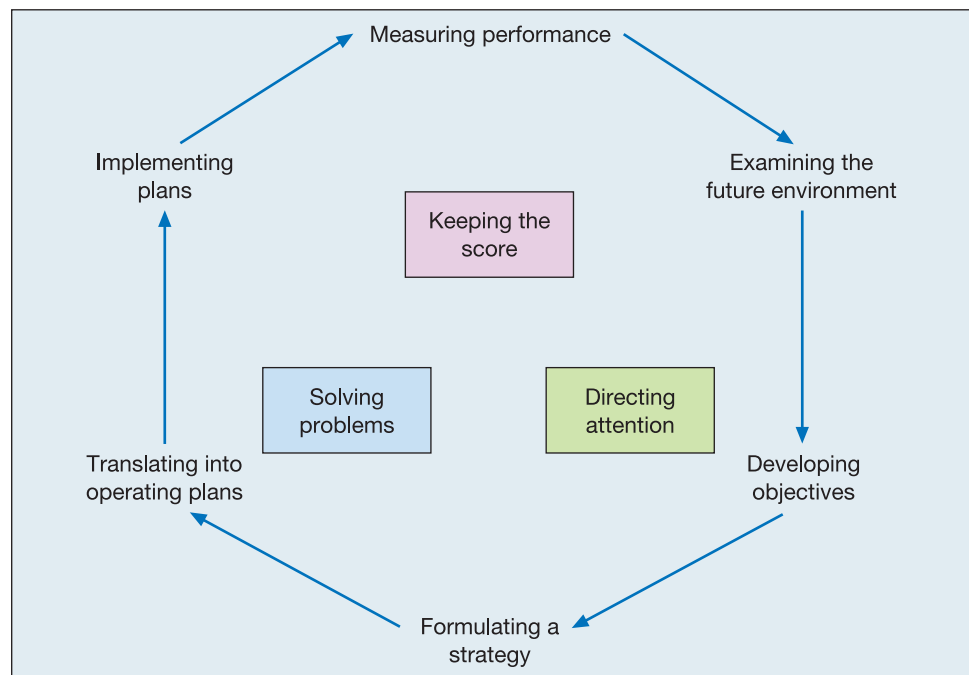
*Solving problems* involves a different type of question. It might be 'Why did that plan go well?' or 'Why did that action fail?' or 'Which of these three choices is the best to take?' In solving problems of this type, *relevance* is an important issue. People who have taken a decision are often reluctant to admit that it has not turned out as expected and may continue to make mistakes unless someone points out that past events are of little or no relevance to decisions on future action. Where choices are concerned, those choices will involve people, each of whom may have different motives for preferring one choice above others. Management accounting information may have a role in providing an objective base for understanding the problem to be solved, even where at the end of the day a decision is based on non-accounting factors.

Some problems resemble making a jigsaw, or perhaps deciding which piece of the jigsaw has gone missing. Other problems are like solving crosswords where the answers must interlock but some of the clues have been obliterated. In solving any problem of that type, logical reasoning is essential. No one can memorise the answer to every conceivable question which might arise. You will find that management accounting tests your powers of logical reasoning in that every problem you encounter will never entirely resemble the previous one.

### 1.4.4 Cycle of profit planning and control

Figure 1.3 illustrates a combination of the management accounting functions of directing attention, keeping the score and solving problems. It shows the cycle of profit planning and control, starting with the measurement of existing performance, which

**Figure 1.3**  
Stages in the cycle of profit and planning control





is an example of the score-keeping aspects of management accounting. From the measurement of existing performance the cycle moves through an examination of the future environment of the business, where techniques of economic analysis would be used. In developing objectives, the management accountant would provide accounting information on targets to be achieved. Formulating a strategy is a management task but the management accountant is then expected to provide detailed budgets which translate that strategy into operating plans. When the plans are implemented the management accountant must be ready to measure the results and compare these with the outcome expected when the operating plans were set. From there the cycle is repeated.

### Activity 1.5

*Look back to your list from Activity 1.4 for planning, decision making and control in setting up a travel agency business. Make another list of ways in which management accounting will help in directing attention, keeping the score and solving problems.*

## 1.5 Judgements and decisions: case study illustrations

You are now presented with four cases where there is a need for decisions and for judgements. After each case study there is a brief analysis of the decisions and judgements that will arise in each.

These four cases indicate areas where management accounting could serve as a tool to provide information which is relevant to decision making and to the formation of judgement at all levels within an organisation. Hopefully, you will have recognised some situations in each case where accounting information will be of help.

The organisation chart in Figure 1.1 includes an expert management accountant. It has already been explained that most medium to large companies include specialist management accountants on their staff. However, from time to time a consultant may be called in to give a wider and more frank appraisal than might be feasible for a paid employee. In this and subsequent chapters you will meet Fiona McTaggart, a freelance management accountant, who is prepared to offer advice on a variety of case study situations. In practice, the management accountant within the organisation might provide similar advice, but this text uses the management consultant so that her comments are not unduly constrained by existing limitations within the business.

Fiona explains what she could offer from her management accounting experience in each of these four case study situations. Read her explanations and in each case identify the places where she is hinting at directing attention, keeping the score or solving problems.

### Activity 1.6

*Read the text of each case study (set out in the box at the beginning of each case) and then make a note of the way in which you think management accounting may help each person. Compare your answer with the discussion which follows each case.*

#### 1.5.1 Case study: Jon Okike

Jon Okike has taken early retirement at the age of 50 in order to develop his hobby of model shipbuilding into a full-time business. He has several models already assembled and has advertised in the model builders' weekly journal. Interested enquiries are starting to come in and he realises that he does not know what price to charge for the models.

## Real world case 1.2

The UK won't meet its targets on renewable energy if offshore wind farm costs continue to spiral, the government has been warned. Centrica said the chance of making any money from wind farms being set up around the British coast were now only slim. Rising prices for raw materials, particularly steel and copper, had pushed up the prices being demanded by the handful of companies who make the giant turbines for the offshore fields. Centrica said it would continue with its plans for three UK wind farms but warned that the outlook was bleak. Sarwjit Sambhi, director of Centrica's power business unit, said: 'The economics at the moment make the returns marginal.'



Source: May, 2008. <http://www.telegraph.co.uk/earth/earthnews/3341902/Rising-costs-threaten-UK-wind-farm-programme.html>

### Discussion points

- 1 Would a critic be justified in saying that management accounting is holding back progress with developing renewable energy?
- 2 What are the non-accounting benefits of a wind farm that could be set against the accounting costs?
- 3 Are there any non-accounting costs of setting up a wind farm?

## Analysis of decisions and judgements

Jon Okike needs to make a decision about pricing policy. That will involve many factors such as looking at what competitors are charging, having regard to the type of customer he expects to attract, and making sure that the price covers the cost of making and selling the models. After he has decided on a pricing policy, he will need to measure its success by making judgements on the level of sales achieved and on the profitability of the product in relation to the capital he has invested in the business.



*FIONA: Jon Okike needs to know the cost of the models he is making. That sounds easy – he has a note of the money he has spent on materials for the models and he has detailed plans which tell him exactly how much material is used for each one. But that's not the end of the story. Jon puts a tremendous amount of time into the model building. He says it is all enjoyment to him, so he doesn't treat that time as a cost, but I have to persuade him that making the models represents a lost opportunity to do something else. The cost of his time could be measured in terms of that lost opportunity.*

*Then there are his tools. He has a workshop at the end of the garage and it's stacked high with tools. They don't last forever and the cost of depreciation should be spread over the models produced using those tools. He needs heat to keep the workshop warm, power for the electric tools and packing material for the models sent in response to a postal enquiry. He has paid for an advertisement in the model builders' magazine and there is stationery, as well as postage and telephone calls, to consider.*

*Costs never seem to end once you start to add them up. It can all be a bit depressing, but it is much more depressing to sell something and then find out later that you've made*

a loss. I could help Jon work out his costs and make sure the price he charges will leave a profit so that he builds up his investment in the business.

Making the decision on selling price would not be the end of my involvement. I would continue to measure costs each month and compare these with sales. I would give Jon reports on profit and cash flow and warnings if working capital was starting to build up. If he gives credit he'll need to keep an eye on the level of debtors, and there will always be a stock, either of raw materials or of finished goods or of both. Trade creditors will fund some of the stock but working capital mismanagement has been the downfall of many a business which tried to expand too fast.

I will also need to keep Jon down to earth in ensuring that what has until now been a hobby can become a successful business. I will direct his attention to professional business reports for this kind of specialist service. I will encourage him to subscribe to information services and I will incorporate such information in my reports to Jon so that he can take a realistic view of his performance compared with what might be expected in the general business of special craft work.

In advising Jon Okike, Fiona McTaggart will direct attention to the costs which are relevant to the pricing decision, she will keep the score by calculating profits once the business is in production and will help solve problems by monitoring the working-capital position.

## 1.5.2 Case study: Sara Lee

Sara Lee has been operating a small hairdressing business for several months. She would like to expand by employing an assistant and by purchasing new dryers and washing equipment. She cannot decide whether the investment would be justified.

### Analysis of decisions and judgements

Sara Lee will be taking a longer-term view in making a decision about investing in new equipment. That equipment must generate cash flows over its expected life. Sara's decision to invest will take into account the number of customers she expects, the prices she is able to charge them, and the cost of paying the proposed assistant, projected ahead for several years. It will also take into account the percentage return expected on the capital invested in the equipment.

If she decides to invest, she will need to monitor the success of that investment by making judgements on the profitability of the product in relation to the capital she has invested in it, and on whether the **return on the investment** is adequate in the light of having expanded the business.



**FIONA:** Sara Lee needs help in taking a longer-term perspective. To assess the profitability of the new equipment and the assistant, I'll first of all need Sara to tell me how many customers she can realistically expect and what she will be able to charge them. I'll need those estimates over the life of the equipment, which will probably be around five years.

Once I have the estimates of cash inflows from customers over the five years, I can set against that the cash outflows in terms of payments for all the costs of providing the service, including the wages of the intended assistant. Then I will apply to those cash flows a factor which makes an allowance for uncertainty in the future and also takes account of the rate of interest Sara could earn if she invested her money in financial markets rather than hairdryers. I'll then compare the expected cash flows with the initial cost of acquiring the equipment, to see whether it's a good idea. Of course, if Sara gets

*the cash flow estimates wrong, then the answer won't mean very much, but that's not my problem.*

*If Sara makes the decision to invest, I'll be needed after that to monitor the success of the project. I can measure the cash flows after the event and give an indication of how well they met expectations. I can compare the cost of the assistant with the revenue generated by the extra work available.*

*Problems might arise if there is a change of fashion and everyone decides they prefer short straight hair. That could cause chaos in the hairdressing industry and might make some of the washing equipment surplus to requirements. There is a great temptation in such situations to hang on to the past because of the cash which was sunk into it. That's often the wrong thing to do because it brings disaster ever closer. It may be better to cut off the activity altogether and limit the losses. I can give a dispassionate view based on cost rather than sentiment and emotion.*

Fiona McTaggart will provide information which is relevant to the investment decision by drawing attention to the cost in comparison with the expected cash inflows. She will keep the score on the cash inflows and outflows once the project is established and she will help in problem solving by evaluating the losses arising if an unsuccessful project continues in operation.

### 1.5.3 Case study: Central Ltd

Central Ltd is a small business manufacturing and assembling plastic components for use in car manufacture. It has been drawn to the attention of the financial controller that one of the plastic components could be purchased elsewhere at a price less than the cost of manufacture. What action should the production director take?

#### Analysis of decisions and judgements

The production director of Central Ltd needs to decide whether to continue manufacturing the component within the business or to cease production and buy the component elsewhere. To make that decision requires a knowledge of the full cost of manufacture and reassurance that the cost has been calculated correctly. It also depends on the relative aims and objectives of the financial controller and the production director, who may be in conflict and who may be putting their own point of view at the expense of the overall good of the business. Costs of ceasing manufacture will also need to be taken into account. Beyond the accounting costs there are human costs and business risks. Is there alternative employment for the staff released from this internal production? Will there be redundancy costs? Is it safe to rely on this outside supplier? What are the risks to Central Ltd if supplies dry up?

Whatever decision is taken, there will be a subsequent need for judgement in monitoring the effectiveness of the decision and its impact on profitability. In the decision and in the subsequent judgements of the effectiveness of that decision, there will be a need for communication and interaction between the financial controller and the production director.



*FIONA: Central Ltd is an example of the football game situation where sometimes the players in a team forget that they are on the same side. I saw a game last week when the home team won on the away team's own goals. The same thing could happen for Central. When people have a defined role in an organisation they can be too closely involved in their own work to see the bigger picture. The financial controller sees the costs of manufacturing and assembling the parts and has identified a cost saving based on a simple*

comparison. It's hard for the production director to fight the logic of that argument but I can see he's worried.

*What I can do is turn his worries into cost arguments which should be considered alongside the direct make-or-buy comparison. The costs may not be capable of such precise calculation but I'll give estimates of the risk to the business and the sensitivity of the situation. I'll pay particular attention to the quality issues and to the risk of disruption of supply. It's more than likely that the financial controller and the production director will still not agree even when they have the information, so I'll present my information in a way which the board of directors can relate to the overall objectives and strategy of the company. Whatever decision is taken, I'll establish a monthly reporting system, to be operated by the financial controller, which will give the earliest possible warning of whether the decision remains in the best interests of the company.*

*That is the traditional management accounting role which I am happy to provide. However, I will also indicate, in conversation with the financial controller and the production director, that it would be important to discover first of all what their competitors are doing about this problem. The competitors will not answer the question directly but potential suppliers of the components may be willing to indicate that there is a similar demand emerging elsewhere. If the problem here is that production costs are too high in relation to the rest of the industry then perhaps the board of directors has to focus on cost reduction rather than external purchase. If the price is lower externally, someone somewhere has apparently found a better approach to cost control.*

Fiona McTaggart will provide information directly relevant to the make-or-buy decision. She will help in problem solving by setting out the information in such a way that others in the organisation can be satisfied that a decision will be in the best interests of the company as a whole. Finally, she will establish a score-keeping system which continues to monitor the effectiveness of the decision taken.

#### 1.5.4 Case study: Anita Khan

Anita Khan is a hospital manager having responsibility for ensuring that the cost of treatment is recovered in full by invoicing the patient or the appropriate organisation which is financing the patient care. Pricing policy is dictated at a more senior level.

#### Analysis of decisions and judgements

Anita Khan has no direct decision-making responsibility but the information she collates and the records she keeps, in relation to identifying costs and charging these costs to patients, will be used in the decision-making process at a more senior level. It will also be used as a tool of judgement on the effectiveness of the hospital's cost control and charging policy for the various treatments and services provided. In this case the criteria for the judgement may be rather different in that there may be less emphasis on profitability and more on the quality of service in relation to the cost of providing that service.



**FIONA:** *Anita Khan doesn't have direct decision-making responsibility. She is a small cog in a large machine. However, the efficiency with which she carries out her job will have a direct impact on the performance of the hospital and will have an impact on future decision making at a more senior level. Charging out to patients the cost of their care is a difficult matter and requires very careful record keeping. Patients who are ill don't question their treatment at the time, but when they are convalescing they have lots of time to look through the bill, especially if the medical insurance company is asking questions. Some*

*patients may be paid for via the health service but at the end of the line there is a fund-holder who wants to ensure that the funds are used to best advantage.*

*The cost of, say, major surgery can be the least difficult to work out because the time in theatre will be known, the staff on duty will be listed and their salary costs can be apportioned over the time taken. But when the patient is back on the ward recovering, there have to be records kept of the type of nursing care, the specialist equipment and supplies, food costs and the hotel-type services associated with providing a bed. Then there have to be charges to cover the overhead costs of heating, maintaining and cleaning the buildings.*

*Anita Khan needs an effective recording system which is accurate in terms of care for each patient but is not so cumbersome to apply that the nurses' time is entirely taken up with clerical recording. Many costs can be applied to patient care on a predetermined charge-out rate based on previous experience. A computerised cost recording system, with a carefully thought out coding system for each cost, is essential. Of the four cases I have considered here, this will be the most time-consuming to set up, but it will give satisfaction all round when it is working and seen to be fair to patients in terms of individual charge-out costs as well as giving the hospital reassurance that all costs are being recovered.*

*The cost-recording system will provide information for the decision-making process in relation to future pricing policy and also for the more difficult decisions as to which specialised medical functions at the hospital are cost effective and which functions do not fully cover costs. There are bound to be problems within the hospital if decisions are needed on expanding or cutting back. Everyone hates the accountant at those times, but at least I can design a system which provides an objective starting point even though non-financial factors are eventually the determining factor.*

Fiona McTaggart is describing here the score-keeping aspects of management accounting. That score keeping will be used as information for the decision-making process and may also have a problem-solving aspect if disputes arise where medical decisions have a cost impact.

### 1.5.5 Comment

These case study discussions have given some insight into how the management accountant has a role to play in contributing to the management of an organisation. Three general themes have been explored, namely keeping the score, directing attention and solving problems. The case studies have shown that within each of these three themes there are many different approaches to be taken, depending on the circumstances. By way of illustration of the scope of management accounting activity, Fiona McTaggart has the following list of special studies she has undertaken, as an adviser on management accounting, where problem-solving skills have been required:

- product cost comparisons
- evaluation of product profitability
- alternative choices of resource usage
- asset management
- labour relations
- capital investment
- investigation on behalf of customer for contract pricing purposes
- directing attention to the activities of competitors.

All of these, and other problem situations, will be encountered in subsequent chapters. This chapter ends with a warning that there will be some new terminology to learn and a review of the role of the management accountant.

### Real world case 1.3

The following advertisement appeared on the website of the National Health Service Careers section.

**Management accountant** working for the Commission for Patient and Public Involvement (CPPIH). This type of post will involve working closely with the head of finance, to establish systems and processes to enable the timely and accurate delivery of monthly management accounts and budget information. The postholder will be involved in the annual budget setting process, provide ongoing support and direction for the budget holders as well as investigating and reporting on variances. They will also be involved in ad hoc projects and reports, such as contributing to the five-year business planning processes. The employer in this example is looking for candidates to be an active finalist or qualified accountant with experience of delivering a financial management service. Alongside expertise in computerized finance packages and proven analytical skills, an ability to demonstrate strong interpersonal, planning and team working skills is required.



Source: <http://www.nhscareers.nhs.uk/>.

#### Discussion points

- 1 How might management accounting in public services differ from management accounting in profit-making organisations?
- 2 The advertisement refers to 'financial management service'. What kinds of financial management are mentioned in the detail of the advertisement?

## 1.6 The language of management accounting

Management accounting is not a difficult subject but it requires a logical mind to understand it. To be successful, methods of management accounting must reflect a reasoned approach to a judgement on a situation problem and a logical basis for making decisions. If reason and logic are strong, then it should not be difficult to understand the approach.

Unfortunately, as with most specialist subjects, management accounting has developed a language of its own, which is helpful to those who work closely with the subject but can sometimes cause problems at the outset for newcomers. This chapter has avoided using specialist terminology, relying on intuitive ideas. However, any progress in understanding management accounting will be limited without the use of that terminology, so subsequent chapters will introduce the technical terms, each of which will be explained. End-of-chapter questions will help you to test your understanding of new terminology before you move on to each new chapter.

One important difference from financial accounting is that there is no official regulatory process governing management accounting. This is very different from the framework of company law, accounting standards and other regulatory processes which are found throughout financial reporting to external users. Consequently, there is relative freedom in management accounting to tailor the accounting process to the

management function. That does not mean that management accounting is any less rigorous professionally than other forms of accounting reporting. In the UK there is a professional body, the Chartered Institute of Management Accountants (CIMA), which provides guidance to its members on good practice in management accounting. That guidance includes a wide range of publications ranging from definitions of terminology to reports on newly emerging techniques. Similar professional bodies having a management accounting specialism exist in other countries.

## 1.7 What the researchers have found

This section describes three research papers. The first describes how the nature of 'management accounting' has been reinvented to meet the needs of business operations. The second describes the perceptions of the operations managers towards management accounting. The third compares the perceptions of managers and accountants regarding information supplied by the management accounting function.

### 1.7.1 Reinventing the management accountant

Parker (2002) reviewed the driving forces that constitute the environment of management accounting and the changing skills demanded of management accountants. He concluded that management accountants need to take on the role of both advising and leading business development. He recommended reinvention 'on a grand scale'. Management accountants would need a more broadly developed knowledge base including areas such as operations, product and process technology, systems, marketing and strategic management. The focus must switch from historical stewardship to strategic planning and forward control. In future, management accountants would be expected to contribute to strategic management, knowledge management, risk management, environmental management and change management. The trends that Parker describes are already established, so Parker's 'grand scale' recommendation is effectively for extending an existing development.

Burns and Yazdifar (2001) surveyed members of the Chartered Institute of Management Accountants (CIMA) to produce 'top 10' lists of features in the changing role of management accountants. The top three tasks for management accountants by 2005 were business performance evaluation (58 per cent), cost control or financial control (40 per cent) and interpreting/presenting management accounts (35 per cent). The top three skills expected of management accountants by 2005 were analytical/interpretive (61 per cent), IT/system knowledge (47 per cent) and broad business knowledge (44 per cent).

### 1.7.2 How operations managers use accounting information

Van der Veecken and Wouters (2002) carried out a case study observation of a large building company in the Netherlands over a period of two years. They asked:

- What strategies do managers use to achieve planned financial project results?
- In what way does accounting information contribute to these strategies?
- Which factors explain the use of accounting information?
- What are the implications for the design of accounting information systems?

They found that higher-level managers used accounting information to help identify poorly performing projects. The foremen in charge of projects observed work on the building site and measured progress by the amount of resources (such as building materials) used. They did not use cost information directly but the cost outcome was not surprising because it reflected their judgement in managing the project. They were



also able to deal with uncertainties and unexpected events based on their experience rather than based on accounting information. The researchers concluded that it is more important that local managers can respond to uncertainties and changes than that they can carry out a precise plan based on cost estimates. The accounting information is more relevant to overall judgements by higher-level managers as to whether satisfactory performance has been achieved on a project.

### 1.7.3 Perceptions of managers and accountants compared

Pierce and O'Dea (2003) visited 11 companies to meet the management accountant and a senior manager in each area of production and in sales or marketing. They put the same questions about use of techniques to the management accountants and the managers. They found some examples of management accounting information that were used by managers less frequently than the management accountants believed, but they also found particular items of information that were used by managers more frequently than the management accountants believed. The main demands of managers were for information that is more timely, broad, flexible and in a better format. When asked about the future role of management accountants, the main theme of managers was to describe the management accountant as a business partner. Interaction, location in the working environment, teamwork and understanding the business were all seen as important characteristics for the effective management accountant.

### 1.7.4 Management accounting in the wider organisation

Innes *et al.* (2009) examined the relationship between human resource management (HRM), management accounting and organisational performance in six case study companies (two in Canada, two in Japan and two in the UK). The researchers carried out 100 telephone interviews (40 in Japan, 30 in Canada and 30 in the UK).

The research reports that the companies studied in this project made great efforts to link specific HR policies with organisational performance. In all six cases, HR managers and management accountants were working closely together to develop strategic plans and annual budgets. In four of the cases, they also developed performance-related bonus schemes in close collaboration and were involved in frequent communication on decision making. The study is interesting because it shows how management accountants work with others in a business and do not operate accounting in isolation.

## 1.8 Summary

You have seen from the discussion in section 1.1.3 and the case studies that management accounting should direct attention towards strategic issues of surviving and prospering in a competitive environment. The remaining chapters of this book will introduce the various techniques that have been developed in management accounting for keeping the score, directing attention and solving problems. The traditional techniques are described, with current thinking and developments explained and contrasted as relevant.

Key themes in this chapter are:

- **Management accounting** is concerned with reporting accounting information within a business, for management use only.
- **Management** takes its widest meaning in describing all those persons (managers) responsible for the day-to-day running of a business.
- The managers of a business carry out functions of **planning, decision making and control**.

- Management accounting supports these management functions by directing attention, keeping the score and solving problems.
- The **contingency theory** of management accounting explains how management accounting methods have developed in a variety of ways depending on the judgements or decisions required.
- **Strategic management accounting** pays particular attention to the provision and analysis of financial information on the firm's product markets and competitors' costs and cost structures, and the monitoring of the enterprise's strategies and those of its competitors in these markets over a number of periods.

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## QUESTIONS

The Questions section of each chapter has three types of question. '**Test your understanding**' questions to help you review your reading are in the 'A' series of questions. You will find the answer to these by reading and thinking about the material in the textbook. '**Application**' questions to test your ability to apply technical skills are in the 'B' series of questions. Questions requiring you to show skills in '**Problem solving and evaluation**' are in the 'C' series of questions.

### A Test your understanding

- A1.1** Define 'management accounting' (section 1.1).
- A1.2** Explain why management decisions will normally require more than a management accounting input (section 1.1.1).
- A1.3** What is meant by a 'contingency theory' of management accounting (section 1.1.2)?
- A1.4** Why is management accounting required to take on an outward-looking role of contributing to business strategy by identifying, measuring and communicating financial information about a wider business community (section 1.1.3)?
- A1.5** Explain the needs of internal users for management accounting information (section 1.2).
- A1.6** Explain, giving a suitable example in each case, what is meant by the management functions of:
- planning (section 1.3.1);
  - decision making (section 1.3.2); and
  - control (section 1.3.3).

- A1.7** Explain, giving a suitable example in each case, how management accounting may serve the purposes of:
- directing attention (section 1.4.1);
  - keeping the score (section 1.4.2); and
  - solving problems (section 1.4.3).
- A1.8** Describe, and explain each stage of, the cycle of profit planning and control (section 1.4.4).
- A1.9** In the chapter there are four case studies where Fiona McTaggart explains what she is able to offer in four situations, using her management accounting experience. Her advice is primarily inward looking and based on the traditional approaches to planning, control and decision making. Add two sentences to each of Fiona's explanations in order to present a more strategic awareness of the activities of competitors (section 1.5).
- A1.10** Suggest reasons for the lack of an agreed set of standard terminology of management accounting (section 1.6).
- A1.11** How has the role of the management accountant been 'reinvented' in recent years (section 1.7.1)?
- A1.12** How do high-level managers and lower-level managers use accounting information in different ways (section 1.7.2)?
- A1.13** How do managers differ from management accountants in their view of accounting information (section 1.7.3)?

## B

## Application

**B1.1**

- Imagine you are the finance director of a company which is planning to open a new supermarket chain. Prepare a chart similar to that shown in Figure 1.2 which sets out key aspects of the planning, decision making and control.
- Give two examples of financial objectives and two examples of non-financial objectives which you might expect of the sales manager of the new supermarket chain.
- Explain how management accounting skills would be required in providing product cost comparisons when the supermarket chain becomes operational.

**B1.2**

A record company is planning to launch an internet music service. Subscribers who pay £15 per month will be allowed to download 100 songs per month to a personal computer. If the subscription lapses, access to the music will be lost. The quality of the file transfer is guaranteed to be high. Legal advice has been obtained to confirm that the arrangement is within copyright regulations. Royalties will be paid to recording artistes based on the number of times that a song is requested.

- Identify the judgements and decisions to be made here.
- Explain how management accounting may help in directing attention, keeping the score or solving problems.

**B1.3**

A group of doctors operates a joint surgery. They are planning to provide a private clinic where minor surgery can be performed on a day basis (no overnight facilities will be offered). The project will require investment in a new building and operating theatre. Three theatre nurses will be required and three healthcare assistants will be employed. Admissions will be dealt with by the existing medical secretaries. The fees charged will cover costs plus a profit percentage based on cost.

- Identify the judgements and decisions to be made here.
- Explain how management accounting may help in directing attention, keeping the score or solving problems.

**B1.4**

A recently retired police officer has received a lump sum award and a pension. She has a hobby of making soft toys which have for some years been sold to friends and colleagues at a price

to cover the cost of materials. She now wishes to turn this into a commercial venture and to sell them through a children's clothing shop, which has agreed to provide shelf space for the sale of 20 toys per month. She is not concerned initially about making a high profit and will be satisfied with covering costs. The shop will take a fee of 5% of the sale price of each toy sold.

- (a) Identify the judgements and decisions to be made here.
- (b) Explain how management accounting may help in directing attention, keeping the score or solving problems.

## C Problem solving and evaluation

### C1.1

You have been invited to write a proposal for the development of a new production line to process dog food. The production of dog food will take up space previously devoted to cat food. Write 250 words (approx.) explaining how management accounting would be used to justify any decision by the production manager to replace cat food with dog food in the production process.

### C1.2

Chris and Alison Weston have been manufacturing and selling children's toys from a workshop attached to their house. Alison has carried out the manufacturing activity and Chris has provided the marketing and financial support. The scale of customers' orders has reached a point where they must make a decision about renting a production unit on a nearby trading estate and employing two assistants. One assistant would be required to help make the toys and the other would carry out routine record keeping, allowing Chris to spend more time on marketing. Write 250 words (approx.) explaining (a) the main judgements and decisions which will arise; and (b) the kind of advice that could be offered by a management accounting expert.

### C1.3

Set out below is a selection of advertisements for posts in management accounting. Read the text of the advertisement and relate the specified requirements to the three management accounting roles set out in this chapter, namely:

- (a) directing attention;
- (b) keeping the score; and
- (c) solving problems.

#### PLANNING AND REPORTING CONTROLLER

Reporting to the group finance director, your key task will be to drive a step change in all areas of corporate reporting and planning and provide analytical impetus to the development of business strategy. Responsibilities will include:

- Ownership and control of the quality of reporting and forecasting throughout the business
- Managing the group's quarterly strategic business unit review, forecasting and annual planning cycles
- Managing the day-to-day Treasury processes including cash-flow forecasting
- Supporting the finance director in all corporate activities including financing, acquisitions, presentations and *ad hoc* projects as required.

This is a high-profile role which interfaces directly with directors, shareholders, advisers, banks, head office functions and divisions.

The ideal candidate will be an ambitious graduate qualified accountant with a minimum of four years post-qualification experience. First class communication skills and good systems knowledge will complement your proven technical expertise.

### HEAD OF MANAGEMENT INFORMATION

Reporting to the financial director, you will be responsible for:

- Developing and automating the production of management accounts and contract cash reporting
- Implementing and managing a robust process for all contract valuations
- Managing all aspects of budgeting, forecasting and group reporting
- Developing relationships with operational teams to improve controls and increase commercial awareness
- A review of financial processes and implementation of new systems and controls.
- The successful candidate will be commercially minded and profit-motivated with the ability to manage a strong team.

### MANAGEMENT ACCOUNTANT

This is a major support services organisation, supplying services and products to government agencies and commercial businesses worldwide. Working closely with the commercial teams, you will provide them with full financial support at every stage of the contract life cycle. Main responsibilities include:

- Assisting with the compilation of new bids and tenders
- Ongoing contract monitoring including budgeting and forecasting
- Development of key performance indicators for the business
- Production of monthly management accounts, analysis and commentary

You will need to have excellent business acumen and highly developed communication skills.

### MANAGEMENT ACCOUNTANT

*(Charitable organisation)*

This is a leading charity providing safe, secure and affordable housing for young people and working with homeless young people to provide safe shelter. Reporting to the head of finance, the role involves working closely with various departments identifying areas of concern and solutions.

Key responsibilities include:

- Reviewing of trial balance, and generation and review of management accounts; identifying and resolving any issues and offering a business support function
- Attending committee meetings to present the accounts to the trustees
- Identifying trends in the management accounts and advising management as to recommendations
- Development of budgets and forecasts
- Investigating and improving financial performance in the operations of the residential centres

This role would suit an individual who is looking to shape the continuing development of the work of the charity.

### HEAD OF MANAGEMENT ACCOUNTS

*(The finance office of a university)*

You will be responsible for the setting, monitoring, control and reporting on budgets and the regular production of management accounts. In addition, you will ensure the provision of a comprehensive payroll service and be responsible for arranging and accounting for capital finance.

**PRINCIPAL MANAGEMENT ACCOUNTANT***(Public-sector organisation)*

This is one of the most successful police forces in the country. With 2,000 employees and an annual budget of over £80 million, it is essential that the organisation has appropriate and well-maintained financial management and information systems to support the demands of modern policing.

We now require a dynamic team leader to ensure the continued development of these systems and to provide a comprehensive financial advice/support service to senior managers.

The successful candidate will be closely involved in the production of medium-term financial plans, annual budgets and financial information systems upgrades as well as the training and development of non-technical staff on financial management.

You will be self-reliant and able to work to tight deadlines whilst maintaining high standards, be capable of clearly communicating financial concepts in a persuasive and effective manner and have a suitable professional qualification with three years' experience in financial management.

## Case studies

### Real world cases

Prepare short answers to Case studies **1.1**, **1.2** and **1.3**.

#### Case 1.4 (group case study)

Form a study group of four to six persons who are to act out the role of the finance director and related staff on the accounting team of a company which is planning to open a new super-market chain at an out-of-town location. Give a ten-minute presentation to the rest of the class explaining the major issues you will be expected to deal with in making a contribution to the decision and the subsequent monitoring of that decision.

#### Case 1.5 (group case study)

Form a study group of four to six persons who are to negotiate the development of a new production line to process canned peas. The canned peas will replace an existing product, canned carrots. Half of the team will argue on behalf of the canned peas while the other half will argue on behalf of the canned carrots. Give a ten-minute presentation to the class (five minutes for each half of the team) explaining how management accounting information will help you to justify the decision you propose and to monitor the implementation of the decision.

## Notes

1. AAA (1966) *A Statement of Basic Accounting Theory*. American Accounting Association, Evanston, IL, p. 1.
2. Otley, D. (1995) 'Management control, organisational design and accounting information systems', chapter 3 in Ashton, D., Hopper, T. and Scapens, R. (eds) *Issues in Management Accounting* (2nd edn), Prentice Hall.
3. Lowe, E.A. (1971) 'On the idea of a management control system', *Journal of Management Studies*, 8(1): 1–12.
4. Bromwich, M. (1990) 'The case for strategic management accounting: the role of accounting information for strategy in competitive markets', *Accounting, Organizations and Society*, 15(1/2): 27–46.