PART

1

An introduction to management and cost accounting: cost terms, systems design and cost behaviour

CHAPTER 1

Management accounting and the business environment

LEARNING OBJECTIVES

After studying Chapter 1, you should be able to:

1. Describe what managers do and why they need accounting information
2. Identify the major differences and similarities between financial and management accounting
3. Describe the role of a management accountant in a decentralized organization
4. Discuss the impact of international competition on businesses and on management accounting
5. Review the impact of organizational and technological change on management accounting
6. Identify emerging issues: increasing importance of services, managing for value, the sustainability agenda and corporate governance

CONCEPTS IN CONTEXT

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One of the key changes affecting the finance function (as well as other support services such as human resources) is the increased use of shared service centres. These centres offer lower costs, clearer focus, better information (IT), new location, new people, scaleability, standardization, and so on. There is a fresh challenge for management accountants to become key players in these changes, as managers of the shared services, or as *business partners* acting as intermediaries between the service centres and their business customers. But in order to achieve these roles, management accountants need to adopt an outward-looking, *value-creating* position at the heart of organizational information flows and supply chain relationship with divisions. This new responsibility contrasts with the traditional transaction processing, back office, tasks that accountants might have been used to.

Source: www.shared-services-research.com; Adecco Group 2010, The big shift: value through partnering, CIMA, London

Management accounting is concerned with providing information to managers – that is, people inside an organization who direct and control its operations. In contrast, **financial accounting** is concerned with providing information to shareholders, creditors and others who are outside an organization. Management accounting provides the essential data with which organizations are actually run. Financial accounting provides the scorecard by which a company's past performance is judged.

Because it is manager oriented, any study of management accounting must be preceded by some understanding of what managers do, the information managers need, and the general business environment. As the organizations and the business environment changes then the role of management accounting changes. Accordingly, the purpose of this chapter is briefly to examine these subjects.

LEARNING OBJECTIVE 1

The work of management and the need for management accounting information

Every organization – large and small – has managers. Someone must be responsible for making plans, organizing resources, directing personnel and controlling operations. In this chapter, we will use a particular organization – a department store, Happybuy Ltd – to illustrate the work of management. What we have to say about the management of Happybuy Ltd, however, is very general and can be applied to virtually any organization. Managers at Happybuy Ltd, like managers everywhere, carry out three major activities – **planning**, **directing and motivating** and **controlling**. Planning involves selecting a course of action and specifying how the action will be implemented. Directing and motivating involves mobilizing people to carry out plans and run routine operations. Controlling involves ensuring that the plan is actually carried out and is appropriately modified as circumstances change. Management accounting information plays a vital role in these basic management activities – but most particularly in the planning and control functions.

Planning

The first step in planning is to identify alternatives and then to select from among the alternatives the one that does the best job of furthering the organization's objectives. The basic objective of Happybuy Ltd is to earn profits for the owners of the company by providing superior service at competitive prices in as many markets as possible. To further this objective, every year top management carefully considers a range of options, or alternatives, for expanding into new geographic markets. This year management is considering opening new stores in Shanghai, Helsinki and Milan.

When making this and other choices, management must balance the opportunities against the demands made on the company's resources. Management knows from bitter experience that opening a store in a major new market is a big step that cannot be taken lightly. It requires enormous amounts of time and energy from the company's most experienced, talented and busy professionals. When the company attempted to open stores in both Beijing and Paris in the same year, resources were stretched too thinly. The result was that neither store opened on schedule, and operations in the rest of the company suffered. Therefore, entering new markets is planned very, very carefully.

Among other data, top management looks at the sales volumes, profit margins and costs of the company's established stores in similar markets. These data, supplied by the management accountant, are combined with projected sales volume data at the proposed new locations to estimate the profits that would be generated by the new stores. In general, virtually all important alternatives considered by management in the planning process have some effect on revenues or costs, and management accounting data are essential in estimating those effects.

After considering all of the alternatives, Happybuy Ltd's top management decided to open a store in the burgeoning Shanghai market in the third quarter of the year, but to defer opening any other new stores to another year. As soon as this decision was made, detailed plans were drawn up for all parts of the company that would be involved in the Shanghai opening. For example, the Personnel Department's travel budget was increased, since it would be providing extensive on-site training to the new personnel hired in Shanghai.

As in the Personnel Department example, the plans of management are often expressed formally in **budgets**, and the term budgeting is applied generally to describe this part of the planning process. Typically, budgets are prepared annually and represent management's plans in specific, quantitative terms. In addition to a travel budget, the Personnel Department will be given goals in terms of new hires, courses taught, and detailed breakdowns of expected expenses. Similarly, the manager of each store will be given a target for sales volume, profit, expenses, pilferage losses and employee training. These data will be collected, analysed, and summarized for management use in the form of budgets prepared by management accountants.

Directing and motivating

In addition to planning for the future, managers must oversee day-to-day activities and keep the organization functioning smoothly. This requires the ability to motivate and effectively direct people. Managers assign tasks to employees, arbitrate disputes, answer questions, solve on-the-spot problems, and make many small decisions that affect customers and employees. In effect, directing is that part of the managers' work that deals with the routine and the here and now. Management accounting data, such as daily sales reports, are often used in this type of day-to-day decision making.

Controlling

In carrying out the **control** function, managers seek to ensure that the plan is being followed. **Feedback**, which signals whether operations are on track, is the key to effective control. In sophisticated organizations this feedback is provided by detailed reports of various types. One of these reports, which compares budgeted to actual results, is called a **performance report**. Performance reports suggest where operations are not proceeding as planned and where some parts of the organization may require additional attention. For example, before the opening of the new Shanghai store in the third quarter of the year, the store's manager will be given sales volume, profit and expense targets for the fourth quarter of the year. As the fourth quarter progresses, periodic reports will be made in which the actual sales volume, profit and expenses are compared to the targets. If the actual results fall below the targets, top management is alerted that the Shanghai store requires more attention. Experienced personnel can be flown in to help the new manager, or top management may come to the conclusion that plans will have to be revised. As we shall see in following chapters, providing this kind of feedback to managers is one of the central purposes of management accounting.

The end results of managers' activities

As a customer enters one of the Happybuy stores, the results of management's planning, directing and motivating, and control activities will be evident in the many details that make the difference between a pleasant and an irritating shopping experience. The store will be clean, fashionably decorated and logically laid out. Checkout staff will be alert, friendly and efficient. In short, what the customer experiences does not simply happen; it is the result of the efforts of managers who must visualize and fit together the processes that are needed to get the job done.

The planning and control cycle

The work of management can be summarized in a model such as the one shown in Exhibit 1.1. The model, which depicts the **planning and control cycle**, illustrates the smooth flow of management activities from planning through directing and motivating, controlling, and then back to planning again. All of these activities involve decision making, so it is depicted as the hub around which the other activities revolve.

LEARNING OBJECTIVE 2

Comparison of financial and management accounting

Financial accounting reports are prepared for the use of external parties such as shareholders and creditors, whereas management accounting reports are prepared for managers inside the organization. This contrast in basic orientation results in a number of major differences between financial and management accounting, even though both financial and management accounting rely on the same underlying financial data. These differences are summarized in Exhibit 1.2.

EXHIBIT 1.1

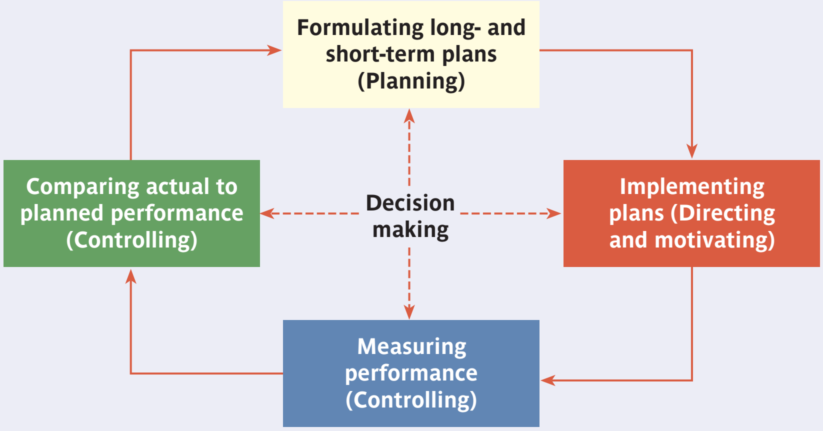


Exhibit 1.1 The planning and control cycle

EXHIBIT 1.2

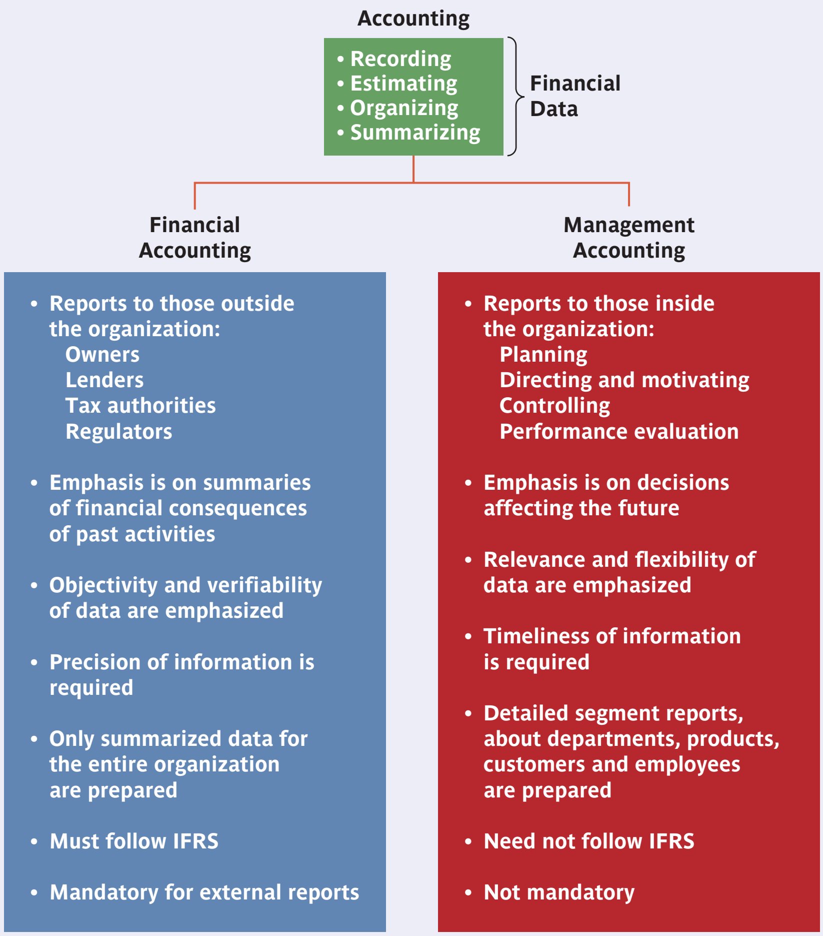


Exhibit 1.2 Comparison of financial and management accounting

As shown in Exhibit 1.2, in addition to the difference in who the reports are prepared for, financial and management accounting also differ in their emphasis between the past and the future, in the type of data provided to users and in several other ways. These differences are discussed in the following paragraphs.

Emphasis on the future

Since planning is such an important part of the manager's job, management accounting has a strong future orientation. In contrast, financial accounting primarily provides summaries of past financial transactions. These summaries may be useful in planning, but only to a point. The difficulty with summaries of the past is that the future is not simply a projection of what has happened in the past. Changes are constantly taking place in economic conditions, customer needs and desires, competitive conditions and so on. All of these changes demand that the manager's planning be based in large part on estimates of what will happen rather than on summaries of what has already happened.

Relevance and flexibility of data

Financial accounting data are expected to be objective and verifiable. However, for internal uses the manager wants information that is relevant even if it is not completely objective or verifiable. By relevant, we mean appropriate for the problem at hand. For example, it is difficult to verify estimated sales volumes for a proposed new store at Happybuy Ltd, but this is exactly the type of information that is most useful to managers in their decision making. The management accounting information system should be flexible enough to provide whatever data are relevant for a particular decision.

Less emphasis on precision

Timeliness is often more important than precision to managers. If a decision must be made, a manager would much rather have a good estimate now than wait a week for a more precise answer. A decision involving tens of millions of pounds does not have to be based on estimates that are precise down to the penny, or even to the pound. Estimates that are accurate to the nearest million pounds may be precise enough to make a good decision. Since precision is costly in terms of both time and resources, management accounting places less emphasis on precision than financial accounting. In addition, management accounting places considerable weight on non-monetary data. For example, information about customer satisfaction is of tremendous importance even though it would be difficult to express such data in a monetary form.

Segments of an organization

Financial accounting is primarily concerned with reporting for the company as a whole. By contrast, management accounting focuses much more on the parts, or **segments**, of a company. These segments may be product lines, sales territories, divisions, departments, or any other categorization of the company's activities that management finds useful. Financial accounting does require some breakdowns of revenues and costs by major segments in external reports, but this is a secondary emphasis. In management accounting, segment reporting is the primary emphasis.

International Financial Reporting Standards (IFRS)

Financial accounting statements prepared for external users must be prepared in accordance with generally accepted accounting principles such as the International Financial Reporting Standards proposed by the International Accounting Standards Board (IASB). External users must have some assurance that the reports have been prepared in accordance with some common set of ground rules. These common ground rules enhance comparability and help reduce fraud and misrepresentation, but they do not necessarily lead to the type of reports that would be most useful in internal decision making. Management accounting is not bound by generally accepted accounting principles. Managers set their own ground rules concerning the content and form of internal reports. The only constraint is that the expected benefits from using the information should outweigh the costs of collecting, analysing and summarizing the data. Nevertheless, as we shall see in subsequent chapters, it is undeniably true that financial reporting requirements have heavily influenced management accounting practice.

Management accounting – not mandatory

Financial accounting is mandatory; that is, it must be done. Various outside parties such as the Stock Exchange regulators and the tax authorities require periodic financial statements. Management accounting, on the other hand, is not mandatory. A company is completely free to do as much or as little as it wishes. There are no regulatory bodies or other outside agencies that specify what is to be done, or, for that matter, whether anything is to be done at all. Since management accounting is completely optional, the important question is always, 'Is the information useful?' rather than, 'Is the information required?'

Basic organizational structure

Since organizations are made up of people, management must accomplish its objectives by working through people. Managing directors of companies like Happybuy Ltd could not possibly execute all of their company's strategies alone; they must rely on other people. This is done by creating an organizational structure that permits **decentralization** of management responsibilities.

Decentralization

Decentralization is the delegation of decision-making authority throughout an organization by providing managers at various operating levels with the authority to make decisions relating to their area of responsibility. Some organizations are more decentralized than others. Because of Happybuy Ltd's geographic dispersion and the peculiarities of local markets, the company is highly decentralized.

Happybuy Ltd's managing director sets the broad strategy for the company and makes major strategic decisions such as opening stores in new markets, but much of the remaining decision-making authority is delegated to managers on various levels throughout the organization. These levels are as follows: the company has a number of retail stores, each of which has a store manager as well as a separate manager for each section such as women's clothing and household appliance. In addition, the company has support departments such as a central Purchasing Department and a Personnel Department. The organizational structure of the company is depicted in Exhibit 1.3.

The arrangement of boxes shown in Exhibit 1.3 is called an **organization chart**. The purpose of an organization chart is to show how responsibility has been divided among managers and to show formal lines of reporting and communication, or chain of command. Each box depicts an area of management responsibility, and the lines between the boxes show the lines of formal authority between managers. The chart tells us, for example, that the store managers are responsible to the operations manager. In turn, the latter is responsible to the company managing director who, in turn, is responsible to the board of directors. Following the lines of authority and communication on the organization chart, we can see that the manager of the Hong Kong store would ordinarily report to the operations director rather than directly to the managing director of the company.

Informal relationships and channels of communication often develop outside the formal reporting relationships on the organization chart as a result of personal contacts between managers. The informal structure does not appear on the organization chart, but it is often vital to effective operations.

Line and staff relationships

An organization chart also depicts **line** and **staff** positions in an organization. A person in a line position is directly involved in achieving the basic objectives of the organization. A person in a staff position, by contrast, is only indirectly involved in achieving those basic objectives. Staff positions support or provide assistance to line positions or other parts of the organization, but they do not have direct authority over line positions. Refer again to the organization chart in Exhibit 1.3. Since the basic objective of Happybuy Ltd is to sell recorded merchandise at a profit, those managers whose areas of responsibility are directly related to the sales effort occupy line positions. These positions, which are shown in green in the exhibit, include the managers of the various departments in each store, the store managers, the operations manager and members of top management.

EXHIBIT 1.3

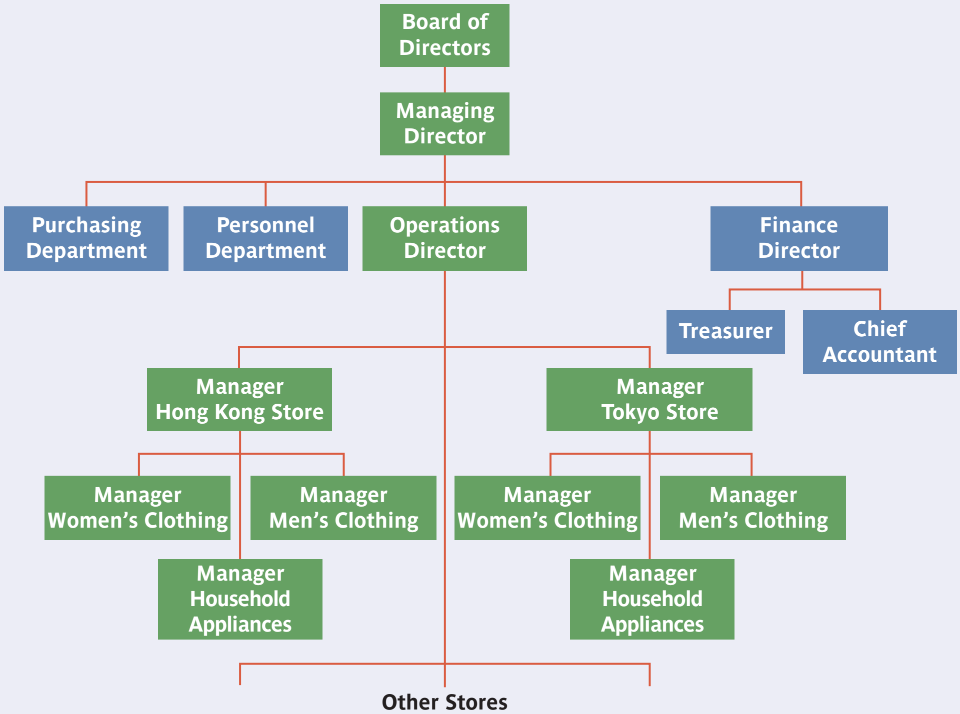


Exhibit 1.3 Organization chart, Happybuy Ltd

By contrast, the manager of the central Purchasing Department occupies a staff position, since the only function of the Purchasing Department is to support and serve the line departments by doing their purchasing for them. The finance function, which is responsible for the organization's management accounting, is also seen as a staff position. The finance office often combines a number of important functions including the management of the company's computer services and other business information systems.

LEARNING OBJECTIVE 3

Expanding and changing role of management accounting

Management accounting has its roots in the industrial revolution of the 19th century. During this early period, most firms were tightly controlled by a few owner–managers who borrowed based on personal relationships and their personal assets. Since there were no external shareholders and little unsecured debt, there was little need for elaborate financial reports. In contrast, management accounting was relatively sophisticated and provided the essential information needed to manage the early large-scale production of textiles, steel and other products.[1]

After the turn of the 20th century, financial accounting requirements burgeoned because of new pressures placed on companies by capital markets, creditors, regulatory bodies and taxation of income. Johnson and Kaplan state that 'many firms needed to raise funds from increasingly widespread and detached suppliers of capital. To tap these vast reservoirs of outside capital, firms' managers had to supply audited financial reports. And because outside suppliers of capital relied on audited financial statements, independent accountants had a keen interest in establishing well-defined procedures for corporate financial reporting. The inventory costing procedures adopted by public accountants after the turn of the century had a profound effect on management accounting.'[2]

As a consequence, for many decades, management accountants increasingly focused their efforts on ensuring that financial accounting requirements were met and financial reports were released on time. The practice of management accounting stagnated. Johnson and Kaplan's book and their thesis of 'Relevance Lost' stimulated a major debate among both academics and practitioners. Johnson and Kaplan (1987) argued that in the early part of the 20th century, as product lines expanded and operations became more complex, forward-looking companies such as Du Pont, General Motors, and General Electric saw a renewed need for management oriented reports that were separate from financial reports. But, in most companies, management accounting practices up through the mid-1980s were largely indistinguishable from practices that were common prior to the First World War. In recent years, however, new economic forces have led to many important innovations in management accounting. These new practices will be discussed in detail later, and especially in Chapters 16–19. These chapters have been written to compare approaches that accept physical and organizational limitations and optimize subject to given **constraints** with more recent approaches that are based on management practices aimed at shifting constraints. These chapters reflect the way that management accounting practices have evolved since the publication of the 'Relevance Lost' thesis.

The sources of management accounting knowledge

The practice and principles of management accounting have been developed over many decades, even centuries. In the early days the main source of practice was practitioners such as early industrialists at Josiah Wedgewood's potteries or at Alfred Sloan's General Motors. More recently other inputs have come from business schools, management consultants and even management gurus (Thrift, 2005). In the particular case of accounting other contributors to managerial knowledge production include professional bodies. Managerial and business knowledge may be visualized as being produced via a circulation of ideas and practices.

Yet the processes that impact on the production and circulation of managerial knowledge should not be seen as infallible. Academic theories may be rejected by practitioners on the grounds of 'irrelevance' and practices may develop that weaken rather than enhance long-run business performance (Johnson and Kaplan, 1987). The latest practices may not really be 'best practice' but rather introduced because of managerial fashions and fads (Seal, 2010). One of the aims of this book is to enable the reader to develop a *critical* understanding of the principles behind management accounting so that faulty practices may be recognized even if they cannot always be changed in a particular organizational setting.

International diversity in management accounting traditions

Management accounting is sometimes presented as a universal tool kit. Yet this image of the subject hides the 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. Although the professional organization of auditors is very widespread throughout the world, the professional organization of management accounting is far less prevalent. The variation in professional organization does not mean that management accounting techniques cannot be applied in different countries but rather that the occupations that control them differ in different countries for all sorts of complex historical[3] and institutional reasons.[4] Indeed, many European countries have problems with the term 'management accounting' because the professions are organized differently and have different rankings in terms of status and technical expertise.[5]

Different traditions mean that historical debates such as the 'Relevance Lost thesis' may have resonance in the US or the UK but not necessarily in Germany or Japan. Indeed, many critics of US (and, by extension, UK) management accounting techniques were partly informed by a historical analysis of the US experience and partly by a perceived competitive weakness compared to the economic successes of Japan in the 1970s and 80s. There is some evidence that management accounting practices are tending to converge under some of the influences such as globalization and new technology, which will be discussed below.[6]

LEARNING 4 OBJECTIVE

Globalization and international competition

Over the last few decades, competition has become worldwide in many industries. This has been caused by reductions in tariffs, quotas and other barriers to free trade; improvements in global transportation systems; and increasing sophistication in international markets. These factors work together to reduce the costs of conducting international trade and make it possible for foreign companies to compete on a more

FOCUS ON PRACTICE

Servitization in manufacturing

How can manufacturing based in developed countries compete with manufacturing in developing countries such as China which have much lower wage costs and less onerous environmental and social obligations? One response to this global competition has been what is known as *servitization*. Servitization blurs the traditional distinction between manufacturing and services. Companies such as the aero engine manufacturer Rolls Royce 'no longer sells aero engines, it offers a total care package, where customers buy the capability the engines deliver – "power by the hour" with Rolls Royce retaining 'responsibility for risk, maintenance, etc.' With servitization, firms offer services and solutions, associated with their manufactured products in what may be seen as a ProductService System.

Exercise: Apply the servitization concept to a company such as IBM in the information technology industry. How has it changed the focus of its business?

Source: Neely, A. 2007. Servitization, *Manufacturing Matters*, Winter; http://www.cranfield.ac.uk/sas/pdf/servitization.pdf

equal footing with local firms. As well as continuing expansion of the European Union (EU), competition from rapidly growing countries such as China and India have led to global economic restructuring with new locations for the outsourcing of manufacturing (China) and services (India) by Western and Japanese multinational companies.

Reductions in trade barriers have made it easier for agile and aggressive companies to expand outside of their home markets. As a result, very few firms can afford to be complacent. A company may be very successful today in its local market relative to its local competitors, but tomorrow the competition may come from halfway around the globe. As a matter of survival, even firms that are presently doing very well in their home markets must become world-class competitors. On the bright side, the freer international movement of goods and services presents tremendous export opportunities for those companies that can transform themselves into world-class competitors. And, from the standpoint of consumers, heightened competition promises an even greater variety of goods, at higher quality and lower prices.

What are the implications for management accounting of increased global competition? It would be very difficult for a firm to become world-class if it plans, directs and controls its operations and makes decisions using a second-class management accounting system. An excellent management accounting system will not by itself guarantee success, but a poor management accounting system can stymie the best efforts of people in an organization to make the firm truly competitive.

Throughout this text we will highlight the differences between obsolete management accounting systems that get in the way of success and well-designed management accounting systems that can enhance a firm's performance. It is noteworthy that elements of well-designed management accounting systems have originated in many countries. More and more, management accounting has become a discipline that is worldwide in scope.[7]

Changes in the business environment and management accounting

LEARNING OBJECTIVE 5

New business processes and technologies

Global competition has been good news for consumers, since intensified competition has generally led to lower prices, higher quality and more choices. However, the last three decades have been a period of wrenching change for many businesses and their employees. Many managers have learned that cherished ways of doing business do not work any more and that major changes must be made in how organizations are managed and in how work gets done. These changes are so great that some observers view them as a second industrial revolution.

This revolution is having a profound effect on the practice of management accounting – as we will see throughout the rest of the text. First, however, it is necessary to have an appreciation of the ways in which organizations are transforming themselves to become more competitive. Since the early 1980s, many companies have gone through several waves of improvement programmes, starting with **just-in-time (JIT)** and passing on to **total quality management (TQM)**, process re-engineering, and various other management programmes often summarized by the term *lean production*. When properly implemented, these improvement programmes can enhance quality, reduce cost, increase output, eliminate delays in responding to customers and ultimately increase profits. They have not, however, always been wisely implemented, and there is considerable controversy concerning the ultimate value of each of these programmes. Nevertheless, the current business environment cannot be properly understood without an appreciation of what each of these approaches attempts to accomplish.

These management approaches have implications for management accounting. In particular, they open up the possibility of managing areas like quality, stock and constraints rather than optimizing a given situation. For example, the traditional optimizing approach for stock management, the economic order quantity (EOQ), has to be placed alongside approaches such as JIT that try to eliminate stock. Later in the book, we contrast a number of optimizing models with more contemporary, active management approaches.

Another significant change that we analyse in later chapters is the influence of new technology, especially in computers and telecommunications. These technologies have not just resulted in the automation of existing manual management accounting systems but have enabled the restructuring of whole industries and economies. Even if some of the hype surrounding the internet has died down a little since the heady days of the late 1990s, the internet has, and is, changing the way business is done. New forms of competition, organization and technologies have implications for management accounting. Some of the more traditional merits of management accounting (such as the idea that businesses plan to make profits!) may have reasserted themselves after the collapse of the 'dotcom' bubble, but the longer lasting changes in **business process** require a response from management accounting if the subject is to remain relevant.

One sector that has changed dramatically in recent years is the airline business, particularly with the success in both Europe and North America of the 'no-frills' airlines such as easyJet, Ryanair and Southwest Airlines. The low-cost airline illustrates many of the features of the combined impact of new organizational forms, business processes, new technology and new personnel approaches.

The low-cost airline example illustrates a combination of new thinking about air travel combined with well-known principles of standardization. The use of new technologies such as databases is combined with older technologies such as the telephone – the essence is the integration of a number of previously separated activities such as booking, ticketing and payment processing.

Enterprise resource planning systems

Some technological changes have not just affected the environment of management accounting but have had a direct impact on the collection and dissemination of management information.[8] The increasing use of sophisticated real time information systems known as **enterprise resource planning (ERP)** provided by companies such as SAP, Oracle, J.D. Edwards and Baan, has changed the nature of management accounting work and the role of the finance function.[9] One of the emerging implications for the management accountant is that there is more emphasis on business support rather than routine information gathering. Furthermore, not only is there a greater dispersion of finance personnel into process areas, but accounting information itself has become more dispersed throughout the organization as it becomes more accessible to non-accounting personnel. We will explore the impact of ERP in more detail in Chapter 18.

Deregulation, privatization and re-regulation

It is also worth noting that the increased competition in the airline industry was not possible until the deregulation effects of 'open skies' policies. Deregulation and privatization of former state-owned monopolies had a significant impact in Europe especially in the UK, which pioneered these policies. The changes in ownership and increased competition has not only affected the huge public utilities that were privatized, they also had a knock-on effect on the companies that supplied these giants.

After financial scandals at Enron around the turn of the millennium and the more recent collapse of banking (popularly known as the *credit crunch*), the trend has been towards tighter, rather than lighter, regulation in **corporate governance**. Any companies listed in North America are subject to the Sarbanes–Oxley Act (2002), while UK companies are expected to comply with the Combined Code (2006) on corporate governance. Although it is too early to know the details, the recent problems faced by Western banks, especially in the US and the UK may lead to new banking regulations in the UK as well. Although many of these issues are seen as financial reporting and auditing issues, there is an emerging awareness that corporate governance also involves the aspects of strategic control systems covered in Chapters 16 and 17.[10]

LEARNING 6 OBJECTIVE

The increased importance of service 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. Many traditional management accounting approaches to issues such as costing were developed with manufacturing industry in mind. In comparison with traditional manufacturing, where the product is easy to see and touch, products in service industries are less tangible. A bank may offer a number of different 'products' such as types of account or loans which are defined by dimensions such as accessibility or repayment terms, secured or unsecured and so on. Services cannot be stored in inventory so that managers in banks and other service industries may be less interested in *product* cost but, rather, which *customers* are profitable and which customers are not. Service industries provide new challenges and opportunities for management accounting information, particularly as competitive success is especially dependent on intangible assets such as employee expertise and customer relations.

Not only are service activities becoming more important relative to manufacturing but they are increasingly subject to reorganization in both public and private sectors.[11] In particular, we have seen the emergence of **shared service centres** where the support services of an entire corporation are concentrated in a single geographical location. Other companies have gone a stage further by subcontracting them to independent companies in a practice known as **outsourcing**.[12]

Management accounting's spread into the public sector is driven by government demands for new measures of performance and new delivery systems. Although its precise form and motivation varies in different countries, this phenomenon, often referred to as the 'New Public Management',[13] may be seen as a global movement.[14] These developments are not without controversy, especially where there is an attempt to apply, in the not-for-profit, public sector organizations, the same management philosophies and techniques that were originally developed for private, profit-making organizations.

Managing for value

Traditionally, accountants were portrayed as 'bean-counters' or 'corporate policemen' with an emphasis on past performance and organizational control. While these functions are still part of an accountant's role, the trend recently has been to emphasize the creation and management of value. Pressures from corporate raiders and new sources of capital, such as private equity, mean that managers have to be increasingly aware of shareholder value. As will be explored in Chapters 14, 16 and 17, there are challenges both to *measure* shareholder value and to discover how to *create* it through the adoption and implementation of corporate strategies. Managers are also aware of the importance of *customer value* and its relationship to shareholder value. Managing for value has to balance the possible gains to short-run profitability arising from cost-cutting exercises to possible long-run damage to shareholder value as costs may be cut at the expense of customer satisfaction. For the management accountant the challenge is not just to devise appropriate financial and non-financial metrics to measure value but to try and understand cause-and-effect relationships.[15]

FOCUS ON PRACTICE

The sustainability of the sustainability agenda

Was sustainability just a fad, a product of an illusory sense of well-being created in the 'bubble economies' of the affluent West? Will the down turn in those economies after the collapse of Lehman Brothers mean that cost cutting and short-term measures will lead to a neglect of sustainability issues? Not according to a recent survey conducted with leading world business leaders. In the survey, 92 per cent of respondents maintained that their company was addressing sustainability even after the down turn. Although the survey reported that 70 per cent of companies had not developed a 'clear business case for sustainability'. . .. Once companies begin to act aggressively, they tend to unearth more opportunity, not less, than they expected to find, including tangible bottom-line impacts and new sources of competitive advantage'. In short, being green makes good business sense particularly in terms of consumer opinion of the company's brand.

Exercise: Consider the huge negative business impact on company share values associated with environmental disasters such as recent oil spills in the Gulf of Mexico.

Source: Berns, M., Townend, A., Khayat, Z., Balagopal, B., Reeves, M., Hopkins, M. and Kruschwitz, N. 2009. The business of sustainability, *MITSloan Management Review Special Report*, Massachusetts Institute of Technology

Managing for environmental sustainability

Whilst concern about the environment has been around for some decades, the threat of rapid human-induced climate change has raised the profile of a whole range of environmental sustainability issues. A recent survey of accountants in business[16] found that 79% of large companies and 56% of smaller- and medium-sized companies had a formal sustainability strategy. Even managers who focus on shareholder value may be concerned about the environment for three main reasons. First, there is a compliance motive – companies may find that they are forced through regulation and green taxes to manage environmental resources more carefully. Second, eco-efficiency not only may save the planet but reduce the business costs. Finally, there may be strategic reasons – companies may have customers who demand green business policies and who are increasingly suspicious of 'environmental window dressing' through environmental reporting. **Environmental management accounting** is not about reporting. It involves the collection and analysis of *physical* information on flows of energy, water and other materials as well as *monetary* information on environmental costs and benefits in order to make environmentally sensitive decisions.[17]

Corporate governance, professional and business ethics

A thorough analysis of what makes a profession goes beyond the scope of this book. Technical competence is one part of being professional. Another important aspect is the adherence to a code of ethics. For example, the Chartered Institute of Management Accountants, which is the largest body specifically for management accountants in the UK, have themselves pointed out that being a professional means having responsibilities beyond the narrow pursuit of profit at any cost. In common with other accountancy bodies, they have a code of practice and mechanisms for monitoring and enforcing professional ethics.

If ethical standards were not generally adhered to, there would be undesirable consequences for everyone. Essentially, abandoning ethical standards would lead to a lower standard of living with lower-quality goods and services, less to choose from, and higher prices. In short, following ethical rules is not just a matter of being 'nice'; it is absolutely essential for the smooth functioning of an advanced market economy. For example, one of the short-term consequences of the Enron scandal[18] is that investors have become suspicious about the reliability of reported accounting numbers. Other problems have arisen in other parts of the financial services industry in the UK, where managers offered unsustainable guaranteed returns or incentivized the sales personnel so that they gave faulty investment or pensions advice. Even more dramatically, we have seen how the bonus culture in Western banks encouraged the creation of huge speculative bubbles in property. The consequences of the collapse of these bubbles are still being felt with depressed output, lost jobs and huge public sector deficits. The common theme in so many of these scandals and collapses is that the single-minded emphasis placed on short-term profits in some companies may make it seem as if the only way to get ahead is to act unethically. When top managers say, in effect, that they will only be satisfied with bottom-line results and will accept no excuses, they are asking for trouble. Recent high-profile scandals show that accountants are often placed in difficult ethical positions. Other issues such as transfer pricing practice in multinational companies (which we look at in Chapter 15) and the 'laundering' of illegally obtained money provide particularly pressing challenges to the integrity of all finance professionals.

Although we argued earlier in this chapter that management accounting is mainly concerned with internal reporting, management accountants cannot totally avoid taking responsibility for the integrity of the basic financial data that forms the basis of both financial and management reports (see Exhibit 1.2). Indeed, as we shall learn in the next three chapters, the classification and computation of cost can have a significant impact on reported profit. In Chapter 17 we will look in more detail at the relationships between corporate strategy, risk management and corporate governance.

Some implications for the roles of management accountants: a first look

The changes in the business environment discussed above have potentially left management accountants with a multitude of roles. The roles may depend on the size of the organization, its line of business and a whole range of issues discussed above and in subsequent chapters. But the role played by the management accountant may also depend on their location in the large corporation. For example, in Exhibit 1.4, we can see that in head office, issues of corporate governance and strategy may be a major concern. In the so-called back office area, the focus will be on more operational matters associated with business processes, organizational structure and information technology. In the front office, the management accountant may be operating outside the designated finance function in multi-functional teams with more direct contact with customers, suppliers and helping to manage frontline processes. In order to fulfil these multiple roles, management accountants need to master a diversity of techniques, concepts and practices which will be elaborated on in the following chapters.[19]

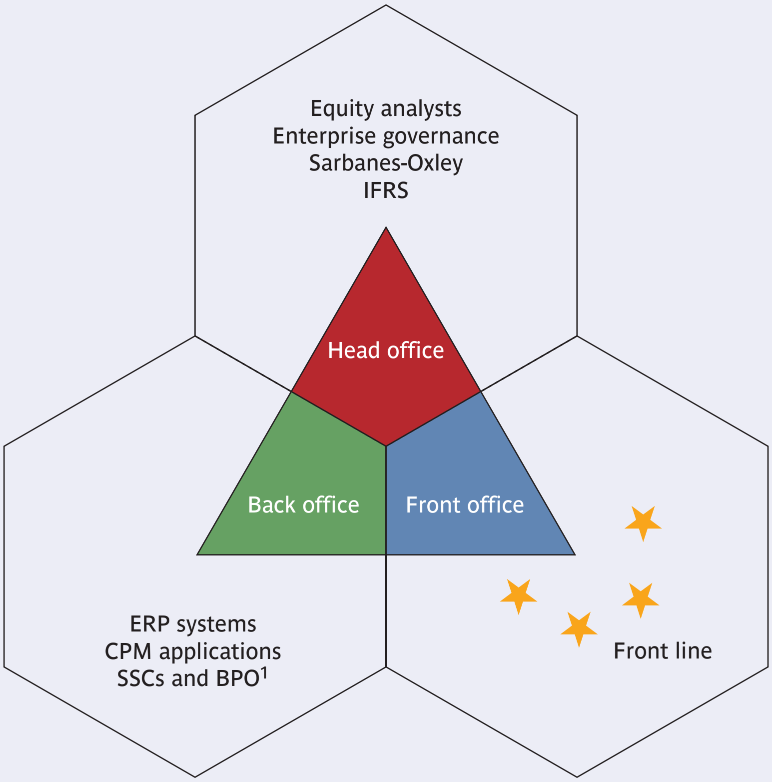
FOCUS ON PRACTICE

New IT and business analysis

Rachel has trained as a management accountant and is now director of divisional finance in a large restaurant and public house chain. The company has an advanced accounting system in which transactions recording and reporting has been automated. Freed up from routine data gathering, Rachel liaises between the regional operational managers and the company's board as she and her team of analysts monitors and manages the financial performance of the many restaurant and pub brands that make up the business.

Exercise: Note how advances in IT have automated the 'score-keeping' aspects of accounting and enabled managers not only to have more up to the minute business intelligence but also freeing up their time for value creation.

EXHIBIT 1.4



[1]Enterprise resource planning (ERP), corporate performance management (CPM), shared service centres (SSCs) and business process outsourcing (BPO).

Exhibit 1.4 The diverse roles of management accountants within large corporations (reproduced with permission from *Improving decision making in organizations* (2007) CIMA technical report, p.5)

Summary

- Management accounting assists managers in carrying out their responsibilities, which include planning, directing and motivating, and controlling.
- Since management accounting is geared to the needs of the manager rather than to the needs of outsiders, it differs substantially from financial accounting. Management accounting is oriented more towards the future, places less emphasis on precision, emphasizes segments of an organization (rather than the organization as a whole), is not governed by generally accepted accounting principles, and is not mandatory.
- Most organizations are decentralized to some degree. The organization chart depicts who works for whom in the organization and which units perform staff functions rather than line functions. Accountants perform a staff function – they support and provide assistance to others inside the organization.
- The business environment in recent years has been characterized by increasing competition and a relentless drive for continuous improvement. Several approaches have been developed to assist organizations in meeting these challenges, including just-in-time (JIT), total quality management (TQM), and the theory of constraints (TOC). Organizations have also restructured with outsourcing and relocation of company activities. Reformed public sectors are increasingly applying management accounting techniques.

- Ethical standards serve a very important practical function in an advanced market economy. Without widespread adherence to ethical standards, the economy would slow down dramatically. Ethics are the lubrication that keep a market economy functioning smoothly.

Key terms for review

At the end of each chapter, a list of key terms for review is given. These terms are highlighted in colour. Full definitions can be found in the glossary at the end of the book. Carefully study each term to be sure you understand its meaning, since these terms are used repeatedly in the chapters that follow. The list for Chapter 1 follows:

Budgets (p. 4)
Business process (p. 12)
Constraints (p. 10)
Control (p. 5)
Controlling (p. 4)
Corporate governance (p. 13)
Decentralization (p. 8)
Directing and motivating (p. 4)
Enterprise resource planning (ERP) (p. 12)
Environmental management accounting (p. 14)
Feedback (p. 5)
Financial accounting (p. 4)
Just-in-time (JIT) (p. 12)
Line (p. 8)
Management accounting (p. 4)
Organization chart (p. 8)
Outsourcing (p. 13)
Performance report (p. 5)
Planning (p. 4)
Planning and control cycle (p. 5)
Segments (p. 7)
Shared service centres (p. 13)
Staff (p. 8)
Total quality management (TQM) (p. 12)

Level of difficulty: BASIC INTERMEDIATE ADVANCED

Questions

connect

1–1 What is the basic difference in orientation between financial and management accounting?
1–2 What are the three major activities of a manager?
1–3 Describe the four steps in the planning and control cycle.
1–4 What function does feedback play in the work of the manager?
1–5 Distinguish between line and staff positions in an organization.
1–6 What are the major differences between financial and management accounting?
1–7 Briefly describe the impact of new technology, globalization and deregulation on the practice of management accounting.
1–8 Suggest three ways in which management accounting in services may differ from its practice in manufacturing industry.
1–9 Suggest three reasons why value seeking companies should care about the environment.
1–10 Why is adherence to ethical standards important for the smooth functioning of an advanced market economy?

Exercises

connect

E1–1 Time allowed: 10 minutes

Listed below are a number of terms that relate to organizations, the work of management and the role of management accounting:

Budgets	Chief Accountant	Decentralization
Directing and motivating	Feedback	Financial accounting
Line	Management accounting	Non-monetary data
Performance report	Planning	Precision
Staff		

Choose the term or terms above that most appropriately complete the following statements:

1 A position on the organization chart that is directly related to achieving the basic objectives of an organization is called a ________ position.

2 When ________, managers oversee day-to-day activities and keep the organization functioning smoothly.

3 The plans of management are expressed formally in ________.

4 ________ consists of identifying alternatives, selecting from among the alternatives the one that is best for the organization, and specifying what actions will be taken to implement the chosen alternative.

5 A ________ position provides service or assistance to other parts of the organization and does not directly achieve the basic objectives of the organization.

6 The delegation of decision-making authority throughout an organization by allowing managers at various operating levels to make key decisions relating to their area of responsibility is called ________.

7 Management accounting places less emphasis on ________ and more emphasis on ________ than financial accounting.

8 ________ is concerned with providing information for the use of those who are inside the organization, whereas ________ is concerned with providing information for the use of those who are outside the organization.

9 The accounting and other reports coming to management that are used in controlling the organization are called ________.

10 The manager in charge of the accounting department is generally known as the ________.

11 A detailed report to management comparing budgeted data against actual data for a specific time period is called a ________.

Problems

connect

P1–2 **Preparing an organization chart**

Time allowed: 30 minutes

Upton University is a large private university located in the Midlands. The university is headed by a vice-chancellor who has five pro-vice chancellors reporting to him. These pro-vice chancellors are responsible for, respectively, auxiliary services, admissions and records, academics, financial services (controller), and physical plant.

In addition, the university has managers over several areas who report to these pro-vice chancellors. These include managers over central purchasing, the university press, and the university bookstore, all of whom report to the pro-vice chancellor for auxiliary services; managers over computer services and over accounting and finance, who report to the pro-vice chancellor for financial services; and managers over grounds and custodial services and over plant and maintenance, who report to the pro-vice chancellor for physical plant.

The university has four colleges – business, humanities, fine arts, and engineering and quantitative methods– and a law school. Each of these units has a dean who is responsible to the academic pro-vice chancellor. Each college has several departments.

Required

1 Prepare an organization chart for Upton University.

2 Which of the positions on your chart would be line positions? Why would they be line positions? Which would be staff positions? Why?

3 Which of the positions on your chart would have need for accounting information? Explain.

P1–3 Ethics and the manager

Richmond plc operates a chain of department stores. The first store began operations in 1965, and the company has steadily grown to its present size of 44 stores. Two years ago, the board of directors of Richmond approved a large-scale remodelling of its stores to attract a more upmarket clientele. Before finalizing these plans, two stores were remodelled as a test. Linda Potter, assistant controller, was asked to oversee the financial reporting for these test stores, and she and other management personnel were offered bonuses based on the sales growth and profitability of these stores. While completing the financial reports, Potter discovered a sizeable stock of outdated goods that should have been discounted for sale or returned to the manufacturer. She discussed the situation with her management colleagues; the consensus was to ignore reporting this stock as obsolete, since reporting it would diminish the financial results and their bonuses.

Required

1 Would it be ethical for Potter *not* to report the stock as obsolete?

2 Would it be easy for Potter to take the ethical action in this situation?

P1–4 Ethics

Suppose all garages routinely followed the practice of attempting to sell customers unnecessary parts and services by recommending unnecessary or expensive repairs.

Required

1 How would this unethical behaviour affect customers?

2 How might customers attempt to protect themselves against this unethical behaviour?

3 How would this unethical behaviour probably affect profits and employment in the garage industry?

Group exercise

GE1–5 GE1–5 Ethics on the job

Ethical standards are very important in business, but they are not always followed. If you have ever held a job – even a summer job – describe the ethical climate in the organization where you worked. Did employees work a full day or did they arrive late and leave early? Did employees honestly report the hours they worked? Did employees use their employer's resources for their own purposes? Did managers set a good example? Did the organization have a code of ethics and were employees made aware of its existence? If the ethical climate in the organization you worked for was poor, what problems, if any, did it create?

Cases

C1–6 Deregulation, new technology and the reorganization of the finance function
Time allowed: 40 minutes

Megacorp plc is a large international utilities company. The company's business environment has changed rapidly in recent years as a result of the various phases of privatization, deregulation, and the resultant industry restructuring. During the past two years, a shared service centre (SSC) has been established in South Yorkshire, consolidating processes that were formerly dealt with in individual business units (such as power generating stations) in many separate locations. The manager in charge of the finance function explained some of the issues as follows:

> 'We actually run ourselves on process lines – "Purchase-to-Pay" or "Procurement-to-Pay", and "Order-to-Cash". The Sales Ledger is consolidated nationally but the rest is all done locally – we run software systems that these days allow you to have both remote sites and central operations and there is still visibility and transparency across the organization. The same applies to the nominal ledger and other accounting. We do all the statutory accounts centrally now and the main database, the main nominal ledger, is based on a server in this building. But, of course, the data can be accessed anywhere. The accounts are still "owned" by the local Finance Director, Finance Controller and finance teams out in each one of the local business units. The finance people in the local business units need to "own" the statutory accounts even though they don't prepare them these days. If they don't "own" the accounts, then they are signing something without understanding what's there.'

Required

Discuss how the organization and culture of the finance function in Megacorp has been affected by new information technology, the deregulation of power generation and the more recent post-Enron concerns with financial probity.

You might find it helpful to refer to CIMA (2001b) and May (2002).

Internet exercise

IE1–7

Access the website of the *Association for Accountancy and Business Affairs* (http://visar.csustan.edu/aaba/home.htm), click on one of the issues and follow the links to newspaper cuttings and other sources.

Endnotes

1. Chandler (1977).
2. Johnson and Kaplan (1987), pp. 129–30.
3. Again see Johnson and Kaplan (1987). See also Loft (1995); Ezzamel, Hoskin and Macve (1990).
4. See, for example, Armstrong (1985) and Armstrong (1987).
5. Bhimani (1996).
6. Granlund and Lukka (1998b).
7. See Granlund and Lukka (1998b).
8. See Scapens, Ezzamel, Burns and Baldvinsdottir (2003).
9. See May (2002).
10. See e.g. Seal (2006).
11. See, for example, Bain and Taylor (2000).
12. Hayward (2002); CIMA (2001a).
13. Hood (1995).
14. Olson, Guthrie and Humphrey (1998).
15. For a historical view on value based management see Ittner and Larker (2001). For a very recent attempt to analyse the cost of customer satisfaction see Cugini, Caru and Zerbini (2007).
16. CIMA (2010).
17. See IFAC (2005).
18. See, for example, Gordon (2002).
19. See Burns and Baldvinsdottir (2007).

Online LearningCentre

When you have read this chapter, log on to the Online Learning Centre for *Management Accounting* at www.mcgraw-hill.co.uk/textbooks/seal, where you'll find multiple choice questions, practice exams and extra study tools for each chapter.