CHAPTER ONE

OVERVIEW TO MANAGEMENT ACCOUNTING

CHAPTER OBJECTIVES

The objective of this chapter is to provide the background knowledge that will enable the leader to achieve a more meaningful insight into the issues and problems of management accounting. This chapter will focus on the traditions and innovation in management accounting system.

Learning Outcomes

When you have finished studying the material in this chapter you will be able to:

1. Explain the Historical Background of Managerial Accounting
2. Explain the meaning of management accounting
3. Describe the need of managerial accounting in organizations and business firms
4. Distinguish between financial accounting and management accounting
5. Understand the role of management accountant in an organization
6. Identify and describe the objectives and functions of management accounting
7. Understand the Management accounting's role in business management
8. Understand the standards of ethical conduct for practitioners of management accounting and financial management

1.1 Introduction

Mangers in an organization make decisions to achieve the organization's objectives. These decisions include how to make their organizations translate their strategic goals or objectives into actions. To do so they need information and accounting provides financial and cost information to managers to assist them in making decisions. Cost and management accounting system are expected to provide managers' with such information they need. In today's competitive operating environment the organization needs non-costing or non financial information for managers for managerial decisions.

1.2 Historical Background of Managerial Accounting

To understanding the role of management accounting today, it is important to understand its history. Therefore, the overview of historical background in management accounting from nineteenth century to present day will be addressed in this chapter.

There has been extensive debate in recent years over the extent to which management accounting is changing. Johnson and Kaplan (1987) argued that management accounting had not changed since the early part of the twentieth century and had lost its relevance for the purpose of informing managers' decisions. Since then, and possibly in response to these criticisms, a number of innovative management accounting techniques have been developed across a range of industries. The most prominent contributions are activity based techniques, strategic management accounting and the balanced scorecard. These techniques have been designed to prop up modern technologies and management processes, such as total quality management (TQM) and just-in-time (JIT) production systems, and the search for a competitive advantage to meet up the challenge of global competition.

These recent techniques, it has been argued that, have affected the entire process of management accounting and have shifted its spotlight from a simple role of cost determination and financial control, to a sophisticated role of creating value through improved exploitation of resources. It has also been argued that the environment in which management accounting is practiced has changed significantly - with advances in information technology, more competitive markets, different organizational structures and new management practices.

During the last two decades, the criticism of conventional cost and management accounting practices for their lack of efficiency and capability in dealing with the requirements of a changing environment relate to the collapse of such practices to provide comprehensive information on activities necessary for organizations *(Askarany, 2004; Baines & Langfield- Smith, 2003; Beng, Schoch, & Yap, 1994; Bork & Morgan, 1993; Cavalluzzo & Ittner, 2003; Gosselin, 1997; Hartnett & Lowry, 1994;*

Maiga & Jacobs, 2003; Lefebvre & Lefebvre, 1993; Spicer, 1992). Lawrence & Ratcliffe (1990) uphold this argument by providing survey evidence of levels of dissatisfaction among both management accountants and managers with the cost and management accounting techniques afterward being used in industry. Bork & Morgan (1993) reiterate this observation signifying that conventional cost and management accounting systems have failed to keep up with the increasing demands imposed on them by technological change in manufacturing environments. Noticeably, for that reason, the management accounting literature has witnessed a growing attention into the study of the flow of cost and management accounting innovations (*Anderson & Young, 1999; Askarany, 2003; Askarany & Smith, 2001; Askarany & Smith, 2003b; Booth & Giacobbe, 1998; Chenhall & Langfield-Smith, 1998; Cooper & Kaplan, 1991; Gosselin, 1997; Hartnett & Lowry, 1994; Maiga & Jacobs, 2003; Malmi, 1999*).

Research on management accounting change mostly relates to practices in developed countries. Literature has cautioned against the transportability of these practices across nations (Kaplan, 1983; Johnson and Kaplan, 1987; Bromwich and Bhimani, 1989; Wallace, 1990; Atkinson et al., 1997). Bromwich and Bhimani (1989) argue that only shifting new management accounting systems developed in foreign surroundings for coping with a changing business environment is not absolutely reasonable because of the divergent conditions under which different companies operate. They further argue that consideration should always be made of the political, economic, social and cultural environments that surround the firm. In the viewpoint of developing countries insights of the "imported" systems may be gained by commencing studies of the manner in which foreign companies establishing operations in developing countries adjust their management accounting systems to the context of the developing world (Wallace, 1990; Peasnell, 1993; Chow et al., 1994, 1999).

The International Federation of Accountants (IFAC), in 1998, describes management accounting before 1950 as a technical activity required for the pursuit of organizational objectives. It was predominantly oriented towards the determination of product cost. Production technology was comparatively simple, with products going through a series of dissimilar processes. Labor and material costs were simply identifiable and the manufacturing processes were mainly governed by the alacrity of manual operations. Therefore, direct labor provided a natural basis for assigning overheads to individual products. The spotlight on product costs was supplemented by budgets and the financial control of production processes.

According to Chandler (1977), management accounting systems (MAS) first appeared in the United States during the nineteenth century. These MAS employed both simple and complicated accounting methods. For example, the early management accounting procedures were simple but seemed to satisfy the needs of business owners and managers. Simple managerial accounting procedures created during the nineteenth century were used to observe and evaluate the output of internally directed processes. Cost accounts were used to determine the direct labor and overhead costs of converting raw materials into goods. The use of sophisticated accounting procedures also dates back to the nineteenth century.

As early as the first quarter of the nineteenth century, according to Porter (1980), some companies in the USA used sophisticated sets of cost accounts. New accounting systems were intended to control and record the disbursements of cash during this period, which provided management with timely and accurate reports on expenditures. During the nineteenth century, a voucher system of bookkeeping which is used for controlling and recording disbursements was also created (Wood, 1895). In contrast, accounting was mainly used as a record of the external relations between business units before the industrial revolution. Information for decision-making and control was usually acquired from market prices (Graner, 1954).

Cost accounting became more than just a utensil for evaluating internal conversion processes during the nineteenth century, according to Johnson and Kaplan (1987). It was also used as a means to evaluate the performance of subordinate managers. Besides, internal accounting systems for evaluating costs, throughput, and working capital were developed during the nineteenth century. New cost measurement techniques for analyzing productivity and relating profits to products were developed during the late nineteenth and early twentieth century (Askarany, 2004).

On twentieth century accounting practices, these techniques had a significant impact. Some of these techniques provided the foundation for the development of standards to monitor labor and material efficiencies and costs. This was the time of the development of scientific management that concentrated on gathering accurate information vis-à-vis the efficiency of workers affianced in specified tasks. Moreover, the use of variance analysis of actual costs and standard costs for the purpose of controlling operations was also developed.

Scientific management experts, during the nineteenth century, also developed new cost accounting procedures to evaluate and control physical and financial efficiency of tasks and processes in complex machine-making firms and to assess the overall profitability of the enterprise (Johnson & Kaplan, 1987). More or less the 1900s managers started paying attention to the productivity and performance of capital. The design of Du Pont management accounting procedures during that period facilitated the evaluation of the performance of capital; these gave momentous attention to the application of return on investment. Such information helped managers in the allocation of new investments among contending economic activities and the financing of new capital requirements (Chandler & Salsbury, 1971).

Before World War I, according to Johnson and Kaplan (1987), the Du Pont Company was using nearly all of the management accounting procedures for planning and controlling purposes, known until the 1980s. As they reported, most of cost and management accounting procedures were developed during the nineteenth and first quarter of the twentieth century. They further stated that some organizations were trying to develop and use accurate cost accounting systems to trace costs exactly to dissimilar lines of products before World War I. This evidence supports that even the thought and logic behind activity based costing for designing an accurate costing method is not new (Askarany, 2004).

The application of non-accounting information (financial and non-financial) in management accounting is not new either which has attracted considerable attention in the last two decades. According to Johnson (1992), as far back as the first half of nineteen century, businesses owners and managers were using non-financial information to control organizational operations. The idea of paying more attention to the working people and customers of organizations as a long-term source of profit also dates back to before the 1950s.

However, the demand for management accounting information for the purpose of planning and control decisions is a much more recent phenomenon although it might be argued that the logic behind most of management accounting techniques dates back to the first half of nineteenth century (Cooper & Kleinchmidt, 1990; Johnson, 1992; Johnson & Kaplan, 1987; and Kaplan, 1984). Moreover, a comparison between today's management accounting procedures and those used before the 1950s would show a substantial number of innovations in this field (Askarany, 2004).

The focus of management accounting shifted to the provision of information for planning and control purposes in the 1950s and 1960s. In this phase, management accounting is seen by IFAC as a management activity, but in a staff role. It involved staff (management) support to line management through the use of such technologies as decision analysis and responsibility accounting. Rather than strategic and environmental considerations, management controls were oriented towards manufacturing and internal administration (Kader and Luthar, 2004).

Management accounting tended to be reactive, identifying problems and actions as part of a management control system only when deviations from the business plan took place (Ashton et al., 1995). Since the 1950s more than 30 popular cost and management accounting techniques have been introduced. The majority of these innovations have been introduced during the last two decades. According to Hagerty (1997) and Smith (1999), the major developments in management accounting since 1950s can be explained as follows:

The increased global competition in the early 1980s and the world recession in the 1970s following the oil price shock threatened the Western established markets. Increased competition was accompanied and underpinned by rapid technological development which influenced many aspects of the industrial sector (Kader and Luther, 2004). For example, the use of robotics and computer-controlled processes improved quality and reduced costs in many cases. Also developments in computers, especially the emergence of personal computers, obviously changed the nature and amount of data which could be accessed by managers. Hence the design, maintenance and interpretation of information systems became of considerable importance in effective management (Ashton et al., 1995).

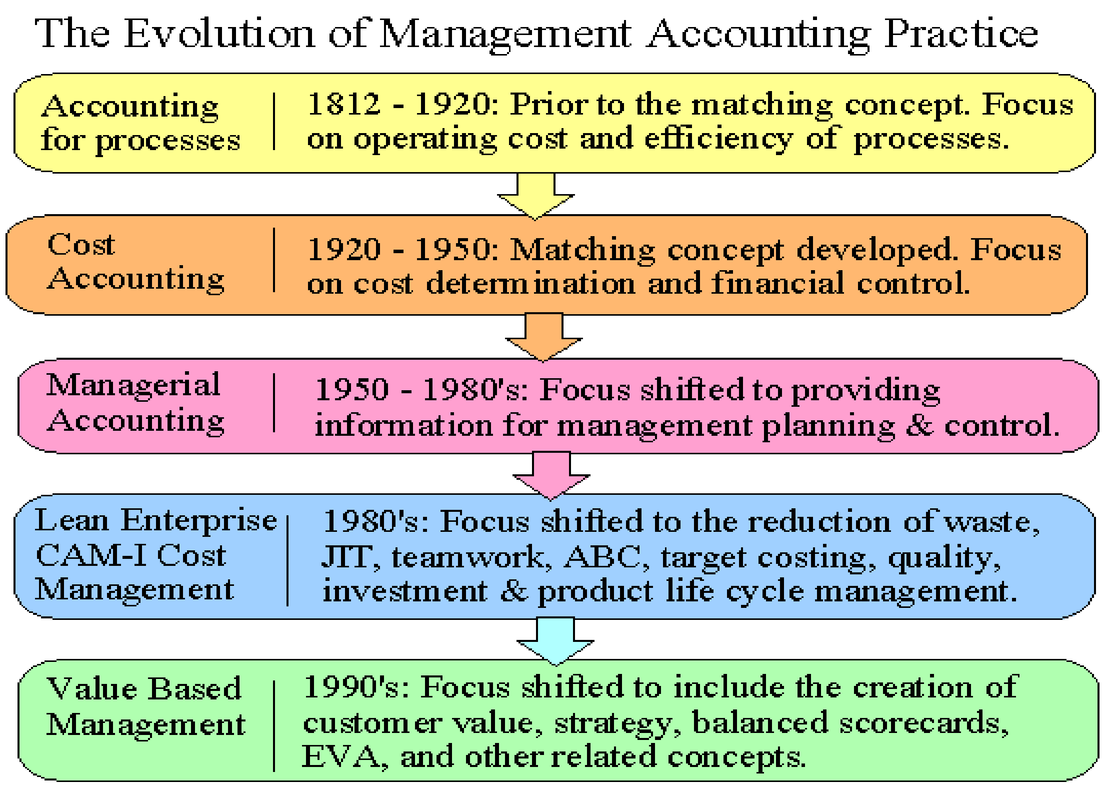
The challenge of meeting global competition was met by introducing new management and production techniques, and at the same time controlling costs, often through reduction of waste in resources used in business processes (IFAC, 1998). In many cases this was supported by employee empowerment. In this environment there is a need for management information and decision making, to be diffused throughout the organization. The challenge for management accountants, as the primary providers of this information, is to ensure through the use of process analysis and cost management technologies that appropriate information is available to support managers and employees at all levels (Kader and Luther, 2004). In brief, cost and management accounting innovations in 1980s can be identified as: Activity based costing, Target costing, Value-added management, Theory of constraints, Vertical integration, Private labels and Benchmarking (Hagerty, 1997 and Smith, 1999).

According to Hagerty (1997) and Smith (1999), cost and management accounting innovations in 1990s can be identified as: Business process reengineering, Quality functional deployment, Outsourcing, Gain sharing, Core competencies, Time-based competition and Learning organization. Reviewing cost and management accounting innovations of the last two decades, Björnenak & Olson, (1999) identify the major recently developed cost and management accounting techniques in the literature as- activity based costing (ABC); activity management (AM) and activity based management (ABM); local information system (LS); balanced scorecard (BS); life cycle costing (LCC) and target costing (TC); strategic management accounting (SMA).

In the 1990s world-wide industry continued to face considerable uncertainty and unprecedented advances in manufacturing and information-processing technologies (Ashton et al., 1995). For example the expansion of the world-wide web and allied technologies led to the appearance of E-commerce which further increased and emphasized the challenge of global competition. The focus of management accountants shifted to the generation or creation of value through the effective use of resources. This was to be achieved through the use of technologies which check up the drivers of customer value, shareholder value, and organizational innovation (IFAC, 1998).

Therefore, we can conclude that, the practice of management accounting stagnated, in the early part of the century, as product line expanded operations became more complex, forward looking companies saw a renewed need for management-oriented reports that was 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 World War I. In recent years, however, new economic forces have led to many important innovations in management accounting. These new practices are discussed in other chapters.

The figure below shows the evolution of Management accounting practice



Source: Johnson (1983)

1.3 Factors Determining Management Accounting Change

Different people mentioned various factors determining management accounting change but perhaps the most frequently quoted were the competitive economic situation of the 1990s, and particularly global competition. The degree to which the claims of increased competition are metaphorical does not in fact matter rather than actual economic effects. It is the perception of managers and accountants which is important, and how they perceive the economic climate in which they operate. If there is a perception of greater competition, then an increased focus is likely to be given to markets and the customer. An added elementary change is the advance in information technology which has taken place in recent years. The momentum of technological change over the last 30 years or so has had a profound effect on organizational life. Predominantly significant over the last 5-10 years has been the extent of the dispersion of computers and computing capacity around the organization. The increased use of the computer has had major effects on the nature of work, especially clerical work, and on information flows around the organization (Burns and Scapens, 2000).

Besides, there have been other significant changes in organizational structure – although again whether they are generated by metaphorical or real economic factors is not apparent. Whereas in the UK in the 1970s, for example, there was a wave of acquisitions and mergers, with the creation of conglomerates, by the 1990s organizations were moving in the reverse direction. The trend was then for de-mergers, with companies focusing on core competencies, and outsourcing non-core activities (Burns and Scapens, 2000). These various changes - in competition, technology and organizational structure - all have important connotations for the nature of management accounting - particularly the way in which conventional accounting techniques are now being used.

1.4 Definitions of Management Accounting

Management accounting is not a specific system of accounts, but could be any form of accounting which enables a business to be conducted more effectively and efficiently. Management accounting in the words of Robert S. Kaplan (1987) (is a system that collects, classifies, summaries, analyses and reports information that will assist managers in their decision making and control activities. Unlike financial accounting, where the primary emphasis is on reporting outsiders, management accounting focuses on internal planning and control activities. Therefore management accounting requires the collection, analysis and interpretation not only financial or cost data, but also other data such as *sales,* price, product demands and measures of physical quantities and capacities. In the process, the system utilizes all techniques of financial and cost accounting including marginal or direct costing, standard costing, budgetary control, etc. Management accounting therefore appears as the extension of the horizon of cost accounting towards newer areas of management.

Management accounting is largely concerned with providing economic information to managers for achieving organizational goals. The information flow system is, therefore, extremely important while designing the system. Managers at each level must have a clear understanding about the objectives and goals assigned and receiving flow of relevant information. It is important to note that overabundance of irrelevant information is as bad as lack of relevant information.

Management accounting is an integral part of management concerned with identifying presenting and interpreting information used for formulating strategy, planning and controlling activities decision making, optimizing the use of resources and safe guarding assets of the firm.

The above definition of management accounting, involves participation of management to ensure that there is effective.

(a) Formulation of plans to meet objectives (strategic planning)
(b) Formulation of short term operation plan
(c) Acquisition and use of finance and recording of transaction

(d) Communication of financial and operating information
(e) Corrective action to bring plans and results into line (financial control)
(f) Reviewing and reporting on systems and operations

Management accounting is primary concerned with data gathering (from internal and external source) analysis, processing, interpreting and communicating the resulting information for use within the organization so that management can more effectively plan, make decisions and control operation.

According to the Chartered Institute of Management Accountants (CIMA, 2005), Management Accounting is "the process of identification, measurement, accumulation, analysis, preparation, interpretation and communication of information used by management to plan, evaluate and control within an entity and to assure appropriate use of and accountability for its resources. Management accounting also comprises the preparation of financial reports for non management groups such as shareholders, creditors, regulatory agencies and tax authorities" (CIMA Official Terminology).

The American Institute of Certified Public Accountants (AICPA, 2008) states that management accounting practice extends to the following three areas:
*Strategic Management***;** advancing the role of the management accountant as a strategic partner in the organization.

Performance Management; developing the practice of business decision-making and managing the performance of the organization.

Risk Management; contributing to frameworks and practices for identifying, measuring, managing and reporting risks to the achievement of the objectives of the organization.

The Institute of Certified Management Accountants (ICMA, 2005), state "A management accountant applies his or her professional knowledge and skill in the preparation and presentation of financial and other decision oriented information in such a way as to assist management in the formulation of policies and in the planning and control of the operation of the undertaking". Management Accountants therefore are seen as the "value-creators" amongst the accountants. They are much more interested in forward looking and taking decisions that will affect the future of the organization, than in the historical recording and compliance (scorekeeping) aspects of the profession. Management accounting knowledge and experience can therefore be obtained from varied fields and functions within an organization, such as information management, treasury, efficiency auditing, marketing, valuation, pricing, logistics, etc."

Therefore, *Management accounting* is concerned with the provisions and use of accounting information to managers within organizations, to provide them with the basis to make informed business decisions that will allow them to be better equipped in their management and control functions. In contrast to financial accounting information, management accounting information is: usually confidential and used by management, instead of publicly reported, forward-looking, instead of historical, pragmatically computed using extensive management information systems and internal controls, instead of complying with accounting standards This is because of the different emphasis: management accounting information is used within an organization, typically for decision-making.

1.5 The Importance of Management Accounting in an Organization

The demand for managerial accounting has increased dramatically as the nature of the business entity has evolved into today's large, geographically dispersed, and complex organization. Consider, for example, the different information needs of the owner or manager of a sole proprietorship and the manager of a large organization. The owner or manager of a sole proprietorship is usually heavily involved with the day-to-day operations of the business. They often make most (if not all) of the operating decisions and generally observe most of the transactions (such as purchases of inventory and receipt of customer orders) that affect their business.

Through this involvement, they acquire a great deal of firsthand knowledge about the events and transactions that affect the entity. As a result, this owner or manager has very limited information needs with respect to the entity.

In contrast, the manager of a large organization has only limited firsthand knowledge of the day-to-day operations of the entity. The large size, increased complexity, and geographic location of the entity makes it almost impossible for the manager of a large organization to operate the entity based on personal, firsthand knowledge. Therefore, he or she must rely on summaries and reports of relevant information prepared by other individuals within the organization. Thus, in making operating decisions concerning the entity, it can be said that this manager has a greater need for information provided through the process of managerial accounting:

Hence, every organization - large and small-has managers. Someone must be responsible for making plans, organizing resources, directing personnel, and controlling operations. Everywhere mangers carry out three major activities - planning, directing and motivating, and controlling:

(i) *Planning*

Planning involves selecting a course of action and specifying how the action will be implemented. The first step in planning is to identify the alternatives and then to select from among the alternatives the one that does the best job of furthering the organization's objectives. While making choices management must balance the opportunity against the demands made on the company's resources: The plans of management are often expressed formally in budgets and the term budgeting is applied to generally describe the planning process. Budgets are usually prepared under the direction of controller, who is the manager in charge of the accounting department. Typically, budgets are prepared annually and represent management's plans in specific, quantitative terms.

(ii) *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 affectively 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 manager's work that deals with the routine and the here and now. Managerial accounting data, such as daily sales reports are often used in this type of day-to-day decision making.

(iii) *Controlling*:

In carrying out the control function, managers seek to ensure that the plan is being followed. Feedback, which signals 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 report suggests where operations are not proceeding as planned and where some parts of the organization may require additional attention.

(iv) *The Planning and Control Cycle*:

The work of management can be summarized in a model. 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 activities revolve.

1.6 The role of Management Accountants within the Organization

Management accounting is generally concerned with informing managers so that they stay up to date with relevant information so that they can make informed business decisions. Management accounting should not be confused with financial accounting (which is a common misconception). Financial accounting tends to be more focused on previous transactions, whereas management accounting is more towards looking into the future. Financial account often involves information for shareholders which is publicly released, whereas management accounting deals with private, confidential information which is often never released to the public.

As a management accountant in an organization, you'll provide operational and financial information to those inside the organization who need it, and you'll regularly report with the business and financial teams for updates on their progress. You're responsible for keeping track of any new information and any changes, and then directing that information to those who can deal with the new information or changes. You're activities will involve reviewing aspects of the business like costs, forecasting ahead based on evidence, and checking previous forecasts to see if they are correct, and if not, then you'll have to understand why they are not correct.

That said, this is a role which can vary considerably from one organization to the next, although the core principles remain the same. A large business can even have many management accountants keeping track of more specific parts of the business. You'd then be responsible for overseeing and forecasting for just that section of the business.

Keeping records is a key skill; you'll need to keep top quality records so that you can quickly provide key information of specific issues that may arise in the organization. Moreover, you'll be required to produce summaries of the key information related to the business, so that internally managers can track progress.

Often management accountants are also involved with controlling activities and ensuring that they are being carried out. As you're collecting so much information, chances are that you're often the first one who'll notice an issue, so in some cases it's your responsibility to track down and resolve that issue (particularly in smaller business where you can't just report to a manager and expect them to take care of everything).

Some of the specific skills you'll need will likely include:
Analysis of data, price modeling, profitability analysis, cost benefit analysis, budgeting, planning, management advice, and financial forecasting.
Overall you'll have a key role in the organization which can be quite varied, from helping with decision making to producing forecasts.

Consistent with other roles in today's organization, management accountants have a dual reporting relationship. As a strategic partner and provider of decision based financial and operational information, management accountants are responsible to manage business team at the same time also have reporting relationships and responsibilities to the corporation's finance organization.

The activities of management accountants provide inclusive of forecasting and planning, performing variance analysis, reviewing and monitoring costs inherent in the business are ones that have dual accountability to both finance and the business team. Examples of tasks where accountability may be more meaningful to the business management team vs. the corporate finance department are the development of new product costing, operations research, business driver metrics, sales management score carding, and client profitability analysis. Conversely, the preparation of certain financial reports, reconciliations of the financial data to source systems, risk and regulatory reporting will be more useful to the corporate finance team as they are charged with aggregating certain financial information from all segments of the corporation. One widely held view of the progression of the accounting and finance career path is that financial accounting is a stepping stone to management accounting. Consistent with the notion of value creation, management accountants help drive the success of the business while strict financial accounting is more of a compliance and historical endeavor

1.7 Objectives of Management Accounting:

The objectives of management accounting are:

(a) To help the management in promoting efficiency
(b) To finalize budgets covering all functions of a business.
(c) To study the actual performance with plan for identifying deviations and their causes
(d) To analyze financial statements to enable the management to formulate future policies
(e) To help the management at frequent intervals by providing operating statements and short-term financial statements
(f) To arrange for the systematic allocation of responsibilities for the implementation of plans and budgets
(g) To provide a suitable organization for discharging the responsibilities

1.8 Functions of Management Accounting

Management accounting performs the following functions

(i) *Preparing Budgets*:
A basic managerial accounting activity relates to the preparation of budgets. *Budgets* are formal plans expressing courses of action in quantitative terms, Budgets can encompass either a short- term or long-

term period of time. For example, accountants often prepare budgets for management which determine how many units of inventory need to be produced in a given period of time (usually a month) in order to meet that period's expected demand. Accountants can also prepare budgets encompassing longer periods of time. For potential capital expenditures, accountants identify the expected costs and cash savings associated with the expenditure to provide management with an indication of the desirability of the expenditure. This type of budgeting is referred to as capital budgeting.

(ii) *Devising Standards*
Performance standards are used by management to identify areas where potential inefficiencies may exist. For example, assume that performance standards suggest that 100 hours of labor are required to produce a given number of units; if 200 hours are actually used to produce this quantity, the difference may suggest that workers are not performing up to their capabilities. Managerial accountants often help establish performance standards for the entity and assist management in interpreting the relationship between actual performance and these standards.

(iii) *Accumulating Data on Costs and Profits*:
When an entity manufactures the inventory it sells to its customers, a critical requirement of the accounting system is that all costs associated with the production of the inventory (referred to as product costs) are accurately accumulated. These costs should be included with the inventory as it moves through the various stages of production and are expensed (as cost of goods sold) when the inventory is sold to customers. Accumulating the costs associated with inventory is a central activity performed by managerial accounting. In addition, managerial accountants also accumulate data on profits. These data are used to provide reports on the profitability of the entity. Information in these reports is used in making both pricing decisions (how much do we need to charge for unit X to "break even" if we sell 100 units?) as well as evaluation decisions (does segment Y earn enough to cover its variable costs?). This latter type of analysis is referred to as *cost-volume-profit analysis* and is an important consideration in the organization's decision to sell its products and/or services.

(iv) *Comparing Actual Activity with Plans or Budgets:*
In many instances, accounting data are used to evaluate personnel and/or pinpoint areas that may require additional attention. Once actual results have been achieved, they can be compared to planned or budgeted results.

Any unexpected differences between actual and budgeted results may suggest the need for increased managerial attention. In addition to identifying areas where additional attention may be needed, individuals and/or departments within the organization are often evaluated based upon how they perform in relation to the budget. The managerial accountant often gathers this information and prepares summary reports that present how actual performance differs from planned (or budgeted) performance.

(v) *Advising Management about Non-routine Decisions*:
The four functions discussed above are related to the normal day-to-day operations of the company. As a result, managerial accountants frequently gather and summarize information related to those types of activities. In other cases, management may request assistance in making decisions of a less routine nature. Some of these decisions include: (1) discontinuing an industry segment or product line, (2) manufacturing components used in producing inventory versus purchasing components from an external supplier, and (3) purchasing long-term assets for use in production (capital budgeting). The managerial accountant will gather information about the consequences of alternatives in these decisions.

1.9 Differences between Management Accounting and Financial Accounting

Managerial accounting information is used internally by managers in planning, organizing, directing, and controlling a firm's activities.
Financial accounting information is accounting information that is either mandatory or voluntarily disclosure by a firm's management to investors, financial and securities analysts, regulators, etc. and as such constitutes public information.

This contrast in basic orientation results in a number of major differences between financial and managerial accounting, even though both financial and managerial accounting often rely on the same underlying financial data. In addition to the to the differences in who the reports are prepared for, financial and managerial 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
The principal differences between management and financial ac-counting are described below:

(i) *Legal requirements;*
There is a statutory requirements for public limited companies to produce annual financial accounts regardless of whether or not management regards, this information as useful, management accounting by contrast is

entirely optional and information should be produced only if it is considered that, the benefits from the use of information by management exceed the cost of collecting it.

(ii) *Focus on individual parts or segments of the business*;
Financial accounting reports describe the whole of the business whereas management accounting focuses on small parts of the organization.

(iii) *Generally accepted accounting principles*;
financial accounting statements must be prepared to conform to the legal requirements and the generally accepted accounting principles, when providing managerial information for internal purposes there is no need any accounting principles

(iv) *Report frequency;*
A detailed set of financial accounts is published annually and less detailed accounts are published semi-annually. Management requires information quickly if it is to act on it. Therefore management accounting reports on various activities may be prepared at daily weekly or monthly intervals.

(v) *Necessity-*
Financial accounting must be done. Enough effort must be expended to collect data in acceptable form and with an acceptable degree of accuracy to meet the requirements of the Financial Accounting Standards Board (FASB) and other outside parties, whether or not the management regards this information as useful. Management accounting, by contrast, is entirely optional, no outside agencies specify what must be done or indeed that anything need be done. Because it is optional, there is no point in collect-ing a piece of (management accounting information unless its value to management's believed to exceed the cost of collecting it.

(vi) *Purpose-*
The purpose of financial accounting is to produce financial statements for outside users. When the statements have been produced, this purpose has been accomplished. Management accounting in-formation, on the other hand, is only a- means to an end, the end being the planning, implementing, and controlling functions of management.

(vii) *Users-*
The users of financial accounting information (other than management itself) are essentially a "faceless" group. The managements of most companies' do not personally know many of the shareholders, creditors, or

others who use the information in the financial statements. Moreover, the information needs of most of these external users must be presumed; most external users do not individually request the information they would like to receive. By contrast, the users of management accounting information are known managers plus the people who help this managers-ana1yze the information. Internal user's information needs are relatively well known because the controller's office solicits these needs in designing or revising the management accounting system.

(viii) *Time Orientation-*

Financial accounting records and reports the financial history of an organization. Entries are made in the accounts only after transactions have occurred. Although financial accounting information is used as a basis, for making future plans, the information itself is historical. Management accounting includes, in its formal structure, numbers that represent estimates and plans for the future as well as information about the past. The objective of financial accounting is to "tell it like it was," not like it will be.

(ix) *Information Content-*

The financial statements that are the end product of financial accounting include primarily monetary information. Management accounting reports deal with no monetary as well as monetary information. These reports show quantities of material as well as its monetary cost, number of employees and hours worked as well as labour costs, units of products sold as well as the amounts of revenue, and so on.

1.10 Management accounting's role in business management

Management accounting is very closely linked to cost accounting; so closely, in fact, that it is difficult to say where cost accounting ends and where management accounting begins. Cost accounting simply aims to measure the performance of departments, goods and services. However, management accounting is much, much more and involves:

(i) *The provision or information for management*:

Indeed, the role of the management accountant could well be described as that of an 'information manager'. The information generated should be designed to assist management, to control business operations and to help management with decision-making. In fulfilling this role the management accounting department/ section must consult with the users of the information, i.e. management, to assess its needs in terms of precisely what information is required and when, etc. The aim is, to provide management with a flow of relevant information, e.g. reports, statements, spreadsheets, etc. as and when required. A frequent flow of information (weekly or monthly) should enable management to respond to emerging problems/ situations as soon as possible. The early detection of problems means earlier solutions & early action.

(ii) *Advising management*:

A key part of management accounting is to advise management about the economic consequences and implications of its (proposed) decisions and alternative course of action. In particular, this advice should answer a frequently overlooked question: What happens if things go wrong? (If interest rates group or if the sales target is not achieved

(iii) *Forecasting*,

Planning and control: A lot of management accounting is concerned with the future and predetermined systems such as budgetary control and standard costing. Such systems investigate the differences (i.e. variances) which arise as a result of actual performance being different from planned performance in terms of budgets or standards. In addition, the management accountant should also be involved in strategic planning, e.g. the setting of objectives and the formulation of policy. The forecasting process will involve accounting for uncertainty (risk) via statistical techniques, such as probability, etc.

(iv) *Communications*:

If the management accounting system is to be really effective it is essential that it goes hand in hand with a good, sound, reliable and efficient communication system. Such a system should communicate clearly by providing information in a form, which the user, i.e. managers and their subordinates, can easily understand (reports, statements, tabulations, graphs and charts). However, great care should be taken to ensure that managers do not suffer from 'information overload', i.e. having too much information much of which they could well do without.

(v) *Systems:*

The management accounting department or section will also be actively involved with the design of cost control systems and financial reporting systems.

(vi) *Flexibility*:

Management accounting should be flexible enough to respond quickly to changes in the environment in which the company/ organization operates. Where necessary information/ systems should be amended/ modified. Thus, there is a need for the management accounting section/ department to be involved with the monitoring of the environment on a continuing basis.

(vii) *An appreciation of other business functions*:
Those who provide management accounting information need to understand the role played by the other business functions. In addition to communicating effectively with other business functions, they also need to secure their cooperation and coordination, e.g. the budget preparation process relies on the existence of good communications, cooperation and coordination.

(viii) *Staff Education:*
The management accounting department/ section needs to ensure that all the users of the information it provides, e.g. managers and their subordinates, are educated about the techniques used, their purpose and their benefits, etc

1.11 Current issues facing Management Accounting

The following three factors will affect your study of management accounting, these three major factors are causing changes in management accounting today

(i) *Shift from a manufacturing-based to a service-based economy*:
The service sector now accounts for large part of the economy for example in Tanzania economy the service based economy is expanding rapidly and the percent of the employment come from the service based economy is increasing rapidly, hence the Service industries are becoming increasingly competitive and their use of management accounting information is growing

(ii) *Increased global competition*:
Global competition has increased in recent years as many international barriers to trade, such as tariffs and duties, have been lowered. In addition, there has been a worldwide trend toward deregulation. The result has been a shift in the balance of economic power in the world. To regain their competitive edge, many companies are redesigning their accounting systems to provide more accurate and timely information about the cost of activities, products, or services. Therefore to be competitive, managers must understand the effects of their decisions on costs, and management accountants must help managers predict such effects

(iii) *Advances in technology*:
By far the most dominant influence on management accounting over the past decade has been technological change. This change has affected both the production and the use of accounting information. The increasing capabilities and decreasing cost of computers, especially personal computers (PCs), has changed

how accountants gather, store, manipulate, and report data. Most accounting systems, even small ones, are automated. In addition, computers enable managers to access data directly and to generate their own reports and analyses in many cases. By using spreadsheet software and graphics packages, managers can use accounting information directly in their decision process.

Thus, all managers need a better understanding of accounting information now than they may have needed in the past. In addition, accountants need to create database that can be readily under stood by managers

1.12 Code of Conduct for Management Accountants:

Practitioners of management accounting and financial management have an obligation to the public, their profession, the organization they serve, and themselves, to maintain the highest standards of ethical conduct. In recognition of this obligation, the Institute of management Accountants has promulgated the following standards of ethical conduct for practitioners of management accounting and financial management. Adherence to these standards internationally is integral to achieving objective of management accounting.

(i) *Competence*:

Practitioners of management accounting and financial management have a responsibility to:

Maintain an appropriate level of professional competence by ongoing development of their knowledge and skills.

Perform their professional duties in accordance with relevant laws, regulations and technical standards.

Prepare complete and clear reports and recommendations after appropriate analysis of relevant and reliable information

(ii) *Confidentiality*:

Practitioners of management accounting and financial management have a responsibility to:

(a) Refrain from disclosing confidential information acquired in the course of their work except when authorized, unless legally obligated to do so.
(b) Inform subordinates as appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that confidentiality
(c) Refrain from using or appearing to use confidential information acquired in the course of their work for unethical or illegal advantage either personally or through third parties.

(iii) *Integrity*:

Practitioners of management accounting and financial management have a responsibility to:

(a) Avoid actual or apparent conflicts of interest and advise all appropriate parties of any potential conflict.
(b) Refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically.
(c) Refuse any gift, favour, or hospitality that would influence or would appear to influence their actions.
(d) Refrain from either activity or passively subverting the attainment of the organization's legitimate and ethical objectives.
(e) Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.
(f) Communicate unfavorable as well as favorable information and professional judgment or opinion.
(g) Refrain from engaging or supporting any activity that would discredit the profession.

(iv) *Objectivity*:
Practitioners of management accounting and financial management have a responsibility to:
(a) Communicate information fairly and objectively
(b) Disclose fully all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented.

1.13 Resolution of Ethical Conflicts:

In applying the standards of ethical conduct, practitioners of management accounting and financial management may encounter problems in identifying unethical behaviour or in resolving an ethical conflict. When faced with significant ethical issues practitioners of management accounting and financial management should follow the established policies of the organization bearing on the resolution of such conflict. If these policies do not resolve the ethical conflict, such practitioner should consider the following course of action.

(a) Discuss such problems with immediate superior except when it appears that superior is involved, in which case the problem should be presented to the next higher managerial level. If a satisfactory resolution cannot be achieved when the problem is initially presented, submit the issue to the next higher managerial level.

(b) If the immediate superior is the chief executive officer or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with a level above the immediate superior should be initiated only with the superior's knowledge. Assuming the superior is not involved. Except where legally prescribed, communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate.

(c) Clarify relevant ethical issues by confidential discussion with an objective adviser to obtain a better understanding of possible course of action

(d) Consult your own attorney as to legal obligations and rights concerning the ethical conflict.

(e) If the ethical conflict still exists after exhausting all levels of internal review, there may be no other recourse on significant matters than to resign from the organization and to submit an informative memorandum to an appropriate representative of the organization. After resignation, depending on the nature of the ethical conflict, it may also be appropriate to notify other parties.

Assessment Question

The student should attempt to answer this question before looking up the suggested solution at the end of the book

1.1

Majengo Co, a medium sized firm of architects, are about to absorb Jambo & partners, a similar sized firm. They have engaged you as management accountant. Part of your duties will be to review the cost and management accounting function of the combined practice and to recruit an assistant. You have an appointment with the senior partner to discuss these issues.

Required

List down notes to use in tomorrow's meeting which cover the following points

(i) The functions of cost and management accounting

(ii) The personal attributes you would expect the assistant management accountant to possess

ACCA Financial Management and Control

Summary

The understanding of the role of management accounting today, it is important to understand its history. Therefore, this chapter has addressed the overview of historical background in management accounting from nineteenth century to present day. The chapter has also described some definitions, objectives and functions of management accounting. We have distinguished between management accounting (internal users) and financial accounting (external users), the chapter also has addressed the current issues facing management accounting which include: the shift from a manufacturing-based to a service-based economy, increased global competition and advances in technology. In conclusion, it is therefore important that, where necessary, management accounting is modified to meet the requirements of today's manufacturing and global competitive environment.

Key Terms and Concepts

- Code of conduct
- Current issues
- Ethical conflicts
- Financial accounting
- Management accounting
- Performance management
- Risk management
- Strategic management
- Value creators

Exercises Questions

1.1

(i) Describe the differences between financial accounting and management accounting

(ii) Describe the different functions of management accounting

1.2

(i) How do management accountants support strategic decisions?

(ii) What role do management accountants perform?

1.3

Examine the extent to which the role and nature of management accountants might differ within the public and private sectors.

1.4

Critically analyze the possible effects of e-commerce on the role of the management accountant

Problems Questions

1.5

(i) Describe organization resource planning systems and their impact on management accountants

(ii) Define the three major types of companies (based on their revenue-generating activities). Which of these types of companies utilize managerial accounting information?

1.6

Does management or the managerial accountant set the goals and objectives of the organization? Does management or the managerial accountant determine the means by which the chosen goals and objectives will be achieved? Does management or the managerial accountant determine what information should be reported, when it should be reported, and how it should be reported?

1.7

Traditionally, management accounting, financial management and financial accounting have been treated as largely separate disciplines. Discuss the extent to which such a categorization is still valid and comment upon the implications for today's management accounting profession.

1.8

Analyze the potential effects of recent developments in the business or public sector environments on the relevance of management accounting systems.

1.9

Analyze the extent to which the management accounting information system of a service-based organization of your choice would be likely to differ from that of a manufacturing company

Examination Questions

1.10

Managerial Accounting–General: A small company producing parts for the automobile industry is taking a hard look at its staff functions to determine whether they have "grown beyond their worth." The standard functions of financial, tax, and managerial accounting are performed by three men. The reason for having a managerial segment seems hazy. As the president states, "I handle any control problems. If someone needs a push, I know it before the accountants tell me. All the accounting people do is confirmed that I push the right one."

(a) If the president is right, should the managerial segment be abolished?

(b) What could be done to improve the existing control function?

(c) If the president believes control is the only function of managerial accounting, what could be done to expand his viewpoint?

(d) Do you think the president worked his way up to his position through the financial side of the business? Is the president's background of any importance in ascertaining possible problems between the financial side of the business and top management? Explain.

1.11

'Management accountants exist to ensure that the changing information needs of managers are met.' Management accountants are in the fortunate position of being the brokers and guardians of information. They may use this information to increase their own power and status.' 'Management accountants have a duty to serve all stakeholders of their organization and a responsibility to ensure the reliability of the information which they process.' To what extent are these statements contradictory or complementary?

Case Studies

Case 1: Daily Telegraph Ltd

Company buyers across Europe aim to cut the cost of procuring raw materials, goods and services this year by 13%, the highest amount in four years. The aggressive target coincides with the arrival of the purchasing manager- once seen as an administrative function – at the finance director's right hand side. But many of the 225 purchasing heads from financial services and manufacturing companies responding to an annual survey by software company Ariba admitted they had little idea what was being spent by other departments. For instance, 37% said they could account for less than 10% of the amount that their companies spent on services. Instead, to hit their cost saving target, more buyers than ever said they will rationalize their supplier bases and pressurize those left to deliver more cheaply. They would continue to renegotiate contracts despite admitting that average year –on year saving from contracted suppliers had fallen from 10% to 7% in that past year, the growing use of non- contracted supplier based on low-cost countries apparently eroding the previous wide price difference between the two.

Discussion questions

1. What are the roles of purchasing manager?

2. What are the roles of management accountant in an organization?

3. What are the limitations of forcing cost savings onto suppliers rather than looking to internal improvements in the buying company?