Managerial Accounting

Chapter -01

What is Management

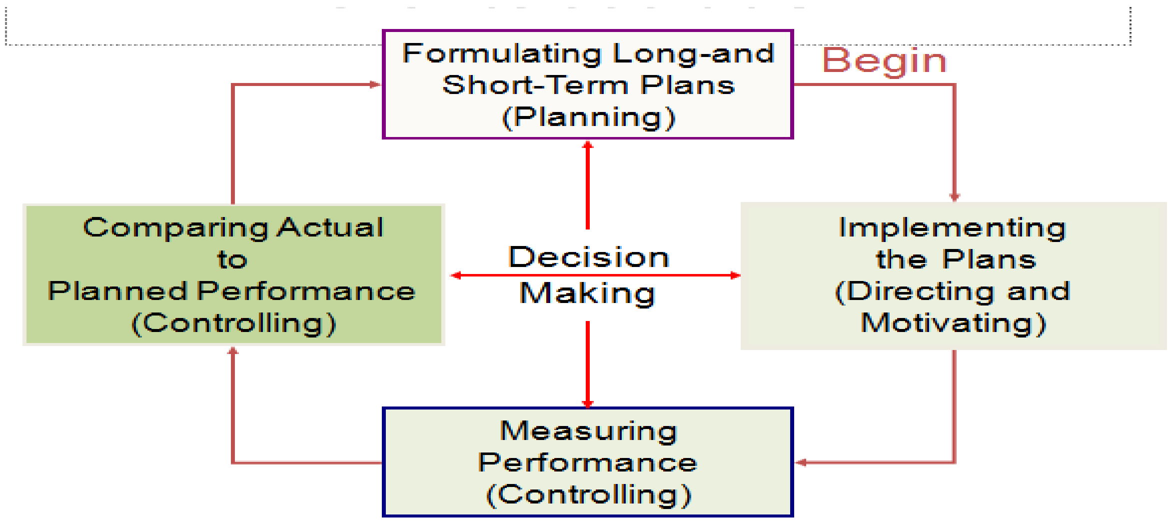
- "Management is the process of designing and maintaining an environment in which individuals, working together in groups, efficiently accomplish selected aims."
- If this definition is expanded further we will get the following as functions of management :
- Planning
- Organizing
- Staffing
- Leading and
- Controlling.

In each stage, management accounting supplies relevant information.

Work of Management

The Planning and Control Cycle :

Garrison and Noreen summarized the work of management in a cycle termed by them as “The planning and control cycle model". This model shows the smooth flow of management activities from planning through directing and motivating, controlling and then back to planning.



Managerial Accounting and Financial Accounting

Managerial Accounting : Managerial accounting provides information for managers of an organization who direct and control its operations.

Financial Accounting : Financial accounting provides information to stockholders, creditors and others who are outside the organization.

Definition Of Management Accounting :

The Committee on Management Accounting of the American Accounting Association (AAA) developed a definition of management accounting :

"The application of ***appropriate techniques*** and ***concepts*** in processing the historical and projected economic data of an entity to assist management in establishing plans for reasonable economic objectives and in the making of rational decisions with a view towards achieving these objectives."

It includes the methods and concepts necessary for effective planning for choosing among alternative business actions and for control through the evaluation and interpretation of performance. Its study involves consideration of ways in which accounting information may be accumulated, synthesized, analyzed and presented in relation to specific problems, decision, and day to day tasks of business management."

Financial Accounting vs. Management Accounting

Issues	**Financial Accounting**	**Management Accounting**
Primary Users	Outsiders : Owners, Lenders Tax Authorities, Regulators	Insiders : for planning, Directing and motivating, controlling and performance evaluation
Constraints	Constrained by generally accepted principles, standards and various regulations	No constraints other than costs in relation to benefits of improved management decisions
Time Focus	Historical or past orientation [Actual]	Future orientation : Formal use of budgets as well as historical records
Time span	Less flexible. Usually one year.	Flexible. Periods may vary from 1 hour to several years
Perspective	Entire organization	Segment report- detailed reports for departments, products, customers and employees.
Objectives	Determination of profit i.e. Revenue > Cost.	Supply of relevant information for decision making.
Compulsion	Reporting is mandatory.	Not mandatory
Behavioral Implication	Behavioral considerations are secondary	Generally planning and control information of any type has behavioral implications.
Quality of Information	Precise, Objective and Verifiable	Relevant, Flexible and Timely
Approach	Unique-disciplinary	Multi-disciplinary

The Changing Business Environment

Management Philosophy :

1) Peter F. Drucker : Management by Objectives/Management by Results.
2) W. Edwards Deeming : Total Quality Management
3) Theory of Constraints
(4) Management by exception,
(5) System theory
(6) Contingency Theory
(7) Agency Theory
(8) Just-in-Time-Systems (JIT)
(9)Value Chain
(10)Process Reengineering
(11)Total Employee Involvement

(1)Management by objectives/Management by Results :

Management by objective's is a comprehensive managerial system that integrates many key managerial activities in a systematic manner and that is continuously directed toward the effective and efficient achievement of organizational and individual objectives. An MBO system has the following elements :

(i) Emphasis on performance appraisal :

Performance is evaluated against the present objectives. It encourages self evaluation by lower level executives.

(ii) Emphasis on short-term objectives and motivation :

Individual goal setting by employees has motivation implications. Short term objectives are relatively more specific. Important factor, here are "incentive"; "participation" and "autonomy".

(iii) Inclusion of Long-Range Planning :

Emphasis too much on short-term objectives may result in "undesirable managerial behavior like-over production, less importance on maintenance and research, poor customer relation etc. Therefore, long-range and strategic planning should also be included in MBO.

(iv) The Systems Approach :

MBO integrates several managerial subsystems like:
(a) design of organizational structure,
(b) portfolio management,
(c) management development,
(d) career development,
(e) compensation programs and
(f) budgeting.
To be effective MBO has to be viewed as a comprehensive system.

(2) Total Quality Management (TQM)

The most popular approach to continuous improvement is known as total quality management. TQM is "a management approach of an organization, centered on quality, based on the participation of all of its members and aiming at long term success through customer satisfaction, and benefits to all members of the organization and to the society." Thus TQM has three important tenets :

(i) It necessitates an internal managerial system of planning, controlling and decision-making for continuous improvement.

(ii) It requires participation by everyone in the organization.

(iii) It focuses on improving goods and services from the customers point of view.

(3)Theory of Constraints (TOC)

A constraint is anything which prevents from performing/doing to maximize profit / production or minimizing cost. Where there are constraints, the success of the organizing depends on the effective management of these constraints. It should be accepted that we have enough of wants to be satisfied with scare resources. These scarce resources are also constraints. For improving performance attempts must be made to handle constraints. Handling of constraints may include:

(i) Constraining factors may be used to contribute maximum to the profitability of the enterprise.

(ii) Diverting resources to relax the constraints.

When there is one constraint, it is easy to handle, but presence of more than one constraint will complicate the situation. In that situation, sophisticated techniques like linear programming may be used.

(4) Management by Exception (MBE)

Management by exception is "a phrase used in connection with presumed actions required where reports on performance differ from original projections (actual costs users standard costs or budgeting prescriptions). Characteristically, these reports bring out favorable and unfavorable variances, the latter being the basis for management by exception."

Management's time and energy must be used to deal with "exceptional" "significant" and "controllable" situations. In every situation, costs must be compared with the expected benefits.

(5) Systems Theory :

System theory is the product of the realization of the interaction between the structural (mechanistic) and human (behavioral) dimensions of organization and the influence of external forces. According to this approach, an organization is considered as a system composed of subunits or subsystems that are continually interact with and mutually dependent on one another." This means that actions that occur within one part of the system not only affect that part but can have a "ripple effect" through other subsystem of the organization

(6)Contingency Theory :

This theory is considered as an outgrowth of systems theory. The central thesis of contingency theory is that :

"there is no universal principles of management that can be applied uncritically in all situations. Organization and management approaches must vary from one firm to the next because it depends on the unique environment conditions and internal factors which are inherent to each organization. Thus, a situational approach to decisions about organizational structure and appropriate managerial behaviors is necessary."

(7)Agency Theory:

"An agency relationship is a contract under which one or more principal engage another person as their steward (agent) to perform some service on their behalf, the performance of which requires the delegation of some decision making authority to the steward." Managers have always been the agents of company shareholders.

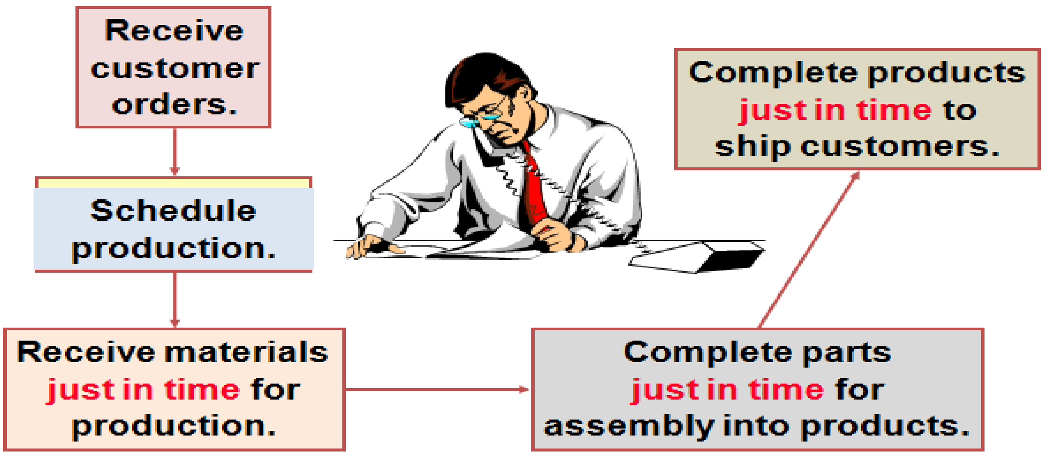
If both parties to the agency relationship are assumed to attempt to maximize their self-interests and if the monitoring of performance is not costless then a good reason exists to believe that the agent will not always act in the best interest of the principal.

(8)Just-in-Time-Systems (JIT):

'JIT is a philosophy about when to do something. The 'when' is as needed and the 'something' is a production, purchasing, or delivery activity. The JIT philosophy is applicable to all departments of all types of organizations. As identified by Barfield, Rainborn and Kinney, JIT has the following three primary goals :

1. Elimination of any production process or operation that does not add value to the product / service.
2. Continuous improvement in production / performance efficiency, and
3. Reduction in the total cost of production / performance while increasing quality.

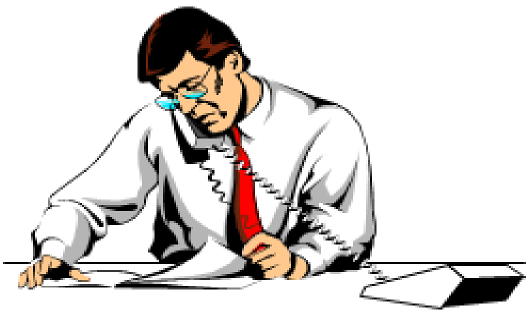
Just-in-Time (JIT) Systems



Benefits of a Just-in-Time (JIT) Systems

Reduced inventory costs

Greater customer satisfaction



Higher quality products

More rapid response to customer orders

Less warehouse space needed

(9)Value - Chain :

Value-chain as "the set of business functions that add value to the products or services of an organization." Functions in the value chain are :

(i) Research Development : the generation of, and experiment with, ideas related to new products, services, or processes.

(ii) Design of products, services or process : the detail and engineering of products.

(iii) Production : the coordination and assembly of resources to produce a product or deliver a service.

(iv) Marketing : the manner by which individuals or groups learn about the value and features of products or services.

(v) Distribution : the mechanism by which a company delivers products or services to the customers.

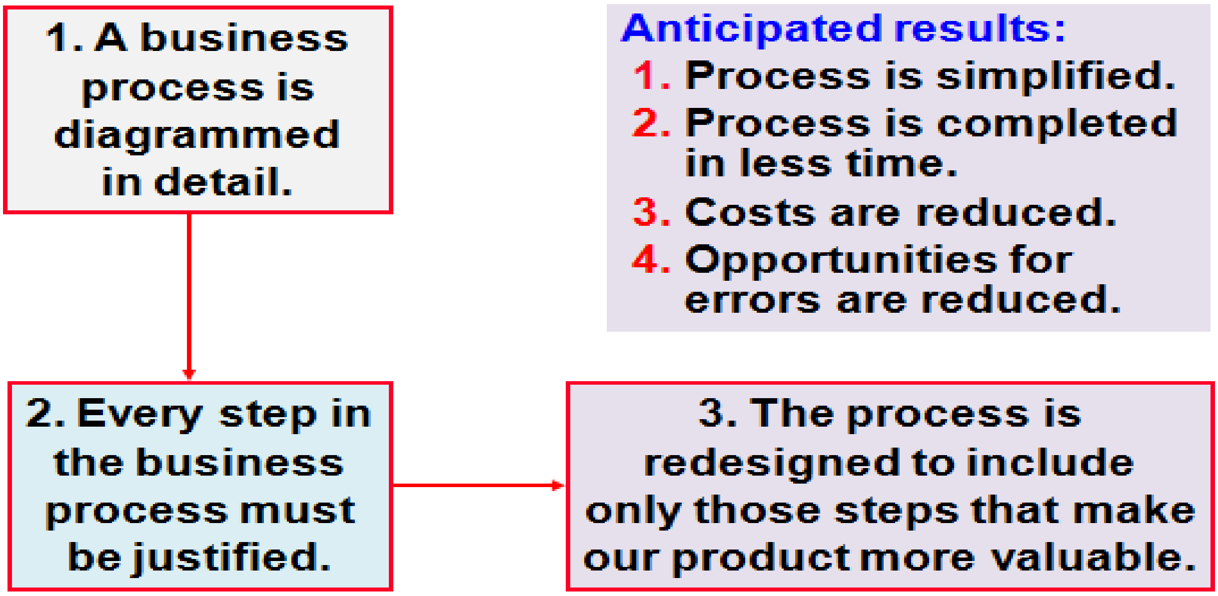
(vi) Customers Service : the support activities provided to the customer.

(10) Process Reengineering

In process reengineering, a business process is diagrammed in detail, questioned and then completely redesigned in order to eliminate unnecessary steps to reduce opportunities for errors and to reduce costs. A business process is a services of steps that are followed in order to carry out some task in a business.

Process reengineering focuses on (i) simplification and elimination of wasted efforts. A central idea of process reengineering is that all activities that do not add to value to a product or service that customers are willing to pay for are known as non-value-added activities and non-value activities must be dropped.

Process Reengineering



(11)Total Employee Involvement

Over the last six/seven decades, much work has been done in this field with same results. The theory is if someone is involved in decision making, and controlling his or her own sphere of influence and so on, he or she will feel much more responsive towards colleagues and systems, consequently employees who participate are happier, and more productive employees.

Organizational Structure :

"Organizational structure is a firm's formal role configuration, procedures, governance and control mechanism and authority and decision-making process." Elements of organizational structure may affect management accounting - its techniques, approaches and role in the firm. It is claimed that the following elements have strongest influence on management accounting :

(a) **Organizational chart :** It reflects the system of relationship of an organization's employees. This relationship is the result of deliberate, conscious planning of the areas of **responsibility, specialization and authority** for each member of the organization.

(b) **Line and Staff :** A line authority gives a superior a line authority over a subordinate in direct line or step where as the nature of the staff relationship is advisory. Management accounting is supportive by nature, providing services and assistance to other units of an organization. It is a specialized decision-support system.

Management Accounting Techniques :

With a view to help management solving business problems and also to generate relevant information for taking decision, a management accountant uses a good number of techniques. Below a list of some of the techniques is given :

(i)Statement of cost of production : On the basis of a actual cost of production a statement of cost of production is prepared to determine total cost and unit cost of production.

(ii)Analysis of financial statements : On the basis of data included in various financial statements, ratios are calculated to determine (i) profitability (ii) activity (iii) solvency and (iv) liquidity of an enterprise.

(iii)Determination of Standard Costs: Standards are set to control the activities with an object to improve performance gradually.

(iv)Budgetary Control : It is a control through budgets. Budgets are guidelines for the future. Actual performance are compared with the budget to find out the difference and to identify the causes of difference so that steps can be taken to remove the causes.

(v)Determination of variable cost of production: This technique is used to decide whether to accept or reject special orders at a price below the regular price.

(vi)Operations Research Techniques: O.R. techniques like "Inventory Model", "Linear Programming Model", Transportation Model can also be used in management accounting.

(vii)Miscellaneous techniques: According to some, "Financial Planning" "Cash Flow Statement" and "Cash Budget" can be used in management accounting. These can better be termed as techniques of financial management.