

Accounting Control System

Topic 1: Introduction to Cost & Management Accounting

- Introduction
- What is Management Accounting
- Difference between Financial Accounting and Management Accounting
- Role of Management Accounting
- How is Management Accounting Information used?
- Management Information and Responsibility Accounting
- Summary
- Review Questions



Learning Objectives

At the end of the topic, the learner will be able to:

- Describe the purpose and role of cost and management accounting within an organization
- Compare and contrast financial accounting with management accounting.
- Distinguish between data and information
- Identify the difference in the information requirements at strategic, tactical and operational levels
- Describe the concept of responsibility accounting
- Distinguish between cost, profit, investment and revenue centre.
- Explain and illustrate the concepts of cost objects, cost units and cost centre

Introduction

Over the past few decades, the environment in which businesses operate has become increasingly competitive. Various reasons have been identified to explain these changes:

- Increasing sophistication of customers
- Globalisation
- Technological advances
- Deregulation of domestic markets
- Increasing pressure from owners / shareholders for competitive economic returns
- Increasing volatility of markets

Though the management functions have not changed and management still needs to do effective planning, organising, directing, controlling and performance evaluation, the effect of the environmental changes has made these functions more complex and role of managers more demanding.

Peter Drucker, an eminent management thinker, rightly points out that “the purpose of business is to create and keep a customer”.

Increasing competition forces management to find new ways to manage business through efficient use of resources such that the organizational objectives are effectively achieved while delighting the customer. All this requires decision making which relies heavily on availability of adequate information, both financial as well as non-financial. Even day to day business operations require information not necessarily provided by financial statements. For example, a manager uses product costs to guide the setting of selling prices and for inventory valuation and income determination. But how does a manager get information on the product costs? Do the financial statements provide that information? Similarly, how can managers in an organisation dealing in multiple products, decide about the relative profitability of products? Where do they look for information on revenues of each product and / or service, sales back logs, unit quantities and demands on capacity resources etc. This is where management accounting and management accounting records come in.



Tell Me More

Changing business environment has led to need for strategic management. Management needs businesses to regularly:

- *Undertake position analysis*
- *Identify and assess the strategic options*
- *Select strategic options and formulate plans*
- *Perform, review and control*

What is Management Accounting

Management accounting is an area of accounting which is concerned with the provision of financial and other information to all levels of management in an organisation to enable them to carry out their planning, controlling and decision making responsibilities and for taking important decisions to help the organization achieve its objectives. Unlike financial accounting, which is concerned with providing information to stockholders, creditors and others who are outside an organisation, management accounting caters to the requirements of those who direct and control the organisation's operations.

Exposure draft of Institute of Management Accountants (IMA) Statement on Management Accounting defines Management accounting as:

'A value adding continuous improvement process of planning, designing, measuring and operating both non-financial information systems and financial information systems that guides management action, motivates behaviour and supports and creates the cultural values necessary to achieve an organization's strategic, tactical and operational objectives'

Thus, management accounting:

- Provides both financial as well as non-financial information
- Supports strategic, tactical and operational decision making

Cost accounting is an important part of management accounting.



Tell Me More

Cost accounting is a system of recording data and producing information about costs, for the products produced by the organization and or the services it provides. It is also used to establish costs for particular activities or responsibility centre.

- *Cost accounting and management accounting refer to the same thing.*
- *Management accounting includes cost accounting and extends to both financial as well as non-financial information*
- *Cost accounting is historical while management accounting is forward looking*

Management accounting uses both financial as well as non-financial information to ensure:

- Formulation of strategic plans
- Budgeting /profit planning
- Appropriate use of finance

- Effective communication of financial and operating information
- Financial control

Examples of financial information used by management accountants include sales growth, profits, market share or return on sales etc. Non-financial information includes product quality, customer satisfaction, customer loyalty, competition etc.



Check your Understanding

Management accounting is primarily for internal users while financial accounting is primarily for external users. Is the statement true or false?

- a) True
- b) False

Answer: a

Difference between Financial Accounting and Management Accounting

Management accounting is different from financial accounting in terms of its:

- **Users:** Mainly “internal” users. The group of internal users includes managers and employees and has a direct concern in prosperity of a business.
- **Types, content and format of report:** Generally involves specific reports. The content and format of the reports are not regulated and involve various level of details
- **Frequency:** It is not limited to end of year reports;
- **Verification:** It does not need external verification (audit).

The main points of difference between Financial Accounting and Managerial Accounting are highlighted in Table 1.1

Financial Accounting	Management Accounting
Describes the performance of a business over the accounting period and the state of affairs at the end of that period.	Helps management record, plan and control the activities of a business and assist in the decision-making process.
There is a statutory requirement to prepare and publish financial accounts	There is no statutory requirement to prepare management accounts
The format of financial accounts is defined by company law and accounting standards	There is no pre-determined format for management accounts.
Focuses on business as a whole	Focus is on specific areas of the business
Most financial accounting information is of a monetary nature	Includes both monetary as well as non-monetary information
The information presents a historic outlook on the financial performance	Focus on analyzing historical performance for drawing futuristic inferences.



Check your Understanding

All of the following statements are correct about Management accounting EXCEPT:

- a) There is no pre-determined format for management accounts.
- b) There is a statutory requirement to prepare management accounts
- c) Management accounting includes both monetary as well as non-monetary information
- d) Management accounting information is meant for internal use

Answer: b

Role of Management Accounting

Management accounting plays a key role in business decision making. These decisions are made to help achieve a wide range of business objectives. Cost and Management accounting helps in determining costs of output products or units or services, their profitability, customer satisfaction levels etc. for strategic planning. It also discloses waste and inefficiencies within the organisation. It explains the movements of profit and also cost effects of policy decisions. Business managers rely on accurate and relevant accounting information provided by management accountants in relation to the measurement, analysis and control of costs and cash flow as a basis for future decision making.

How is Management Accounting Information used?

Management uses management accounting information to ensure proper strategic planning, budgeting / profit planning and for financial management and control.



Tell Me More

Management uses information provided by management accounting to take business decisions. There is a difference between facts, data and information.



Data has no clear meaning until it is processed, analyzed and organized into information.

There is a range of management accounting techniques that managers use to make business decisions. The choice of a technique depends on the required decision.

Management accounting techniques often used are:

- *break even analysis*
- *budgeting for costs and revenues*
- *cash flow forecasting*
- *investment appraisal including traditional as well as discounted cash flow techniques*

Information Requirements at Various Hierarchy Levels

Information is required for decision making at all levels of an organization.



Key Point

Primarily an organisation can be divided into three levels:

- *Strategic planning & control*
- *Tactical planning & control*
- *Operational planning & control*

The levels in an organization are depicted in Exhibit 1.1

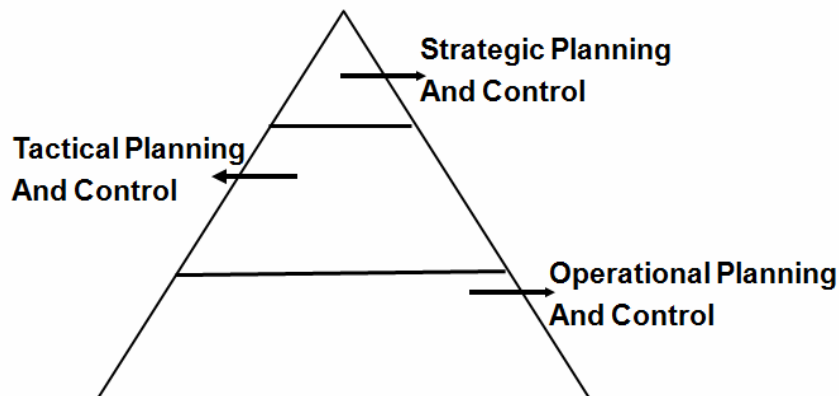


Exhibit 1.1: Organizational Hierarchy

Strategic level is concerned with strategic decisions. These include preparing for change, setting a direction for the future, moving from where the organization is today to a point in an anticipated future or enabling management to design a Business Level Strategy and the Value Proposition.

Tactical control level is concerned with tactical planning whereby the managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organization's objectives.

Operational control level or operational planning is concerned with decisions assuring that specific tasks are carried out effectively and efficiently

There are differences in the type of information required at each level. This is depicted in Exhibit 1.2.

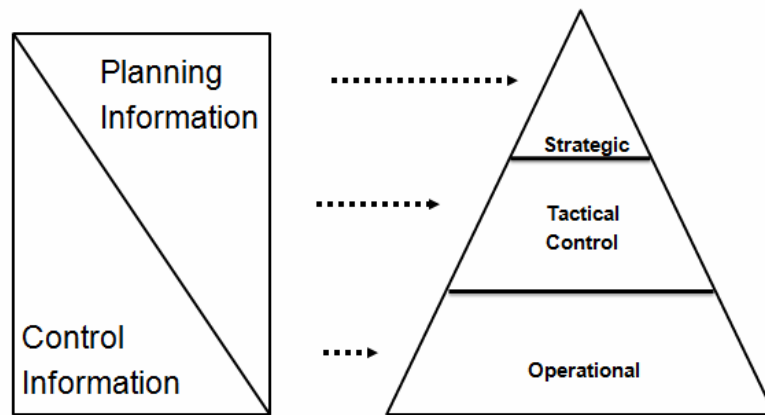


Exhibit 1.2: Information Requirements at Different Levels

Thus, strategic level requires more information for planning and operational level requires information for controlling operations and performance.



Check your Understanding

Sales and production budgets are examples of which types of management information?

- a) Strategic*
- b) Tactical*
- c) Operational*

Answer: b



Tell Me More

Management accounting information should be:

- *Relevant and purposeful*
- *Timely*
- *Understandable*
- *Accurate*
- *Complete but not excessive*

Information should have more value than the cost of producing it. Moreover, it should be communicated by appropriate channel.

Management Information and Responsibility Accounting

Management accounting information is also required for Responsibility Accounting within an organization.

“Responsibility accounting is a system of providing financial information to management, where the structure of the reporting system is based on identifying individual parts of a business which are the responsibility of a single manager”

The individual part of a business whose manager has personal responsibility for its performance is also called responsibility centre. As a responsibility centre manager needs enough information to control his responsibility centre, a responsibility centre also affects the nature of management reporting.



Tell Me More

Some important terms associated with Responsibility Accounting include:

Cost: *a sacrifice or giving up of resources for a particular purpose.*

Cost Object: *anything for which a separate measurement of costs is desired. For example, cost of manufacturing a product, cost of department, cost of selling in a geographic region etc.*

Cost Driver: *any factor whose change causes a change in the total cost of a related cost object.*

Cost Unit: *a unit of product or service in relation to which costs are ascertained.*

The hierarchy of responsibility centers in an organization is depicted in Exhibit 1.3

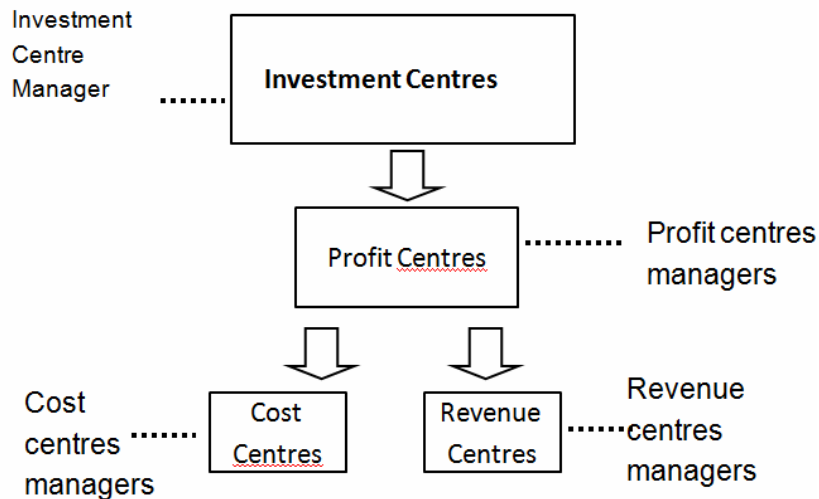



Exhibit 1.3: Hierarchy of Responsibility Centres

 **Key Point**

Hierarchy of responsibility center consists of:

- *Cost centre*
- *Revenue centre*
- *Profit centre*
- *Investment centre*

Cost Centre is a production or a service location, function, activity or item of equipment whose costs may be accumulated and attributed to cost units. Example of cost centers in a manufacturing organization is its machining or assembly or finishing department or stores and warehousing. Within an accounting system, all costs incurred by a cost centre are charged to that centre.

Revenue Centre is the part of the organization that earns sales revenue. Its manager is responsible for revenue earned but not for costs of the operation.

Profit Centre is the part of the business for which both costs incurred and revenue earned are identified. The manager is therefore responsible for both costs and revenues and is in a position to plan for both.

Investment Centre is a profit centre with additional responsibilities for capital investment and possibly for financing. An investment centre can include several profit centres. Managers of investment centres are responsible not just for decisions affecting revenues and costs but also investment decisions.



Check your Understanding

John is a profit centre manager. What is he responsible for in his segment of the organisation?

- a) Costs only*
- b) Revenues only*
- c) Both costs and revenues*
- d) Cost, revenue as well as investment*

Answer: c



Summary

The key points that emerge from this topic are:

- Management accounting is an area of accounting which is concerned with the provision of financial and other information to all levels of management in an organisation to enable them to carry out their planning, controlling and decision making responsibilities
- Cost accounting is an important part of management accounting
- Management accounting is different from financial accounting in terms of its users, types, content and format of report, frequency of reports and its verification
- Business managers rely on accurate and relevant accounting information provided by management accountants in relation to the measurement, analysis and control of costs and cash flow as a basis for future decision making
- Strategic level requires more information for planning and operational level requires information for controlling operations and performance
- Management accounting information should be relevant and purposeful, timely, understandable, accurate, complete but not excessive
- As a responsibility centre manager needs enough information to control his responsibility centre, a responsibility centre also affects the nature of management reporting



REVIEW QUESTIONS

1. *Select the correct option. Which of the following statement(s) about responsibility centres is / are correct?*
 - a) *Performance of a revenue centre can be measured in terms of its return on investment*
 - b) *A cost centre manager is responsible for only the costs and not the sales of his centre*
 - c) *Service organisations do not have cost centres*
2. *Select the correct option. The key difference between management accounting and financial accounting is that:*
 - a) *Management accounting deals with historic information*
 - b) *Management accounting is a statutory requirement and organisations are required to maintain management accounts*
 - c) *Financial accounting is mainly concerned with implementation of decisions*
 - d) *Financial accounting deals with external financial reporting*
3. *What is management accounting? How is it different from financial accounting?*
4. *Why may financial information alone be insufficient in meeting the informational requirements of a business?*
5. *How are the information requirement needs at operational level different from tactical and strategic levels?*
6. *Identify management accounting information needs of the manager of an outlet manager of fast-food restaurant that has multiple outlets in the country. The need should be examined in terms of type of information, frequency and timeliness of information required by the manager. How will the information requirements differ for a regional manager of the fast-food restaurant?*
7. *Describe the hierarchy of responsibility centres in the case of a bank.*