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Management through Accounting

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Preface

Two streams of development in connection with the operation of business enterprises have produced a new discipline in the area of accounting. First, extensive research, the construction of theories, and the definition of concepts in the field of management have produced impressive advances in understanding and controlling business affairs. Using the traditional functional activities of business as the springboard, inquiry into the behavioral sciences and organization theory, and in management science and decision theory, has resulted in new and promising insights regarding the managerial processes.

The second development of significance to accounting has been the technological breakthrough in data processing, provided by the teaming of high-speed computers with various recording and transmission systems. This has permitted the processing of information in a form and at a cost which alters all prior concepts of practical data handling.

In combination, these two streams of development have outstripped traditional financial accounting concepts in their ability to adequately serve the decisional needs of management. A new discipline, *managerial accounting,* has emerged.

As the scope and importance of accounting enlarges, which seems reasonable to expect in view of developments described above, the delineation between management and accounting will be less obvious and important. *Managerial accounting* as viewed in this book is synonymous with *management through accounting.* The common denominator of the functions of both management and accounting is the making of an effective decision based upon appropriate information. The great contribution of managerial accounting is the elimination in business management of intuition, which is neither dependable nor reproducible.

Whereas the employment of managerial accounting concepts has been recognized in business for some time, the identification of a unique discipline has been obscured by transitional efforts to merge its two main ingredients without disturbing the image of either too severely. Most treatises on managerial accounting have tended to focus on traditional financial accounting as the dominant function, with special attention directed to the manner in which financial data might be useful to management.

This book concerns a more intimate merger of the two older professions of management and accounting wherein the informational needs of *the manager determine the accounting means for their satisfaction.*

This feature is reflected in the subject development of the book. Three principal managerial functions (appraisal and diagnosis, planning, and controlling) serve as the focal points for the exploration of the analytical concepts, the required informational characteristics, and their application to concrete situations. The approach is as follows: first, the managerial process is analyzed; then underlying concepts related to the information that is needed to serve the processes are explored; and finally, the actual incorporation of the informational resources into the management function is demonstrated.

The educational philosophy implicit in this presentation assumes an active role on the part of both the student and the instructor. Rather than emphasizing the procedural aspects of data gathering, recording, and reporting, the text establishes a frame of reference, creates an environment, and identifies useful concepts to stimulate inquiry into concrete situations. The latter are furnished in the "Student Activities" section of each chapter. This approach leaves both the student and instructor with opportunity to assume a responsible and creative role both in reacting to the challenge of the concrete situations, and in anticipating the procedural means for accomplishment.

This book is the product of over ten years of interaction between the author and business associates, professorial colleagues, and students. The debt for insight and criticism, although widely distributed, must be acknowledged. The more concrete encouragement in the form of allotment of time and resources was provided by the administration of the School of Business of Northwestern University. Many satisfying associations were established with the managements and personnel of a number of business firms whose personal and sometimes disturbing experiences are displayed in these pages.

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The project would never have survived without the efforts of my wife, who kept the spark of interest alive for motives known only to herself. She has climaxed her contribution by performing all of the typing chores single-handed.

R.L.S.

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The Management Frame of Reference

INTRODUCTORY NOTE

Responsible management is the one essential ingredient of long-run business success. The frequent occurrence of unplanned and non-controllable events does not alter this fact. Such disturbances as the death of a vice-president, the discovery of a new process or product, or a break in the price structure are only elements in the environment within which management must function. The setting of goals and the accumulation of the means for their accomplishment are the unique contributions of management. These achievements diminish the impact of chance on the organization's affairs. The degree of compatibility between the two (goals and means) is a measure of the competence of those who direct the affairs of the enterprise, and invariably a determinant of the organization's success. For this reason, an understanding of management is essential to an understanding of any of the component elements in the operation of a business. Indeed, management may be viewed as a composite of all such elements.

Accounting as a prime activity in the functioning of an enterprise, along with such other activities as marketing and production, may reasonably be viewed as an isolated process containing its own objectives, procedures, terminology, and concepts. However, such qualities are relatively sterile without the perspective provided by an appreciation of the activity's purpose in furthering the ends of the enterprise. Such enterprise objectives as profit realization, market penetration, operational productivity, administrative harmony, and citizenship responsibility intimately affect and are affected by the accounting processes. Determining the most efficient manner of processing a product, the utility of production standards in worker performance, and the measurement of the price elasticity of demand for the company's product all rely upon financial analysis rooted in the ledger accounts. And, on the other hand, each of these uses demands a unique informational characteristic from the financial data employed. This interrelationship is so fundamental that for all but the purely clerical functions, accounting must be viewed within its enterprise setting.* The

* See Chapter 2 for a more thorough development of the distinction between financial and managerial accounting.

study of accounting procedures apart from the purposes to be served and the environmental setting in which they are to be employed may serve a professional need (although with questionable effectiveness), but may prove actually dangerous as a contribution to the needs of the enterprise. Some grasp of the nature of management is the first need. Then, by investigating the informational requirements of various managerial functions, the accounting contribution may be brought into focus.

1. MANAGEMENT FUNDAMENTALS

There is little likelihood that the process of management can ever be reduced to a formula. Even attempts to evaluate managerial competence are subject to serious error. New and unforeseen problems and opportunities are continually confronting a business organization. Policies and actions which seemed effective yesterday may be inadequate in tomorrow's changed environment. The magnitude of variables acting upon a business entity is so vast that even with the advantage of modern data processing instruments, mathematical and other theories of logical decision making, and the new concepts of management science, attempts to formalize and automate decision making are limited to only small fractions of the field of responsibility of management. Consequently uncertainty is an ever present characteristic of the manager's environment. Yet in spite of this reality, useful ways of analyzing administrative action can be employed. There are common elements to all administrative behavior which are susceptible to identification, definition, measurement, and comparison. The objective sought is to commit as large a portion of the managerial job as is possible to a rational process which can be analyzed, understood, perpetuated, and communicated and can thus enter into the pattern of behavior of the company personnel. It is true, of course, that intuitive management may be just as successful, but it cannot be predicted or perpetuated. To insure that even the successful manager may continue his desirable performance, some kind of identification of the common ingredients of his successive actions must be made. In the case of the experienced executive this identification may be nothing more than a feeling of uneasiness in its absence. But to perpetuate this "skill" through less experienced personnel, a more objective identification and definition of its characteristics is required. Then, as is the case with all talents, the continuous employment of the skill may eventually phase into an "intuitive" process. One of the basic premises of all management training is that there exist some underlying truths about successful business administration which can be identified and communicated. Maybe the understanding of the truths develops only with intimate personal involvement with the processes of management, but the accomplishment may be accelerated by an awareness of some of the characteristics of the management job.

THREE VIEWS OF MANAGEMENT

What are some of these underlying truths, common elements, or critical considerations of management? To identify them, three distinct dimensions are recognized: the enterprise objectives, the managerial process, and the administrative environment.

The Enterprise Objectives

To what ends are management efforts directed? [1] Certainly economic gain is a dimension. But even a cursory analysis of managerial behavior will demonstrate that profit maximization is seldom the sole or even the dominant basis for action. One reason for this is the very real difficulty of translating all managerial decisions into economic payout terms. But perhaps even more significantly, economic value is only one dimension of the worth of a thing or a state of being. Prestige, power, satisfaction of accomplishment, and a sense of acceptance and belonging are highly valued personal objectives which, as well, find reflection in the organization personality and thus strongly influence behavior.

If profit maximization does not dominate managerial action, is there any ultimate goal toward which all enterprise efforts are directed? For several reasons, attempts to answer this question are of questionable merit. Each participant in the affairs of the organization has his own unique objectives and consequently nothing so grand as an ultimate organizational

[1] We are speaking of management as the composite of purposeful effort within the enterprise rather than as individuals with personal goals unique from those of the firm.

objective could reasonably be defined to encompass this diversity. It would have to be described in such general and abstract terms as to be of little operational usefulness in influencing the behavior of the organizational personnel. In order for the notion of objectives as a concept for understanding management to have any value, it must be dealt with on a plane which serves as a practical guide for coordinating diverse activities. For this reason it is useful to think in terms of a "family of enterprise objectives," each member of which tends to provide a focal point for some but not all elements of the total operation. An example of such a family might comprise profitability, market standing, productivity, administrative atmosphere, and citizenship. Other formulations could obviously be made employing differing levels in the hierarchy leading to ultimate goals, and differing motivations for influencing behavior. However, in any given situation some formulation is essential if rational (purposeful) effort is to be made. It should also be noted that an assignment of priorities or other types of relationships among the various members of the family of objectives might appropriately be attempted, but the specific situation must determine their nature.

Once we agree to employ something less than an ultimate objective as our guide, we inevitably face the need to reconcile the diverse targets. This process of suboptimization of objectives may be illustrated by the decision to make contributions to welfare agencies (in the interest of citizenship and at the expense of profits), by inauguration of job specialization (in the interest of productivity and at the expense of administrative atmosphere), or by any other strategy which bears differentially upon several of the defined objectives.

Management may thus be understood by reference to the purposes of the organization to which it is attached. Management is purposeful, but the purposes are frequently conflicting. Management must recognize these conflicts but make the purposes compelling to the participants in the enterprise. And management must define and alter the organizational purposes to give realistic allowance to changing skills, resources, competition, economic climate, and other environmental factors.

The Administrative Process

Another way to view management is in terms of its functions. Although it is very unlikely that any two responsible managers would describe their functions in the same way, there are probably several more or less common requirements of all management positions. Taking a cue from the medical profession, we might classify these management processes broadly as diagnosis and therapy. For our purposes we shall employ a finer distinction, however, by designating diagnosis as the awareness of conditions and events and the identification and definition of issues. Therapy will include planning, organizing, and controlling. And to complete our analytical framework, we will recognize the administrative activities which include directing, motivating, and communicating.[2]

Awareness of conditions and events—There is a necessity for responsible managers to maintain a continuous and alert awareness of conditions and events relating to the operation of the enterprise. This is normally accomplished through personal observation and contact with people and their activities, by studying reports and other communications, by attending meetings, and by storing up opinions and reactions wherever they are encountered. In this process, care must be exercised and skill developed to recognize accurate, authentic, and pertinent facts. However, opinions, impressions, and attitudes play a vital role in the management processes as well. Some factual data become recognized as being so vital to the functioning of the business that routine procedures are inaugurated to insure a constant flow into the appropriate stations for processing and interpretation. Sole reliance upon such evidence, however, may prove dangerous, since the dynamics of business do not permit effective anticipation of all informational needs. Normally, to be most useful and manageable, detailed factual data must be accumulated in aggregates and later classified into useful groupings. Illustrative groupings for purpose of diagnosing problems are described in the next section. However, it should be recognized that cross-classifications and the elimination of unnecessary details may be frequently needed in order to see the data in a more accurate perspective. Further usefulness is added to raw data when they are provided with a means of measurement, given relationship with other data, and ranked in terms of relative significance. These processes are not exclusive to quantitative data but, of course, find particular significance when dealing with quantities.

Identification and definition of issues—The ability to sense, and then to "come to grips" with a problem or opportunity justifying managerial attention is essential to effective managerial performance. Judicious screening of issues insures effective employment of the skills and resources of the organization. In fact, probably the most vital aspect of management's job is the thorough diagnosis of issues, for planning and acting presupposes a well-defined purpose to be served. The better the diagnosis, the easier, the more accurate, and the more acceptable the planning and the implementation of actions will become. It is true that management responsibility includes the providing of an "image" of leadership to an organization to insure stability and continuity to the activities and relationships of the participants. But intelligent, aggressive wrestling with the non-routine issues inevitably imbedded in all enterprise situations provides the real challenge for leadership. This function requires the identification and definition of the circumstances where significantly differing alternatives may be followed.

[2] These functions are treated in greater detail in subsequent chapters, and in fact serve as the primary basis for the subject development of the book.

Here the manager calls upon his awareness of events and recognizes in the interplay of circumstances an opportunity or a necessity of choice. The effective administrator will actively seek out these decision-making situations, for the earlier the issue is sighted, the more likelihood that the decision will be beneficial. Few such situations having any real non-routine significance to the firm will be made evident without aggressive probing below the surface evidence. When the making of a choice is forced upon a manager it is probably too late to utilize it most effectively. For at least two reasons skill in the investigation and diagnosis of issues is important: first, because most decision-making issues must be sought out, uncovered, and isolated from the camouflage of routine affairs; and second, because, typically, what first appears to be the issue is only a poor reflection or symptom of the basic problem. Part II develops many of the dimensions and processes connected with the diagnostic efforts of management and demonstrates the role of accounting in performing this function.

Planning—Once an issue has been identified and defined, plans must then be formulated for dealing with it. This is the creative aspect of the management job. It involves the establishing of objectives and the developing of strategies and tactics for their accomplishment. It should be noted that this planning process takes place at all levels of management responsibility. The determination of the company's competitive role in the industry, as well as the foreman's choice of the manner in which a customer's order should be processed, involves planning. In fact, the goal of one level of responsibility may be merely the means for achieving the goal of another higher level of responsibility. This distinction between objectives and plans is determined largely by the point of view of the participant. The importance of this concept lies in its providing a basis for isolating problems, distinguishing between symptoms and causes, fixing responsibility, and pointing out the courses of action that may be needed. The important point to keep in mind is that no managerial action can be performed in isolation and that an understanding of the interrelationships between objectives and plans when looking forward, and causes and effects when looking backward, is a necessary part of effective decision making.

The following are the most critical aspects of the planning function:

1. A thorough understanding of the problem or opportunity for which a decision is being sought, including all of the environmental circumstances bearing on the issue.
2. A search for optional ways of dealing with the issue.
3. A projection of the anticipated consequences of adopting each of the options.
4. A comparison of the results in terms of significant criteria.

Concerning the first of these aspects, it should be emphasized that decisions regarding action are of very little significance if addressed to the