conceptual foundations of management accounting

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CONCEPTUAL FOUNDATIONS OF MANAGEMENT ACCOUNTING

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EDITOR'S FOREWORD

The environment for accounting has undergone revolutionary changes in the last decade. Demand for accountability by managers of both public and private organizations has risen significantly. Electronic data transmission, storage, and processing and other information technologies have developed to allow accountants to use methods and processes that would have been considered impossible, or uneconomical, just a few years ago. At the same time, new quantitative methods for solving accounting problems have been developed, and the behavioral sciences have suggested that the impact of accounting goes well beyond the systems and reports which are the most visible product of the accountant's work.

The speed with which these developments have occurred has made it difficult for teachers and students of accounting, and for managers and accountants themselves, to keep their knowledge up-to-date. New solutions to problems, and sometimes even new kinds of accounting problems themselves, are not treated in many textbooks. In addition, problems and solutions often cross boundaries between what were once considered separate disciplines of study. The student or manager seeking a learning aid in an era of change will frequently be frustrated. In many respects, materials which have been available do not reflect either the new developments or the unprecedented opportunities for creative thinking and problem solving which accounting presents.

Each book in this Addison-Wesley Series treats a new development or subject which has not been widely treated in textbooks which are widely available. In addition, because each book concentrates on a single set of problems, methods, or topics in accounting, each provides comprehensive coverage in an economical form. The Series was conceived to help all who work with or process accounting information, all of whom must continue to learn in order to keep pace with the changes which are occurring. Each book has been carefully developed by an outstanding scholar.

Books in this Series were prepared in the belief that the evaluation of accounting and its importance to managers will continue, and with faith that books are an effective means to assist all who are interested to participate in the developments which will take place in the future. Our goal has been to improve the practice and processes of accounting, and to help all who use accounting information to do so more effectively.

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PREFACE

This book is designed to provide additional material for a typical course in management accounting. The student in management accounting should be aware not only of the new multidisciplinary scope of the field but also of the conceptual foundations which justify this extended scope. Most management accounting texts do not introduce and integrate all these foundations and are generally restricted to an exposition of cost accounting techniques. In my judgment, what is needed is to show the student that management accounting has a conceptual grounding in various disciplines, justifying the adaptation of their techniques to managerial problem solving. It is to this view of management accounting that this book is addressed.

Four conceptual foundations envisioned for management accounting are presented: Accounting foundations (Chapter 1); Organizational foundations (Chapter 2); Behavioral foundations (Chapter 3); and Decisional foundations (Chapter 4). A recurrent theme in each of these chapters is that a failure to grasp any of these conceptual foundations of management accounting may result in deficiencies in the management accounting system and inadequacies in the provision of the diverse services required by both the small and the complex organizations of today.

I wish to acknowledge Professors Martin Bariff and William J. Bruns, Jr., who made valuable comments. The

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Management accounting is designed, first, to supply information to internal decision makers of a given organization, second, to facilitate their decision making, third, to motivate their actions and behavior in a desirable direction and, finally, to promote the efficiency of the organization. It is accounting-based and individual-, organization-, and decision-centered. Thus, management accounting requires an accounting, behavioral, organizational, and decisional grounding. An understanding of each of these foundations may allow the management accountant to design a management accounting system responsive to the diverse needs and demands emanating from within and from without the organization. A failure to grasp any of these foundations, as they pertain to either the accounting discipline, the individual, the organization, or the decision, may result in deficiencies in the management accounting system and failures to adequately provide diverse services required by both small and complex organizations.

The book has four major themes corresponding to the four conceptual foundations envisioned for management accounting. Without attempting to summarize the entire book, here are a few brief overview comments on each of the conceptual foundations of management accounting.

Accounting foundations

The accounting characteristic or problem of management accounting is one of determining the ways in which accounting information may be accumulated, classified, analyzed, and adapted to specific problems, decisions, and day-to-day conduct of an organization. These management accounting techniques should be derived and supported by a management accounting conceptual framework. Chapter 1 of this book shows that an emerging management accounting conceptual framework exists with the identification in the literature of its required elements; namely, the objectives, qualitative characteristics, concepts, and techniques of management accounting.

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Organizational foundations

The organizational characteristic or problem of management accounting is one of tailoring the internal reporting system to the organizational structure and to the significant elements which approximate the patterning and order inherent in organizations. This objective requires a good understanding of the elements of organization structure and the theories of organization. Chapter 2 discusses the elements of organization structure that may affect the ways the management function will be exercised, including the nature of the organization, the organization structure or hierarchy, the line and staff relationships, and the functions of the controller. The theories of organization that point to significant elements which approximate the patterning or order existing in organizations and define the ways management accounting will better provide its services include the rational perspective, the classical perspective, the human relations perspective, and the natural systems perspective.

Behavioral foundations

The behavioral characteristic or problem of management accounting is one of adapting the internal reporting system to the different factors that shape the "cognitive make-up" of individuals within the organization and affect their performance. These factors include the perception by the individual of what should be the objective function or goals of the firm, the various elements likely to motivate the individual to perform, and the decision-making model most relevant to particular contexts and most preferred by the individual. As seen in Chapter 3, the objective function may be either a stockholder wealth maximization, a managerial welfare maximization, or a social welfare maximization. The factors that may motivate the individual to perform are specified by the different motivation theories; namely, the need theory, the two-factor theory, the value/expectancy theory, the achievement theory, and the inequity theory.

Finally, the individual may adopt as a decision-making model the rational view, the satisficing process-oriented view, the organizational procedures view, the political view, or the individual differences view. Each of these behavioral concepts identify factors and situations that influence the individual behavior, and indicate avenues for management accounting to adapt its services.

Decisional foundations

The decisional characteristic or problem of management accounting is one of determining the types of decision and decision systems, the type of information and information system needed. Several frameworks have been proposed in the literature for viewing these decisional foundations, namely, the Anthony framework, Simon framework, Gorry-Scott Morton framework, Forrester framework, Dearden framework, and Blumenthal framework. Each of these frameworks, discussed in Chapter 4, provides the basis for making resource allocation decisions about information systems in general and management accounting in particular.

Chapter One

THE ACCOUNTING FOUNDATIONS

Management accounting is one of the areas in the field and profession of accountancy. As suggested by the 1958 American Accounting Association (AAA) Committee on Management Accounting, it "involves consideration of the ways in which accounting information may be accumulated, synthesized, analyzed, and presented in relation to specific problems, decisions, and day-to-day tasks of business management."[1] An appreciation of management accounting requires a good understanding of the different facets of accounting in organizations. A clarification of each of the areas of accounting will help identify the scope of management accounting, the possibility of a management accounting theory, and a taxonomy of management accounting techniques.

The aim of this chapter is to clarify the role of management accounting in the field of accounting per se, and argue for a management accounting theory as a frame of reference for the justification of present and new management accounting techniques.

1.1 NATURE OF ACCOUNTING

The financial community has always regarded the accounting discipline as one of its principal tools in the decision-making process. The primacy of decision has been stressed by both Paton and the "Statement of Basic Accounting Theory":

> The purpose of accounting may be said to be that of interpreting the financial data . . . to provide a sound guide action by management, investor and other interested parties.[2]
>
> The committee defines accounting as the process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.[3]

Thus, accounting is perceived as utilitarian in purpose and descriptive in nature. Stated in means-end terms, the end sought is good information, the means employed are descriptions. Accounting provides information for two distinct but closely related purposes: (1) making decisions within the organization; and, (2) reporting to persons outside the organization who have a legitimate interest in its affairs.

The first reporting scheme is the area of internal or management accounting, the second is the area of external or financial accounting. What is the extent of the differences in scope of both financial and management accounting?

1.2 FINANCIAL VERSUS MANAGEMENT ACCOUNTING

Financial accounting deals with reporting information that pertains to the financial position, performance, and conduct of a firm for a given period to a set of users and the market in general. Management accounting is more oriented toward internal decision making and purposively channels relevant and timely information to internal managers. Both are production processes of different accounting data for different problem-solving situations.

Financial accounting is the result of applying generally accepted accounting principles to the recording of transactions between different entities. As such, financial accounting statements conform to a set of rules established by the profession. Management accounting, however, reflects the use of techniques from different disciplines, including accounting, for internal problem solving. Therefore, management accounting techniques may differ from generally accepted accounting techniques, and from one firm to another. They do not conform to any set of prescribed rules, and much may be left to the decision-maker's philosophies.

In short, the frame of reference used in management accounting is much broader than that used in financial accounting. Boyd and Taylor considered the specific difference to be the following:

1. The managerial approach places the student in the role of a *user* of financial data in decision making. The conventional approach assigns the student the role of *preparer* of financial statements for use by others.
2. The student of managerial accounting is called upon to use his entire knowledge of the business world in making business decisions based upon accounting data. Conventional accounting limits itself to accounting techniques, principles, and practices, and rarely deals with decisions other than those required in the preparation of financial statements.
3. An attempt is made to consider the external and internal business environment in managerial accounting. Conventional accounting usually ignores these conditions.
4. The arrangement and emphasis of topical material differs under the two methods because of the differences in objectives.
5. The purpose of managerial accounting is to make a decision related to a business problem. Conventional accounting has as its end the ability to prepare adequate financial statements.[4]

To this list of differences, it may be also added that financial accounting data are required to be objective and verifiable, while management accounting emphasizes relevance and flexibility.

1.3 MANAGEMENT VERSUS COST ACCOUNTING

Although the relationship between cost accounting and management accounting has not been explicitly clarified, it is usually believed that it is one of point of emphasis. Cost accounting deals mainly with cost accumulation, inventory valuation, and product costing. It emphasizes the cost side. The objective function is implicitly perceived to be cost minimization. Similarly, management accounting deals with the efficient allocation of resources.

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