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Better Decisions
Through Management Accounting

As one talks with and listens to business executives of well-run corporations today, he cannot fail to be impressed by the new and vital role that accounting plays in their day-to-day decisions. This new and expanded sphere of accounting activity appears to be taking the name of management accounting. The title indicates recognition of accounting as a tool for success in business management—if not for business survival. The field of accounting is now well into a major transition in its development; in addition to its important but limited role as a custodial and external reporting function, it is becoming recognized as a vital force in planning for and producing business profits.

To understand this important development, we should review some of the factors that have conditioned the growth of accounting in this country. The early history of accounting reflects the need for a formal record-keeping function to satisfy management's needs. In those early days, the concepts of business planning and control that had taken shape in the minds of entrepreneurs were simple ones. Nevertheless, accounting was called upon mainly to fulfill management's need to keep track of debtor and creditor claims and of joint venture business relationships. There was scarcely any requirement or need for external financial reporting.

During the current century, we have seen rapid developments in our business economy exert strong influences on the accountant's role. Three stand out as particularly significant. First, we have seen rapid growth of the corporate form of business enterprise with widely disbursed ownership. For obvious reasons, this has placed emphasis upon stewardship reporting or accounting for the benefit of "outsiders" who are significant corporate owners but who are not managers of the corporate business. Second, the corporate income tax and regulatory restrictions have created a great demand for the accountant's services as

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an independent reporter of financial results. And third, a general social consciousness has developed that favors the protection of third parties in activities of corporations.

All of these factors have encouraged, and are still encouraging, a rapid rate of growth of the accounting profession. The direction of this growth has been understandably related to these factors, which are somewhat limited in their scope. Professional accounting has until recently been strongly oriented toward external reporting of financial data. It has prospered under the professional trade-marks of independence, integrity, objectivity, and technical competence—attributes so essential to this type of an orientation. This part of the accountant's work is not likely to decline in absolute importance. Public accountants are continually confronted with new and challenging business situations that add to the need for unbiased reporting to the public.

It is unfortunate but unmistakably clear that the commendable response to the need for independent external reporting has been allowed to overshadow and retard the use of accounting data as a tool of management. Preparation of accounting reports for individuals and groups with different and sometimes conflicting interests has called for a balancing or fusing of objectives. To accomplish this, accountants have relied on conservatism, consistency, objectivity, and a degree of uniformity. These characteristics of conventional accounting thinking and practice have not been conducive to a forthright effort to provide useful information for management action.

Worth-while progress was made from 1920 to 1945 in establishing the concept of control by exception through the use of cost standards and flexible budgets. After the idea of production standards had been fairly well formulated in the minds of industrial engineers and businessmen, accountants hit upon the notion of integrating such standards in dollar terms into the accounting and reporting functions. Somewhat later, the use of control budgets for indirect costs was considered. These were significant steps toward a management orientation of accounting. However, the requirements of inventory valuation and income measurement still took precedence in the accounting process, thus delaying the acceptance of standards and budgets for internal cost control.

ACCOUNTING AS A TOOL

The Need

The steady increase in competitive pressures and in the size and complexity of most successful businesses during the past fifteen years has given emphasis to management-oriented accounting. The tendency toward decentralized and highly diversified operations requires more information for directing action at middle- and lower-management levels. It has also emphasized the importance of a co-ordinating force such as that found in an effective accounting organization. Business managers are recognizing more and more the futility of management by intuition and are clamoring for quantitative data to give rational direction. Then, too, these pressures for a management orientation of accounting have been accompanied by the rapid development of electronic data processing equipment and important advances in management science techniques, which provide a great potential for refined and voluminous analyses of business data.

Management accounting is gradually taking its rightful place in providing a measurement tool and a communicating medium to support a semiscientific approach to decision-making. It has passed the probationary period and is approaching a stage of full-fledged acceptance in well-run businesses—both large and small.

A Definition

The Committee on Management Accounting of the American Accounting Association has attempted to give a one-sentence definition of management accounting. It states that

"Management accounting is the application of appropriate techniques and concepts in processing the historical and projected economic data of an entity to assist management in establishing a plan for reasonable economic objectives and in the making of rational decisions with a view toward achieving these objectives."[1] This definition is perhaps somewhat cumbersome, but it does highlight some unique and essential characteristics of the management orientation of accounting. It sets up management's needs as the criterion of acceptability; it extends the field of accounting into projections of the future; it emphasizes the planning and control functions of management.

The development of a set of concepts, principles, or rules of management accounting as a counterpart to "generally accepted accounting principles" for external reporting is sometimes suggested. I believe that the formulation of some general and basic concepts may be helpful, but that principles or rules of procedure should not be emphasized as a part of the toolbox of management accounting. To emphasize them would inevitably prevent the accounting function from meeting the pragmatic test of management usefulness; principles and rules would limit the flexibility that must be a characteristic of management accounting.

SOME BASIC CONCEPTS

Although management accounting should not be thought of as a neat package of ideas, it is based on several interrelated concepts that seem fundamental to an accounting activity that is to serve management. I would list first the process of planning toward a known profit goal. If business management does not set a definite profit objective, its efforts cannot be optimally co-ordinated and chances for success are limited. Certainly, businessmen may keep in mind a certain profit objective without assistance from accounting. They should, however, call upon the controllership or management accounting function to formalize the plan, to break it into the parts that point out the routes to be followed, and to ensure proper co-ordination of the various steering mechanisms.

A second fundamental concept of management accounting is a recognition of the need for effective communication through reports. Reports should highlight both accomplishments and deficiencies. They should offer an interpretive follow-up on results of management actions; they should provide means of controlling the progress toward the profit objective and enable management to redirect projects that are not fulfilling expectations; they should both motivate and direct management action.

An accounting activity that is to serve management must deal with costs and revenues by functional segments of the business that coincide with personnel responsibility assignments. Management accounting should reflect plans and performance of specific individuals. Only by relating accounting measurements to the targets set up for individuals can reasonable corrective action be taken and proper motivation provided.

Management accounting must be concerned with the future. It is concerned with historical reporting only insofar as such information will help direct or influence future actions. It is a tool to assist management in steering a course toward profits; only indirectly is it concerned with ground already covered.

Another basic idea that is essential to a good information system for the management of a multiproduct company involves the analysis of both historical and projected data in terms of products and product groups. The general increase in product diversification in most companies gives this analysis particular significance. Business managers must decide on product-line pricing policy, direction of new

[1] "Report of the Committee on Management Accounting," *The Accounting Review*, XXXIV (April, 1959), 210.

product development programs, allocation of sales promotion funds and effort, and the adding or dropping of a product or a line of products. Information developed through an effective accounting organization can provide and, in many cases, does provide support for management action in all of these areas.

One of the most striking fundamental characteristics of the current quantitative approach to management decision-making is the concern for incremental costs, revenues, and profits or the use of the concept of profit contribution. The basis for these ideas is, of course, to be found in classical marginal economic analysis for the firm. The maximizing of profits by equating marginal costs and marginal revenues has long been a tool used by economists in an effort to explain business actions and patterns of price changes in a free economic system. Only recently, however, have these basic concepts been tailored and consciously used in business decision-making. Although it is not possible to fortify the decision-maker with precise measures of marginal costs and marginal revenues, an accounting function may provide approximations of average incremental information. Such information will support decisions in terms of their contributions toward designated profit goals.

For the accountant to provide incremental data and for the manager to use the data properly, both must understand the basic economics of their business and of their industry. They must be informed on their competitive strengths and weaknesses in order to distinguish between relevant and irrelevant data, and to anticipate the results of specific decisions. Such understanding and information will prevent the misuse of basically useless data.

To provide useful incremental *revenue* information, the accountant usually must join forces with market research, product development, and perhaps other functional groups. It should be a team effort, but the management accountant should be the prime mover. He should lead the effort to get relevant figures even though they may be only approximations with an appraisal of the possible error.

To provide good incremental *cost* information, the management accountant must have the cooperation of production and marketing groups. Here, his role may be even more important. He must study and understand cost behavior. He must search out the causal factors in cost changes and determine the magnitude of cost responses to each of these factors. This is not a small order, but it is something that any accounting activity can tackle if aggressive accounting leadership is available.

DOES SIZE AFFECT NEED?

A question often asked is whether the concepts mentioned are applicable to both small- and medium-sized businesses. There should be no hesitation in giving an answer. While the specific needs of management depend in part upon the size of the organization, the general needs for tailored information and a sound approach to the problem are not related to size. The cost of operating a useful accounting function is dependent, to some degree, on the volume of transactions and the number or variety of decisions to be made. These are, in part, a function of size. But there is nothing about a management accounting approach that makes it practical only for large firms. The question should not be, "Can we afford it?" If a question is to be asked, it should be, "Can we afford to be without it?" Most business activities must be fortified with good internal financial and operating information if they are to survive. The accounting or controllership function can be the lifesaver.

Although the concepts of management accounting are rapidly gaining acceptance, there are still many businesses — perhaps a majority—that consider their accounting departments as a necessary but lifeless activity involving keeping track of things and filing nuisance-type reports. These companies, large or small, are failing to take advantage of a potential source of operating information that could spell the difference between success and failure. Without substantial additional cost, the accounting function can be used to assure decentralized actions that will contribute to the over-all profit objective of the company by providing individual personalized goals that are internally complementary and consistent. It can motivate individuals to greater and more effective effort by creating an awareness of cost performance, of revenues produced by individual actions, and of departmental or product-line profit contributions.

By orienting toward management's needs, product lines that had been thought to be highly profitable may be shown to be marginal. Other products may contribute more to over-all profits. Still others may be shown to be a continual drag on profits and should be considered for elimination. Project proposals for new machinery or new plant locations may be viewed in terms of their likely effects on profits in both the short and long run. Decisions on product pricing may be made in view of relevant cost information. Management action in these and many other areas need no longer be made by guess, by hunch, or by uninformed opinion. Good business judgment is a valuable talent, but uninformed good judgment may fall far short of informed good judgment, which is within the reach of those who are willing to develop and use accounting data that is tailored to fit their needs.

MY OBJECTIVE has been to encourage an awareness of the dynamic and crucial role that accounting can fill as a tool for management action and to define some basic concepts that must underlie the management accounting approach. I have not pointed to specific techniques by which this approach may be implemented.

Management and accounting personnel of businesses where little has been accomplished in this area may find immediate assistance in current literature in the field, by attendance and participation in technical conferences, and by enrollment in certain adult education programs of selected universities and professional associations. The National Association of Accountants, the Controllers' Institute of America, and the American Management Association have done a great deal to bring enlightenment through their educational programs and publications. Investigation into some of the specifics of management accounting should be richly rewarding.