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**Accounting
Technicians
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Management Accounting



CHAPTER 1: THE NATURE AND PURPOSE OF MANAGEMENT ACCOUNTING

In order to communicate we need a language. Accounting is the language used in business to communicate financial and non-financial information to the organisation's stakeholders – those parties who have an interest in how the business is performing. This chapter considers how management accounting information is communicated and why managers need this information.

LEARNING OUTCOMES

Upon completion of this chapter you should be able to:

1. Identify users of accounting information
2. Understand the difference between management and financial accounting
3. Appreciate the purpose and uses of management accounting

REVISION RESOURCES

SEMINAR: This topic will be reviewed and discussed in **Revision Seminar 1**.

EXAM QUESTIONS: **Pilot and Past papers** are available from the website of Accounting Technicians Ireland and are essential aides when studying Management Accounting topics.

1.1 Accounting information

Accounting is the language used by businesses to communicate with interested parties. Each party has its own information requirements. Access to accounting information differs according to the relationship between the business and the interested party.

1.1.1 Users of accounting information

Organisations have many stakeholders who require information for their own purposes:

- Equity Investors require information on investment values and potential income to be earned from their investments.
- Managers require information for decision making, planning and control purposes.
- Employees require information about the organisation's ability to meet wage demands and provide employment security.
- Loan and Trade Creditors and Suppliers require information about the organisation's ability to meet ongoing and future financial obligations.
- Governments and regulators require information to assess taxation liabilities, for economic projections, for enforcement of corporate legislation.
- Special interest parties require information pertaining to their specific interests, for example environment groups, community groups, lobby groups.

Summary of users of accounting information:

Illustration 1.1



These users of accounting information can be broadly classified into two categories:

- Users who are external to the organisation (e.g. equity investors, loan creditors).
- Users who are internal to the organisation (e.g. management).

Two branches of accounting have evolved to deal with the needs of these two user groups:

- Financial accounting is concerned with providing information to external users.
- Management accounting is concerned with providing information to users within the organisation to assist with effective and efficient management of the business.

1.1.2 Management Accounting versus Financial Accounting

There are many differences between management and financial accounting as set out below. However it is important to remember that the primary information used for the preparation of management accounts and financial accounts stems from the same source – costs incurred and revenues earned by the organisation.

The major differences between the two branches of accounting are:

- ❖ *Legal requirements.* Company law imposes a statutory obligation on public limited companies to produce financial statements on an annual basis. These accounts must be prepared in accordance with prescribed accounting principles and are subject to statutory audit. There is no legal requirement or obligation to prepare management accounts, notwithstanding the fact that good business practice suggests that the regular production of accounting information is a useful tool to assist management in carrying out their duties in a proper manner. There is no requirement to audit management accounts.
- ❖ *Frequency.* Financial statements must be prepared annually. There are often regulatory requirements to present less detailed accounts on a semi-annual or quarterly basis. Where there is benefit to be gained from the production of management accounts the frequency of production is at management's discretion typically ranging from daily, weekly, monthly, or at ad-hoc times to suit management needs.
- ❖ *Primary users.* Financial accounting presents accounting information for use by a wide variety of external parties, as well as internal managers. Management accounts are solely for the use of the internal management of the organisation.
- ❖ *Time focus.* Financial accounting reports has an historic time orientation, focusing on what has happened in the past financial year. By contrast, management accounting has a future time orientation using accounting information to project future trends and using historic information in order to be able to control current and future business performance.

- ❖ *Format & content.* Both company law and accounting standards provide templates for the presentation of financial statements and instruction on minimum information disclosure. Given the fact that financial accounting information is in the public arena, there is an inherent acknowledgment by regulators of the sensitivity surrounding the disclosure of certain information and the main focus of these disclosure requirements is on summarised financial data. Financial statements focus on the business in its entirety. Management accounting operates on the basis of meeting the needs of internal management. The format and content of management accounts are contingent upon the specific requirements of management. Different companies will have different information requirements and their individual management accounts will reflect this. As internal reports, management accounts will often contain business sensitive information for a restricted audience and can focus on both financial and non-financial information, such as critical success factors (measures of factors or aspects of an organisation's performance deemed to be critical or essential to its competitive advantage and thereby its success). In addition, management accounts will often present very detailed information at a department level or product line level.

Summary comparison of management and financial accounting:

Illustration 1.2

	Management	Financial
Legal requirements	No legal requirements. No audit.	Company law and accounting standards requirements. Statutory audit requirement.
Frequency	As required.	Annually, semi-annually, quarterly.
Primary users	Internal management.	External parties.
Time focus	Present and future.	Historic.
Format & content	To suit management requirements. Detailed information.	Prescribed by accounting standards and company law. Summary information.

This syllabus focuses on specifically Management Accounting.

1.2 What is Management Accounting?

Management accounting involves applying accounting and financial management principles to the provision of information to managers within an organisation to help them plan and control the organisation's activities and to make business decisions.

1.2.1 Management accounting information for managers

When you select an item for purchase you will have to pay the selling price of the product. How has this price been arrived at?

When you decide to renovate your house you will compare quotes from different builders. How have the quotes been calculated? Why are they different?

When you undertake a college course you have to pay fees. What basis has been used to set these fees?

When you buy supermarket own brand products have you ever wondered who produces them and why the manufacturer has chosen not to market them under the manufacturer's own brand?

As the consumer you may not pay much attention to these questions, but as the manager of a business, whether it is in the manufacturing or service industry, or a not-for-profit organisation, you must pay attention to the factors both financial and non-financial that underpin these decisions. Failure to do so may result in the failure of your business.

Every organisation has managers. These managers have a responsibility to the stakeholders to manage the business in the most effective and efficient way, to maximise the organisation's potential. This involves the managers undertaking adequate **planning** for the short and long-term future, ensuring that the business is being properly **controlled** to ensure plans succeed, and making **decisions** that will enable the business to survive and grow into the future. Management accounting equips managers with information required to carry out these tasks.

1.2.2 Planning

The process of planning involves identifying goals and deciding how to achieve them. Plans can be set for the long-term, for example a strategic plan covering the next 2-5 years time horizon and for the short term, for example a budget covering the next 12 months time horizon. The budgeting is a management accounting report. It is a quantitative expression of a plan. It shows the expected financial implications of the decisions taken and helps identify the resources needed to achieve the goals.

1.2.3 Control

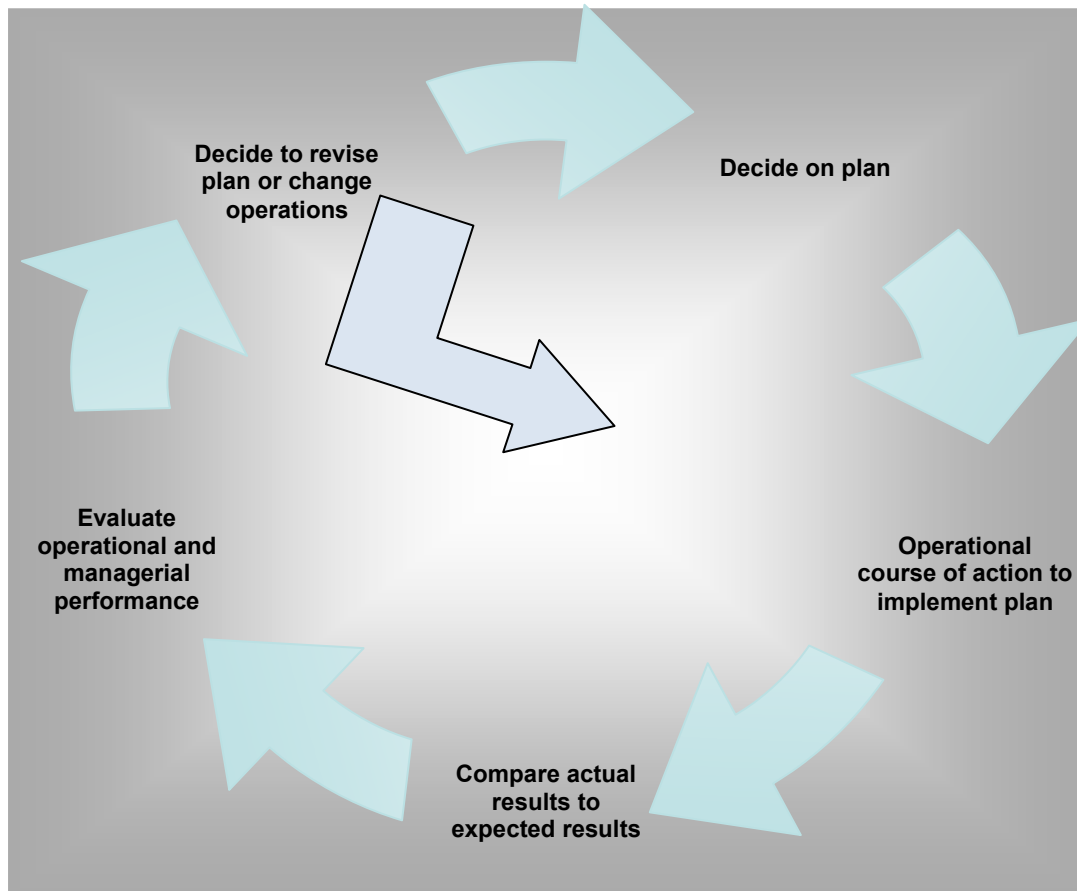
Control involves implementing the plans and evaluating business and operational performance by comparing actual outcomes to budgeted outcomes. Differences (variances) between actual and budgeted outcomes must be identified and criteria put in place to determine when variances should be investigated – management by exception. This is a management accounting process called variance analysis. As well as controlling and evaluating operational and financial performance from a divisional perspective, managerial performance can also be appraised.

1.2.4 Decision making

Decision making involves deciding between alternative courses of action, having given due regard to all information relevant to the particular decision. Management accounting information helps managers to distinguish between financial data, costs and revenues, that are relevant and those that are not relevant.

Planning and control cycle

Figure 1.3



SAMPLE QUESTIONS & SOLUTIONS PROGRAMME

The following questions examine the key areas you are expected to know for this particular subject, and will assist you significantly in your preparation for your examination in May/August 2010. In addition to the questions below, please also refer to the Summer 2009 examination paper which is contained in this manual for your reference. Pilot papers for this subject can be downloaded from www.AccountingTechniciansIreland.ie

Questions:

1. Briefly describe the main users of accounting information. What are their specific information requirements?
2. Outline the key differences between management accounting and financial accounting.
3. Why do you think managers need management accounting information?
4. What types of information, financial and non-financial would the following require:
 - a. Buyer in a clothing retail operation
 - b. Production manager in a toy factory
 - c. Managing director of a private hospital
 - d. Project managers in an overseas charity aid organisation
5. Briefly describe a typical planning and control cycle. Why do you think it is important for business to implement this cycle?

Solutions to the chapter questions above will be available online for students from January 2010 (in order to have provided you with sufficient time to have covered certain parts of the course.)

For those of you of wish to attempt any of the above chapter questions (and without looking at the solutions online!), you can email your answers to solutions@accountingtechniciansireland.ie from January 11th, 2010. Detailed feedback* will be provided to you within 3 working weeks of receipt. (These questions will not in any way count towards your summer examination marks.) This is a free service to our students and you are strongly advised to avail of it as past students have noted the benefits.

** Proof of purchase of this manual may be required.*