EIGHTH EDITION

MANAGEMENT ACCOUNTING FOR DECISION MAKERS

Peter Atrill
Eddie McLaney

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ACCOUNTING
FOR DECISION MAKERS

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For password-protected online resources tailored to support the use of this textbook in teaching, please visit **www.pearsoned.co.uk/atrillmclaney**

Preface

Management accounting is concerned with ensuring that managers have the information they need to plan and control the direction of their organisation. This book is directed primarily at those following an introductory course in management accounting. Many readers will be studying at a university or college, perhaps majoring in accounting or in another area, such as business studies, IT, tourism or engineering. Other readers, however, may be studying independently, perhaps with no qualification in mind.

The book is written in an 'open learning' style, which has been adopted because we believe that readers will find it to be more 'user-friendly' than the traditional approach. Whether they are using the book as part of a taught course or for personal study, we feel that the open learning approach makes it easier for readers to learn.

In writing this book, we have been mindful of the fact that most readers will not have studied management accounting before. We have therefore tried to write in an accessible style, avoiding technical jargon. Where technical terminology is unavoidable, we have tried to give clear explanations. At the end of the book (in Appendix A) there is a glossary of technical terms, which readers can use to refresh their memory if they come across a term whose meaning is in doubt. We have tried to introduce topics gradually, explaining everything as we go. We have also included a number of questions and tasks of various types to try to help readers to understand the subject fully, in much the same way as a good lecturer would do in lectures and tutorials. More detail on the nature and use of these questions and tasks is given in the 'How to use this book' section immediately following this preface.

The book covers all the areas required to gain a firm foundation in the subject. Chapter 1 provides a broad introduction to the nature and purpose of management accounting. Chapters 2, 3, 4 and 5 are concerned with identifying cost information and using it to make short-term and medium-term decisions. Chapters 6 and 7 deal with the ways in which management accounting can be used in making plans and in trying to ensure that those plans are actually achieved. Chapter 8 considers the use of management accounting information in making investment decisions, typically long-term ones. Chapter 9 deals with performance evaluation and pricing, including strategic management accounting. This is an increasingly important area of management accounting that focuses on factors outside the organisation but which have a significant effect on its success. Chapter 10 deals with the problems of measuring performance where the business operates through a divisional organisation structure, as most large businesses do. It also considers the use of non-financial measures in measuring performance. Finally, Chapter 11 looks at the way in which management accounting can help in the control of short-term assets, such as inventories (stock) and cash.

In this eighth edition, we have taken the opportunity to improve the book. We have continued to increase the emphasis on the need for businesses to operate within a framework of strategic planning and decision making. This includes greater focus on the business environment and, in particular, on the crucial importance of creating and retaining customers. We have continued to highlight the changing role of management accountants to enable them to retain their place at the centre of the decision-making and planning process. We have taken the opportunity to rearrange some of the the contents, particularly in Chapters 5 and 9, so as to make the ordering of material more logical. We have expanded discussion on the area of responsibility accounting. We have also added more examples of management accounting in practice.

We should like to thank those at Pearson Education who were involved with this book for their support and encouragement. Without their help it would not have materialised.

We hope that readers will find the book readable and helpful.

Peter Atrill
Eddie McLaney

How to use this book

Whether you are using the book as part of a lecture/tutorial-based course or as the basis for a more independent mode of study, the same approach should be broadly followed.

Order of dealing with the material

The contents of the book have been ordered in what is meant to be a logical sequence. For this reason, it is suggested that you work through the book in the order in which it is presented. Every effort has been made to ensure that earlier chapters do not refer to concepts or terms which are not explained until a later chapter. If you work through the chapters in the 'wrong' order, you may encounter points that have been explained in an earlier chapter which you have not read.

Working through the chapters

You are advised to work through the chapters from start to finish, but not necessarily in one sitting. Activities are interspersed within the text. These are meant to be like the sort of questions which a good lecturer will throw at students during a lecture or tutorial. Activities seek to serve two purposes:

- To give you the opportunity to check that you understand what has been covered so far.
- To try to encourage you to think beyond the topic that you have just covered, sometimes so that you can see a link between that topic and others with which you are already familiar. Sometimes, activities are used as a means of linking the topic just covered to the next one.

You are strongly advised to do all the activities. The answers are provided immediately after the activity. These answers should be covered up until you have arrived at a solution, which should then be compared with the suggested answer provided.

Towards the end of Chapters 2–11 there is a 'self-assessment question'. This is rather more demanding and comprehensive than any of the activities. It is intended to give you an opportunity to see whether you understand the main body of material covered in the chapter. The solutions to the self-assessment questions are provided in Appendix B at the end of the book. As with the activities, it is very important that you make a thorough attempt at the question before referring to the solution. If you have real difficulty with a self-assessment question you should go over the chapter again, since it should be the case that careful study of the chapter will enable completion of the self-assessment question.

End-of-chapter assessment material

At the end of each chapter, there are four 'review' questions. These are short questions requiring a narrative answer and intended to enable you to assess how well you can recall main points covered in the chapter. Suggested answers to these questions are provided in

Appendix C at the end of the book. Again, a serious attempt should be made to answer these questions before referring to the solutions.

At the end of each chapter, there are normally eight exercises. These are more demanding and extensive questions, mostly computational, and should further reinforce your knowledge and understanding. We have attempted to provide questions of varying complexity.

Answers to five out of the eight exercises in each chapter are provided in Appendix D at the end of the book. These exercises are marked with a coloured number, but a thorough attempt should be made to answer these questions before referring to the answers. Answers to the three exercises that are not marked with a coloured number are given in a separate teacher's manual.

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Chapter 1

INTRODUCTION TO MANAGEMENT ACCOUNTING

INTRODUCTION

Welcome to the world of management accounting! In this introductory chapter, we examine the role of management accounting within a business. To understand the context for management accounting we begin by examining the nature and purpose of a business. Thus, we first consider what businesses seek to achieve, how they are organised and how they are managed. Having done this, we go on to explore how management accounting information can be used within a business to improve the quality of managers' decisions. We also identify the characteristics that management accounting information must possess to fulfil its role. Management accounting has undergone many changes in response to developments in the business environment and to the increasing size and complexity of businesses. In this chapter we shall discuss some of the more important changes that have occurred.

Learning outcomes

When you have completed this chapter, you should be able to:

- Identify the purpose of a business and discuss the ways in which a business may be organised and managed.
- Discuss the issues to be considered when setting the long-term direction of a business.
- Explain the role of management accounting within a business and describe the key qualities that management accounting information should possess.
- Explain the changes that have occurred over time in both the role of the management accountant and the type of information provided by management accounting systems.

WHAT IS THE PURPOSE OF A BUSINESS?

Peter Drucker, an eminent management thinker, has argued that '*The purpose of business is to create and keep a customer*' (see reference 1 at the end of the chapter). Drucker defined the purpose of a business in this way in 1967, at a time when most businesses did not adopt this strong customer focus. His view therefore represented a radical challenge to the accepted view of what businesses do. Almost fifty years later, however, his approach has become part of the conventional wisdom. It is now widely recognised that, in order to succeed, businesses must focus on satisfying the needs of the customer.

Although the customer has always provided the main source of revenue for a business, this has often been taken for granted. In the past, too many businesses assumed that the customer would readily accept whatever services or products were on offer. When competition was weak and customers were passive, businesses could operate under this assumption and still make a profit. However, the era of weak competition has passed. Today, customers have much greater choice and are much more assertive concerning their needs. They now demand higher quality services and goods at cheaper prices. They also require that services and goods be delivered faster with an increasing emphasis on the product being tailored to their individual needs. If a business cannot meet these needs, a competitor often can. Thus the business mantra for the current era is '*the customer is king*'. Most businesses now recognise this fact and organise themselves accordingly.

Real World 1.1 discusses how this mantra applies to business schools offering programmes for business executives.

Real World 1.1

The customer is king

For corporations, there is just one message to come out of the recession about business school executive development programmes: it is a buyers' market where the customer is king. And for most business schools, there is also only a single message: rethink your business model if you want to survive.

Customer responsiveness, total quality management and global sensitivity – all topics on which business professors can expound at length – now have to be part of what business schools practise as well as what they preach. Gone are the days when a business school could run a course because it had a professor who understood the subject; customer need has now become paramount.

With both training companies and management consultancies encroaching on the patch of the traditional business education providers, schools have seen two to three years of painful decline in revenues from executive education programmes. Now they hope that business is returning.

Where business is returning, demand has clearly changed. Companies – which pay on average $1,000 per person per day for business school programmes – are putting themselves squarely in the driving seat in the design and delivery of programmes. They are demanding the kinds of performance measures that inform other aspects of their businesses.

Business schools have talked for years about the best ways of measuring corporate return on investment for short business school programmes, and concluded that it could not really be appraised. Now some companies have decided to impose their own measurement systems, and are withholding payment for programmes until they are convinced that they have been successful.

Corporate clients are also less likely to fly their managers to overseas business schools, now requiring the professors to travel instead. In both open-enrolment and customised programmes, the schools that are proving their worth are those that are prepared to take the programmes to the clients. Even Harvard Business School, the doyen of the industry, now teaches programmes in China and India.

Technology is also much in demand, to save time and money. 'Money is an issue,' says Prof Valor (IESE Business School). 'But time is money, too.' Companies are increasingly replacing elements of classroom programmes with internet-based sessions – web seminars and online study groups or learning tools.

FT *Source*: Adapted from Bradshaw, D. (2011) Business school strategy: customer becomes king, *Financial Times*, 9 May.

HOW ARE BUSINESSES ORGANISED?

Nearly all businesses that involve more than a few owners and/or employees are set up as limited companies. Finance will come from the owners (shareholders) both in the form of a direct cash investment to buy shares (in the ownership of the business) and through the shareholders allowing past profits, which belong to them, to be reinvested in the business. Finance will also come from lenders (banks, for example) as well as through suppliers providing goods and services on credit.

In larger limited companies, the owners (shareholders) tend not to be involved in the daily running of the business; instead they appoint a board of directors to manage the business on their behalf. The board is charged with three major tasks:

1. setting the overall direction for the business;
2. monitoring and controlling the activities of the business; and
3. communicating with shareholders and others connected with the business.

Each board has a chairman, elected by the directors, who is responsible for the smooth running of the board. In addition, each board has a chief executive officer (CEO) who is responsible for running the business on a day-to-day basis. Occasionally, the roles of chairman and CEO are combined, although it is usually considered to be good practice to separate them and so to prevent a single individual having excessive power.

The board of directors represents the most senior level of management. Below this level, managers are employed, with each manager being given responsibility for a particular part of the business's operations.

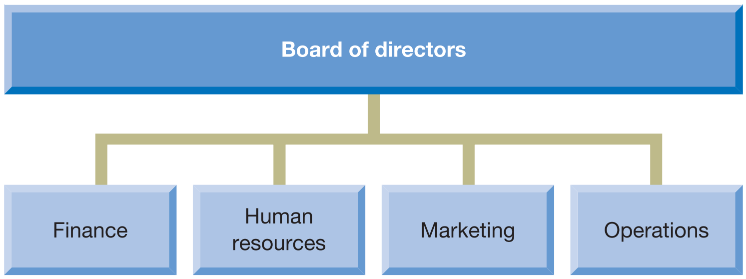
Activity 1.1

Why are larger businesses *not* managed as a single unit by just one manager?

Three common reasons are:

- The sheer volume of activity or number of employees makes it impossible for one person to manage them.
- Certain business operations may require specialised knowledge or expertise.
- Geographical remoteness of part of the business operations may make it more practical to manage each location as a separate part, or set of separate parts.

The operations of a business may be divided for management purposes in different ways. For smaller businesses offering a single product or service, separate departments are often created. Tasks are grouped according to functions (such as marketing, human resources and finance) with each department responsible for a particular function. The managers of each department will then be accountable to the board of directors. In some cases, a departmental manager may also be a board member. A typical departmental structure, organised along functional lines, is shown in Figure 1.1.



This is a typical departmental structure organised according to business functions.

Figure 1.1 A departmental structure organised according to business functions

Departments based around functions allow for greater specialisation, which, in turn, can promote greater efficiency. The departmental structure, however, can sometimes become too rigid. This can result in poor communication between departments and, perhaps, a lack of responsiveness to changing market conditions.

The structure set out in Figure 1.1 may be adapted according to the particular needs of the business. Where, for example, a business has few employees, the human resources function may not form a separate department but rather form part of another department. Where business operations are specialised, separate departments may be created to deal with each specialist area. Example 1.1 illustrates how Figure 1.1 may be modified to meet the needs of a particular business.

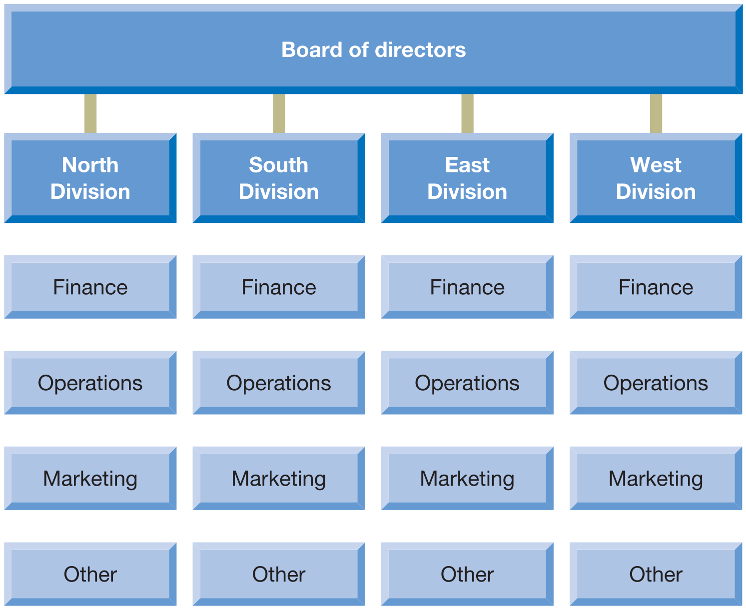
Example 1.1

Supercoach Ltd owns a small fleet of coaches that it hires out with drivers for private group travel. The business employs about sixty people. It could be departmentalised as follows:

- *Marketing department*, dealing with advertising, dealing with enquiries from potential customers, maintaining good relationships with existing customers and entering into contracts with customers.
- *Routing and human resources department*, responsible for the coach drivers' routes, schedules, staff duties and rotas and problems that arise during a particular job or contract.
- *Coach maintenance department*, looking after repair and maintenance of the coaches, buying spares, and giving advice on the need to replace old or inefficient coaches.
- *Finance department*, responsible for managing cash flows, costing business activities, pricing new proposals, measuring financial performance, preparing budgets, borrowing, paying wages and salaries, billing and collecting amounts due from customers, and processing and paying invoices from suppliers.

For large businesses that have a diverse geographical spread and/or a wide product range, the simple departmental structure set out in Figure 1.1 will usually have to be adapted. Separate divisions are often created for each geographical area and/or major product group. Each division will be managed separately and will usually enjoy a degree of autonomy. This can result in much greater responsiveness to changing market conditions. Within each division, however, departments are often created and organised along functional lines. Certain functions providing support across the various divisions, such as human resources, may be undertaken at head office to avoid duplication. The managers of each division will be accountable to the board of directors. In some cases, individual board members may also be divisional managers.

A typical divisional organisational structure is set out in Figure 1.2. Here the main basis of the structure is geographical. North division deals with production and sales in the north and so on.



This is a typical organisational structure for a business that has been divided into separate operating divisions.

Figure 1.2 A divisional organisational structure

Once a particular divisional structure has been established, it need not be permanent. Successful businesses are likely to be innovative and constantly seeking to improve their operations. This may well extend to revising their divisional structure. Take for example the business whose structure is depicted in Figure 1.2. At some stage, senior management may conclude that the needs of customers and/or operational efficiency would be better served by having a structure that was based on product lines rather than on geography. This may result in reorganising so that there is a separate division for each product, irrespective of where production takes place or where customers are based.

Real World 1.2 provides an example of a reorganisation at a well-known business. In this case, the ultimate goal was to allow the business to respond more effectively to customer needs in a fast-changing environment.

Real World 1.2

Installing updates now

Microsoft chief executive Steve Ballmer has announced an operational realignment and a reshuffle of top management in a fresh attempt to remake the software company for an era in which the rules are set by rivals such as Apple and Google. The changes are meant to position the company better to come up with new computing experiences that take advantage of the mobile devices and services that are defining the way technology is now delivered, Mr Ballmer said in an email to employees.

The shake-up includes an attempt to break down the walls between the large operating divisions that have long kept Microsoft employees in carefully defined silos. These have been blamed by many observers and former executives for holding back new ideas that span the range of Microsoft's activities. It also marks a complete reversal of the structure Mr Ballmer put in place in 2005, when he created a cadre of powerful and autonomous divisional business leaders. The earlier approach, intended to copy the success of companies such as General Electric, had left Microsoft ill-prepared for the fast-moving technology world, said Rob Helm, an analyst at Directions on Microsoft.

In particular, a desire to defend earnings from the Windows PC operating system, the main profit generator, has long been seen as a drag on innovation. The influence of Windows has waned as growth in personal computing has moved to smartphones and tablets dominated by software made by Apple and Google. One person familiar with the company's thinking said the reorganisation was not expected to be enough, on its own, to revive Microsoft's prospects, and that attention was also being given to important areas such as senior executive talent and strategy. Realigning the company was overdue, but still made sense given the new market environment Microsoft is facing, this person added.

Under Mr Ballmer's latest plan, Microsoft's engineers will be pooled in four groups, for instance bringing together all of those working on operating systems for products such as PCs, mobile devices and the Xbox games console who were previously in different divisions. That should make it easier for Microsoft to come up with a single software platform that operates across all devices, making it more competitive with Apple's iOS and Google's Android software, according to analysts. 'This is something they had to solve; they had to remove internal friction to actually deliver it,' said Al Hilwa, an analyst at IDC.

Alongside the engineering groups, Mr Ballmer has centralised marketing and business development functions under new executives reporting to him, eating away at the divisional business fiefdoms.

FT *Source*: Adapted from Waters, R. (2013) Steve Ballmer shakes up Microsoft structure in battle to compete, ft.com, 11 July.

In the Microsoft example, we can see that the existing divisional structure was seen as being too rigid. A looser structure was, therefore, put in place. We shall explore the benefits and problems of divisionalisation in some detail in Chapter 10.

While both divisional and departmental structures are very popular in practice, other organisational structures may also be found.

HOW ARE BUSINESSES MANAGED?

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

- the increasing sophistication of customers (as we have seen);
- the development of a global economy where national frontiers have become less important;
- rapid changes in technology;
- the deregulation of domestic markets (for example, electricity, water and gas);
- increasing pressure from owners (shareholders) for competitive economic returns; and
- the increasing volatility of financial markets.

The effect of these environmental changes has been to make the role of managers more complex and demanding. This, along with the increasing size of many businesses, has led managers to search for new ways to manage their businesses. One important tool that has been developed in response to managers' needs is **strategic management**. This is concerned with establishing the long-term direction for the business. It involves setting long-term goals and then ensuring that they are implemented effectively. To enable the business to develop a competitive edge, strategic management focuses on doing things differently rather than simply doing things better.

Strategic management aims to provide a business with a clear sense of purpose along with a series of steps to achieve that purpose. The steps taken should link the internal resources of the business to the external environment of competitors, suppliers, customers and so on. This must be done in such a way that any business strengths, such as having a skilled workforce, are exploited and any weaknesses, such as being short of investment finance, are not exposed. To achieve this requires the development of strategies and plans that take account of the business's strengths and weaknesses, as well as the opportunities offered and threats posed by the external environment. Access to a new, expanding market is an example of an opportunity; the decision of a major competitor to reduce prices is an example of a threat.

Real World 1.3 provides an indication of the extent that strategic planning is carried out in practice.

Real World 1.3

Strategic planning high on the list

A recent survey investigated the use of various management tools throughout the world. It found that strategic planning is used by 43 per cent of those businesses that took part. This made it the joint most popular management tool. The survey, which is conducted annually, has placed strategic planning in first position for three of the last five years and in second position for two of those years.

The survey results were based on interviews with 1,208 senior executives throughout the world.

Source: Rigby, D. and Bilodeau, B. (2013) *Management Tools and Trends 2013*, Bain and Company.

The strategic management process can be approached in different ways. One well-established approach, involving five steps, is described below.

1 Establish mission, vision and objectives

The first step is to establish the mission of a business, which may be set out in the form of a **mission statement**. This is a concise declaration of the overriding purpose of the business.

It addresses the question '*What business are we in?*' To answer this question, managers should focus on those customer needs that the business seeks to satisfy rather than on the products currently produced. Thus, a publisher of novels might, for example, conclude that it is really in the entertainment business. The **vision statement** is closely connected to the mission statement and declares the business's aspirations. It addresses the question '*What do we want to achieve?*' Once again, it should be in as concise a form as possible. By answering both questions, managers should be provided with a clear focus for decision making.

Activity 1.2

Can you think why mission statements and vision statements should be concise?

Having to produce concise statements forces managers to think carefully about the essential nature of their business and the aspirations that they have for it. In practice, this can prove more difficult than it may sound. Concise statements have the added advantages that they are easier to remember and to communicate to employees, owners and others.

The mission and vision of a business will often adorn its website. **Real World 1.4** provides examples of both types of strategic statement for one large business.

Real World 1.4

Power trip

Aggreko plc provides power generation and temperature control solutions to customers who need them quickly or for a short period of time. Its mission is:

> **To offer specialist energy solutions that are delivered by our high-quality people in such a way that we continually grow our global list of satisfied and long-term customers.**

Its stated vision is:

> **To be the leading global player in the specialist energy marketplace.**

Source: www.aggreko.com, accessed 8 February 2014.

Having established the purpose and aspirations of the business, objectives must then be developed to translate these into specific commitments for the forthcoming period. Objectives are designed to introduce real discipline into the strategy process. They should provide clear targets, or outcomes, which are both challenging and achievable and which can provide a basis for assessing actual performance. Quantifiable objectives provide the clearest targets; however, some areas of performance, such as employee satisfaction, may only be capable of partial quantification. Other areas, such as business ethics, may be impossible to quantify.

In practice, the objectives set by a business are likely to range across all key areas and might include a commitment to achieve:

- a specified percentage share of the market in which the business competes;
- a high level of customer satisfaction;
- a high degree of employee involvement;
- a specified percentage of sales revenue being generated from newly-developed products;
- high standards of ethical behaviour in business dealings;

- a specified percentage operating profit margin (operating profit as a percentage of sales revenue);
- a specified percentage return on capital employed.

Businesses tend not to make their statement of objectives public, often because they do not wish to make their intentions clear to their competitors.

2 Undertake a position analysis

With the **position analysis**, the business seeks to discover how, given its attributes, it is placed in relation to its environment (customers, competitors, suppliers, technology, the economy, political climate and so on). This will be done in the context of its mission, vision and objectives. This is often approached within the framework of an analysis of the business's strengths, weaknesses, opportunities and threats (a **SWOT analysis**). A SWOT analysis involves identifying the business's strengths and weaknesses as well as the opportunities provided and threats posed by the world outside the business. Strengths and weaknesses are internal factors that are attributes of the business, whereas opportunities and threats are factors expected to be present in the environment in which the business operates.

Activity 1.3

Ryanair Holdings plc is a highly successful 'no-frills' airline. Can you suggest some factors that could be strengths, weaknesses, opportunities and threats for this business? Try to think of two for each of these (eight in all).

Strengths could include such things as:

- a strong, well-recognised brand name;
- a modern fleet of aircraft requiring less maintenance;
- reliable customer service concerning punctuality and baggage loss; and
- an internet booking facility used by virtually all passengers, which reduces administration costs.

Weaknesses might include:

- limited range of destinations;
- use of secondary airports situated some distance from city centres;
- poor facilities at secondary airports; and
- poor customer service concerning complaints.

Opportunities might include:

- new destinations becoming available, particularly in eastern Europe;
- increasing acceptance of 'no-frills' air travel among business travellers; and
- the development of new fuel-efficient aircraft.

Threats to the business might come from:

- increased competition – either new low-fare competitors entering the market or traditional airlines reducing fares to compete;
- increases in fuel prices and airport charges;
- increasing congestion at airports, making it more difficult to turn aircraft around quickly;
- changes in the regulatory environment (for example, changes in EU laws concerning the maximum monthly flying hours for a pilot) making it harder to operate; and
- vulnerability to a downturn in economic conditions.

You may have thought of others.