

## Chapter 1

# Introduction to Managerial Accounting

Regardless of your major or intended career path, most of you will become managers one day. A manager has responsibility and control of selected parts of a company's operations, or in some cases, multiple aspects of operations. Only those of you that happen to stay at the 'bottom' of a company, prefer never to get promoted, or never accept any responsibility for some aspect of a business, will miss the 'management' opportunity. Fortunately, none of you will likely fall into this persona given that you have taken the initiative to attend college. Understanding managerial accounting will help you move up the ladder more quickly, regardless of your chosen career path.

## How Can Managerial Accounting Help You?

In any responsible business capacity, your boss and all other management levels above you will want to know how well you handle your responsibilities. To do so requires that they measure your performance. The evaluation process is similar to your perceptions in each college course in which you enroll. During your first class meeting in each course, one of your initial goals is to find out how your performance will be evaluated. In a business environment, you want to know what they expect, i.e., how they will measure your performance. While you won't be earning letter grades in the business world, your performance will ultimately translate into promotions, bonuses, raises, reprimands, or perhaps dreaded walking papers.

## Tools of Performance Measurement

Managers use a number of tools to measure performance. The approach to measurement depends on what will be measured and against what benchmark the performance will be measured. A benchmark can be viewed as a goal to meet, or a standard that management expects its employees to achieve. A significant management component involves planning, which is accomplished through the use of budgets. Recall from financial accounting that the primary purposes of being in business are to make a profit and to add value to a company. Budgets are forecasts of how the profits and value-added aspects will be achieved, in other words, a company's financial plan. For example, as a manager you may be given a budget that tells you how much to spend, how many units to produce, or how many customers to process. These items will become benchmarks that management will use as measurement tools. At the end of the period, your actual performance will be compared the budget amounts to see how well you have performed. You must understand what the numbers in budgets represent and how the managers that prepare budgets determined the amounts. Why? You will certainly want to know how to maximize your performance evaluation. For example, if a large portion of your grade in this course was based on attendance, you would maximize performance by attending class every day. You may strive to process customers promptly in a business operation if that is the basis on which your performance evaluation is based. That's where managerial accounting comes in. It will provide you with an understanding of what goes into the benchmarks by which you will be evaluated.

## What is Managerial Accounting?

Managerial accounting is often referred to as management accounting. The Institute of Management Accountants describes management accounting as “the internal business-building role of accounting and finance professionals who design, implement, and manage internal systems that support effective decisions, and support, plan, and control the organization's value-creating operations.”<sup>1</sup> In short, managerial accounting supports the decision making process through planning and controlling operations. Planning primarily appears in the budgeting process. Controlling occurs when managers compare actual performance with budgeted amounts to identify differences and then act upon differences that appear to be significant.

## Comparing Managerial and Financial Accounting

So how does managerial accounting differ from financial accounting? Both provide information to users to make decisions. One difference between the two concerns which users for which the information is provided. Financial accounting provides information to stockholders, creditors and others who are external to the company. Managerial accounting focuses on users inside the company. This internal group includes all levels of management, and sometimes various employee groups.

A number of distinctions between financial and managerial accounting can be made which appear in Figure 1-1.

Compared to financial accounting, managerial accounting:
<ul style="list-style-type: none"> <li>• Is more flexible</li> <li>• Does not focus on generally accepted accounting principles (GAAP)</li> <li>• Has a future rather than past focus</li> <li>• Is more timely</li> <li>• Emphasizes parts of a company (the details), rather than the whole company</li> <li>• Emphasizes both qualitative and quantitative information</li> </ul>

*Figure 1-1 Comparison of Financial and Managerial Accounting*

### More flexible

While a few reports are standardized, many are ‘off the cuff’ or spontaneous ideas converted into an analysis that might be helpful for decision making. A manager might decide to compare administrative costs at the east and west divisions, or determine the cost difference if a new type of plastic is used to manufacture rulers, or any number of other non-standard analyses that may help with decision making.

### NOT GAAP

Because managerial accounting information is used solely for internal purposes, it does not have to comply with GAAP. Outside agencies such as the Securities and Exchange Commission (SEC), the Financial Accounting Standards Board (FASB), and the Internal Revenue Service (IRS) provide reporting rules and guidelines for external reports. These agencies are concerned whether a company’s external reports are in compliance with GAAP because users outside the company rely on the information. External users want to know what actually happened, not what is being planned or how a company analyzes its costs. No rules or specific formats exist for a company’s internal reports, so management free-forms many to meet the decision at hand.

### Future emphasis

Managerial accounting emphasizes the future while the past is the emphasis with financial accounting. What appears in financial accounting reports is historical in nature, representing results of transactions

<sup>1</sup> <sup>1</sup> *What is Management Accounting?*. Institute of Management Accountants, <[http://www.imanet.org/about\\_management.asp](http://www.imanet.org/about_management.asp)>

that have already occurred. Managerial accounting is often considered forward-looking in that much of it represents expectations for the future. While the latter often uses past results as a basis for estimating future results, financial accounting specifically avoids any forecasting or predictions for the future to avoid misleading external users.

**More timely**

Managerial accounting is more timely than financial accounting in that analyses are created as needed, rather than periodically at the end of accounting periods as occurs with financial accounting. This often forces the use of estimated amounts which may not be as accurate as actual results. This sacrifice of accuracy is given up in order to get information more quickly so decisions can be made as quick as possible.

**Emphasis on parts and details**

Managerial accounting focuses on segments and products of an organization, while financial accounting focuses on the company as a whole. For example, for external reporting purposes, General Electric reports gross profit on its income statement which reflects the gross profit of its entire product line. While a potential investor or customer may prefer to know how much profit is associated with a particular model of dishwasher, General Electric prefers to keep such detailed information confidential. On the other hand, an internal report made available to management would certainly contain profit information related to individual products and product lines. From a managerial accounting perspective, General Electric focuses on individual products and services or the parts of a company's operations with lots of detail. From the financial accounting perspective, General Electric focuses on the company as a whole.

**Emphasizes on both quantitative and qualitative considerations**

Managerial reporting is unique in that qualitative considerations receive a fair amount of attention in decision making. Qualitative aspects are those items that cannot be quantified into amounts. They include 'touchy-feely' considerations such as employee morale, community and environmental effects, and the company's public image. Because qualitative items cannot be easily converted into dollars, they do not appear in external financial reports.

**Goals of Managerial Accounting**

The goal of managerial accounting is to provide information for internal decision making, primarily for planning and control purposes. The types of decisions made by managers rely substantially on accounting information. Because financial accounting information does not provide enough detail for internal decisions, it must be broken into more detail of the individual products or services provided by a company. Not only do managers need to know the cost of a product or service, they need the costs broken into smaller components so they are able to perform 'what-if' analyses and forecasts for the future. Some types of decisions that managers often make include pricing products, dropping a product or product line, buying new equipment to replace old, evaluating the performance of managers or divisions of a company, or making rather than buying a part or product. The two primary functions of managerial accounting are planning and controlling. Both of these help managers accomplish decision making.

**A Management Function: Planning**

From an accounting perspective, planning is the communication of a company's goals. Because ultimately a company's results are translated into dollars, planning is achieved through the budgeting process as a basis for decisions made by managers. Budgets are the financial plans of a company. They identify the sources or inflows of economic resources, and the uses or outflows of economic resources of a company. Recall from financial accounting that assets are economic resources that provide future benefits. Budgets identify where assets will come from and where they will be used.

They ultimately create benchmarks of profits, cash flows, and financial position that the company expects to achieve.

### **Another Management Function: Controlling**

The controlling function is achieved through measuring performance, comparing the actual performance with budgets, and taking action when needed. Managers use different approaches to analyze performance, a number of which are covered in this text. Both the performance of managers and the performance of a segment, product, or other unit of company are measured.

To illustrate, suppose the Jacksonville Jaguars make it to the Super Bowl this season. To do so, they must perform well. In the case of football, performing well equates to winning football games. Determining who performed well is a bit more challenging. Was it the ‘manager’ of the football team—the coach? Or was it the team itself? If we credit the coach, we are evaluating the manager. If we credit the team, we are evaluating the team as a whole. The same concepts apply to most business operations. We can evaluate managers or the company segments for which they are responsible. What action might be taken as a result of exemplary performance? The coach may be offered an extended contract. For a poor performance (a number of lost football games), the head coach may be fired. In these two cases, the manager, i.e., the coach, is being evaluated. Is it really the coach who wins or loses the games, or is the performance of the entire team responsible? The key is to be sure you know what you are evaluating (controlling)—the manager, or the department, segment, or unit for which the manager is responsible.

### **Effects of Technology on Manager Decisions**

Recent escalations of technology impact a number of management decisions. Most notably, the Internet has broadened competition due to the increase of access to suppliers and customers. Not only has the Internet enhanced a company’s ability to obtain materials and services needed, it has enabled a company to market its own products and services worldwide. Within a company, technology has automated many processes that had been formally performed by manual labor. As a result, companies have eliminated employees and acquired more plant assets such as equipment. Because computers capture data automatically, managers are desiring more information for decision making. They are no longer satisfied with knowing how much one unit of product will cost. Instead, they want to know the cost of each activity that goes into creating a product or service. Technology’s impact on multiple activities has caused managers to focus on all aspects of a company’s value chain.

### **What is the Value Chain?**

A value chain includes all the activities of a company which ‘add value’ to the company’s goods or services. To add value means to contribute something to make it worth more. The concept of a value chain was made popular in 1985 by Micheal Porter.<sup>2</sup> A value chain includes all the steps a company goes through in order to get it product or service to a customer. Porter calls these the ‘value-adding’ activities of a company. For our purposes, they include

- Acquiring materials, supplies, and services
- The production process
- Selling and marketing
- Delivery to customers and the related service or maintenance of those customers
- Related "support activities" including: all those activities that support the production of goods or services, such as administration, human resources, R&D, accounting, payroll, facilities cleaning, etc.

Every company has a value chain, although components may vary somewhat among companies. Because the activities in the chain involve costs, managerial accounting involves planning and

---

<sup>2</sup> Michael Porter. Competitive Advantage: Creating and Sustaining Superior Performance, New York, NY. The Free Press.

controlling all the value chain activities. As you continue through this text, you will see how many of these activities are analyzed, how their costs are determined, and how they are used in the decision making process.

## Management Accounting Responsibility

The controller is responsible for performing managerial accounting activities, i.e., the planning and controlling activities necessary for decision making. He or she is considered the top managerial accountant and is responsible for not only the topics we will cover in this text, but also the external financial and tax reporting aspects of a company's financial system. More recently as a result of the Sarbanes-Oxley Act of 2002 (SOX), companies must assess and document their internal control structure. This Act added more responsibility to the corporate controller. The controller's areas of responsibility appear in Figure 1-2.

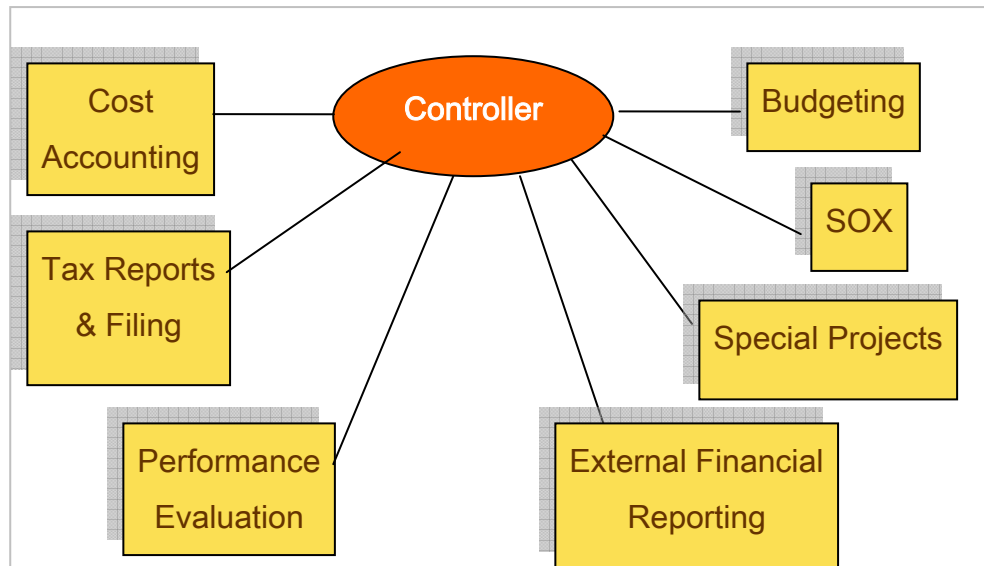


Figure 1-2 Controller's Areas of Responsibility

## Expectations

Most of you will be relieved to know that the content of the managerial accounting course will seem more practical than financial accounting. There is more emphasis on making decisions and learning how accounting information is modified to enhance the decision making process. You will focus more on products and services and the related profit aspects, rather than the company as a whole. You will notice considerably fewer journal entries because you already understand how transactions impact financial statements. (Do I hear cheering?!)

With that in mind, don't let your guard down. The first few chapters introduce a number of new categories and classifications for costs. Understanding the classifications *really, really well* is crucial to understanding the concepts that follow since cost categories are the basis of almost every topic throughout the course.

