1 Introduction

Manufacturers in general recognize the importance of a knowledge of the cost of their product, yet but few of them have a cost system on which they are willing to rely under all conditions.

While it is possible to get quite accurate the amount of materials and labor used directly in the production of an article, and several systems have been devised which accomplish this result, there does not yet seem to have been devised any system of distributing that portion of the expenses, known variously as indirect expense, burden or overhead, in such a manner as to make us have any real confidence that it has been done properly.

As an illustration, I may cite a case which recently came to my attention. A man found that a cost on a certain article was 30 cents. When he found that he could buy it for 26 cents, he gave orders to stop manufacturing and to buy it, saying he did not understand how his competitor could sell at that price. He seemed to realize that there was a flaw somewhere but he could not locate it. I then asked him what his expense consisted of. His reply was labor 10 cents, material 8 cents, and overhead 12 cents.

The next question that suggested itself was how the 12 cents overhead would be paid if the article was bought. The obvious answer was that it would have to be distributed over the product still being made, and thereby increase its cost. In such a case it would probably be found that some other article was costing more than it could be bought for, and, if the same policy were pursued the second article should be bought, which would cause the remaining product to bear a still higher operating expense rate.

If this policy were carried to its logical conclusion, the manufacturer would be buying everything before long, and be obliged to give up manufacturing entirely.

People as a whole will finally discard theories which conflict with common sense, and, when their cost figures indicate an absurd conclusion, most of them will repudiate the figures. A cost system, however, which fails us when we need it most, is of but little value and it is imperative for us to devise a theory of costs that will not fail in use.

Wise words indeed, and on a subject which clearly requires more in-depth analysis. But this misses the point, which is not to re-enter the 'make versus buy' debate, but to highlight the source of the citation. These extracts were part of a speech identifying the inadequacy of our cost accounting systems, delivered in 1915 by H.L. Gantt (see Gantt, 1994: 4), the father of Gantt charts, and a contemporary of F.W. Taylor. Yet such is the rate of progress in cost accounting research over the past 90 years, that such views would not be out of place in the pages of a current issue of a management accounting journal. With such progress it is unsurprising that many view accountancy as more art than science, a view that this volume will attempt to rectify.

The fact that the problems identified by Gantt (i.e., allocation of overheads, performance measurement) are the same ones that still occupy us now is a clear indication that we are looking in the wrong places for answers and travelling down too many blind alleys. By taking a cue from Mr Gantt and ensuring that we develop management accounting principles which facilitate relevant, common-sense solutions, a goal-oriented approach will surely emerge.

Too often, while the stated goal of an organization may be to increase its corporate wealth, the basis of measurement is short-term profit rather than a longer-term or share-priced-related indicator. It is not always clear that current actions are wholly consistent with overriding corporate goals.

Increasing the wealth of the organization through its trading activities demands that we generate and act upon management information which facilitates optimum business decisions in terms of wealth generation. To do so, we need to get back to basics by focusing on fundamental accounting information; paying less attention to such as standard costing and materials requirements planning, and more to our wealth-creation goal.

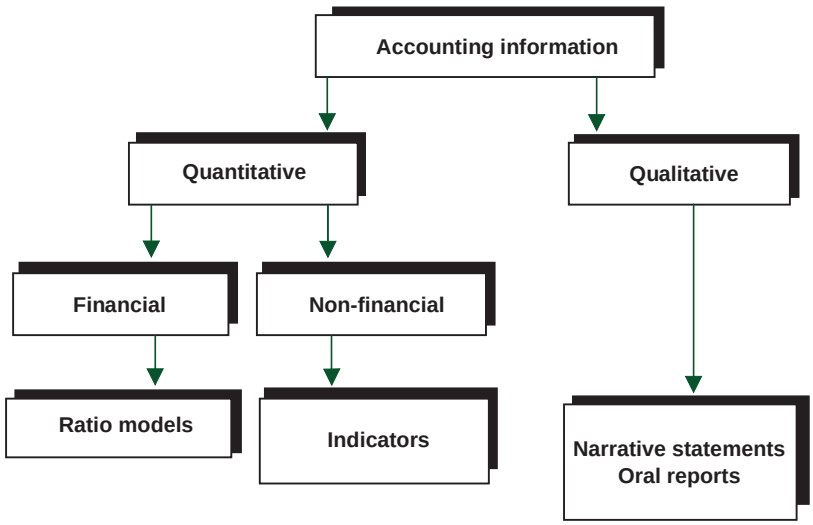
Accounting information can be quantitative or qualitative, financial or non-financial. Traditional methods of processing information are biased towards the use of quantitative financial information, often to the exclusion of all else. As a consequence, decision-making models in accounting usually focus on financial ratio combinations and make little use of non-financial indicators or non-traditional information sources.

Figure 1.1 shows the range of alternatives, with the left-hand side of the diagram very much the focus of attention. In some instances financial ratio models work extremely well (in, for example, the early-warning models of distress among competitors or suppliers, considered in Chapter 9); in others they are less than useful. In such instances we must ensure that we use relevant information and, where that information is not currently available, we should institute procedures to collect it. The importance of fundamental analysis of the appropriate data in order to improve our decision-making capabilities and generate a competitive edge is central to the message of this book.

Recent developments in management accounting have, however, not revolved around *techniques* of data analysis. These remain pretty much at the stage they reached in the 1950s, although advances in computer hardware and software have improved the speed and efficiency of operations. Instead, recent work has focused on the availability of traditional data from on-line sources, new data from non-traditional sources, and on changing attitudes towards the interpretation of data and the implementation of change.

Figure 1.2 illustrates the diverse range of management accounting activities in the planning and control framework. Traditional management accounting teaching, and most textbooks, still follow the right-hand route through this diagram, focusing on the use of accounting information to

FIGURE 1.1



The nature of accounting information

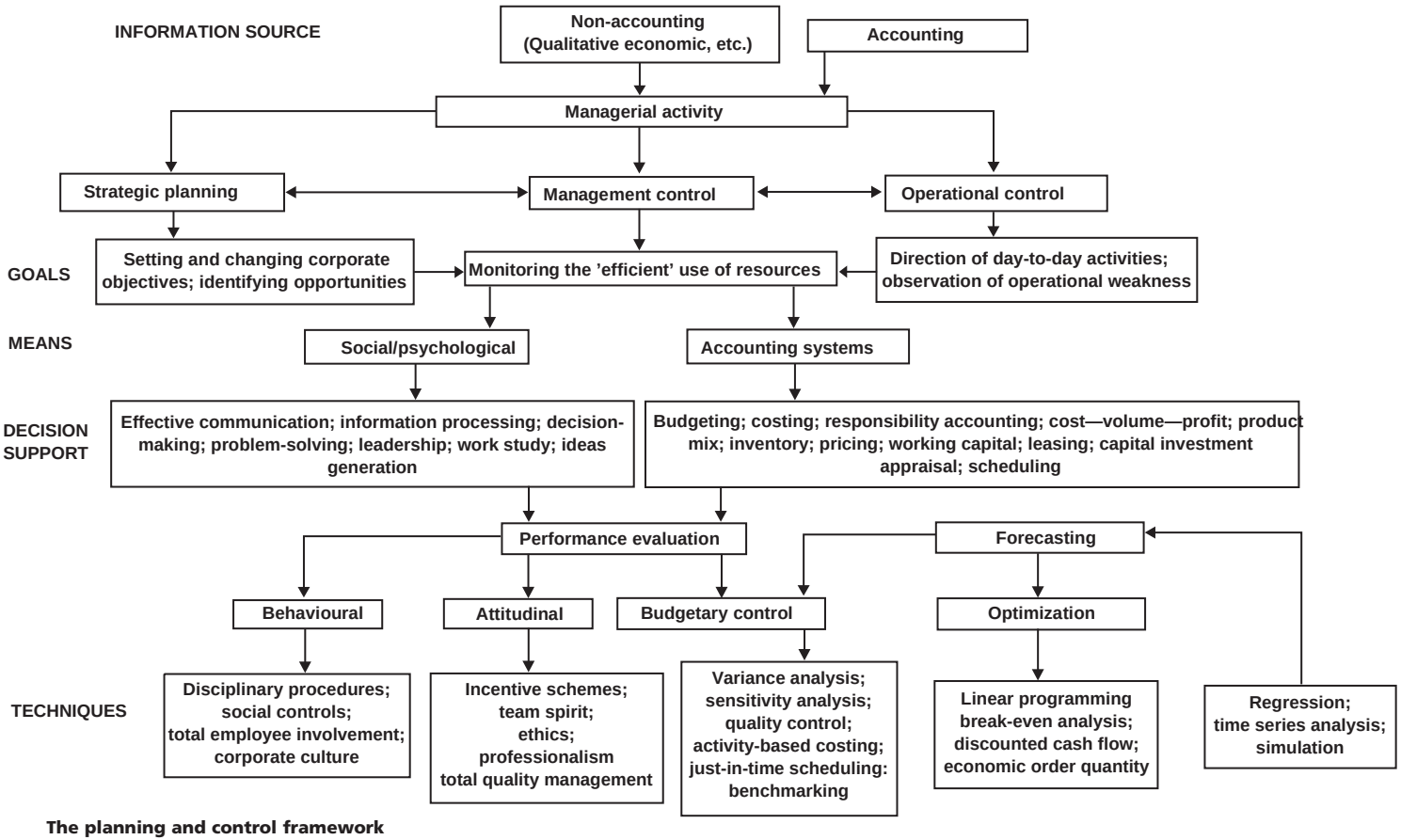
institute managerial and operational control and management reporting, based on traditional accounting systems. The new management accounting tools recognize the relevance of the traditional methods, where appropriate, but change the emphasis towards the left-hand side of the diagram. The focus is then on a decision support system (leaning on disciplines outside the traditional realm of accounting) in order to facilitate decisions congruent with stated corporate goals. Behavioural, cultural and attitudinal changes in both management and the workforce at large are necessary if such systems are to work properly, and many of the latest developments are designed to reinforce such changes.

The need for a revised focus stems from the failure of financial accounting to satisfy our need for timely, decision-useful information. Financial accounting information focuses on compliance, with the adherence to standards, rules and procedures being paramount. The information requirements and processing differences of users and the communication of such information is, at best, a secondary consideration. Thus, while we finish with accurate, consistent, reliable and replicable historic information with which to pursue a stewardship function, the information is hardly timely and the opportunities for legal manipulation are plentiful; see Griffiths (1986), Smith (1992), Clarke et al. (1997) and Fox (2004) for a multitude of examples.

Management surveys have repeatedly shown that financial accounting numbers are used as the basis for strategic decisions despite the inappropriate assumptions they embrace. Management accounting is *present*- and *future*-oriented and historic information is often of limited, though significant, usefulness.

Cost accounting systems fail to address the causes of overhead costs and the use of one cost system for several alternative purposes inevitably causes problems. It is no surprise, then, that misleading numbers are generated when we attempt to use the same accounts for inventory valuation, product costing and process control.

FIGURE 1.2



The planning and control framework

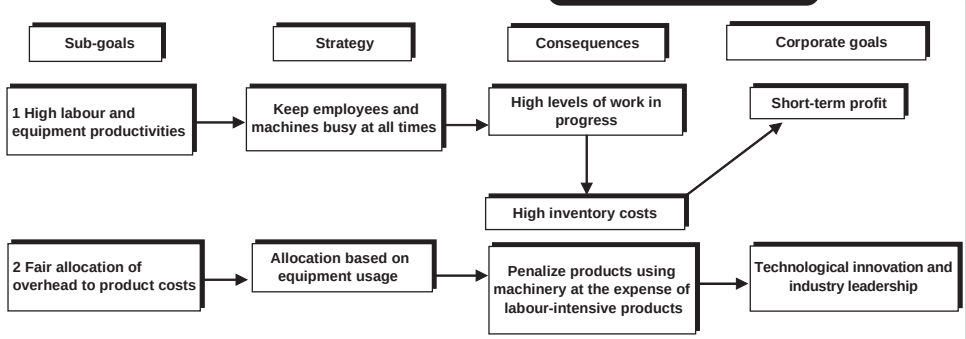
The solution lies in the innovative use of new information sources, predictions and estimates, and of non-financial data. Close enough may indeed be good enough when it comes to management accounting decision-making, because, in an uncertain environment, information must be timely even if it is imprecise. Opportunities for the manipulation of information still exist, but the source of that manipulation is largely behavioural, rather than lying in non-compliance with accounting standards. Potentially decision-useful information may be biased by individuals acting in their own interests rather than those of the company, plant or division. New initiatives aim to improve the decision-usefulness of information by increasing goal congruence; that is, by changing the attitudes and work practices of individuals so that they pursue goals which are in the long-term interests of the enterprise of which they are a part.

Figure 1.3 illustrates how easily goal conflict can occur through misperceptions and over-reliance on short-term financial accounting numbers. In case 1, short-term profit is the stated corporate goal, presumably based on strategic considerations. However, actions at lower levels of the organization may not be consistent with such a goal. At the operational level the time span on which employees focus may be a month, week, day or even shift. Performance measurement may be based on time envelopes of eight hours (or less), making it easy to lose track of longer-term objectives. Productivity measures are frequently employed to monitor the use of resources and, where supervisors' performance is based on productivity achievements, it is hardly surprising that they focus on idle time and slack for both labour and equipment. The consequences of keeping everyone and everything busy all the time include:

- high levels of work in process;
- high inventory costs;
- work carried out and costs incurred before necessary; and
- increased machine maintenance and downtime.

In an absorption costing environment all of these practices will increase short-term profit but produce outcomes inconsistent with the corporate goal. Goals must be communicated clearly down through the corporate structure and performance measures devised which produce behaviour congruent with them.

FIGURE 1.3



The potential for goal conflict

Case 2 stems from the financial accounting stipulation that overhead costs be allocated to product costs in a 'fair' manner. In practice this usually means on the basis of direct labour hours or direct machine hours. An inappropriate choice of allocation method could be detrimental to the achievement of corporate goals. If the company is pursuing one of the niche strategies outlined by Porter (1980) – industry leadership via technological innovation – then the use of direct machine hours will penalize those products using machinery and benefit those that remain labour-intensive; an outcome contrary to that required. In this context, Hiromoto (1988) recommends allocation on the basis of strategic goals, ignoring ideas of 'correctness' or 'fairness' by deliberately penalizing those operations whose activities are not congruent with corporate goals. In Chapter 5, a wider consideration of cost drivers within the context of activity-based costing presents us with many more opportunities for implementing strategies consistent with stated goals.

SUMMARY

In this chapter we have identified some of the deficiencies commonly apparent in management accounting systems and performance measurement frameworks, together with their potential implications. In Chapter 2, we turn to a consideration of the development of management accounting techniques, so paving the way for the detailed discussion of a practical approach to performance measurement and the implementation of strategic management accounting in Chapter 3. The associated issues raise a number of current concerns, and suggest alternative methods, which then provide the focus for the remaining chapters.