7 Developments in Management Accounting

7.1 History of management accounting

Introduction

The following headings, each of which relates to a particular period of time, give a flavour of the various phases in the history and development of management accounting.

- cost recording – prior to the nineteenth century
- cost analysis – nineteenth century
- cost accounting – first half of the twentieth century
- management accounting – between 1950s and 1980s
- strategic management accounting – 1980s to mid-1990s
- cost management – mid-1990s onwards

Cost recording

Collecting and recording information about activities has been carried out since man first started to write, if not before.

Cost analysis

'Management accounting' began to develop when individuals and businesses recognised the need to attach costs to activities and products.

Between 1880 and 1914 an approach to running a factory known as scientific management was developed. Frederick Taylor, known as the father of scientific management, was largely responsible for this. Scientific management was a method for analysing factory productivity and was used in a number of industries, including the metal industries.

Standard costs were developed to:

- *plan workflow* so as to use materials and time to their best advantage.
- *show good and bad working* – according to Percy Longmuir writing about cost analysis in foundries: Solomons (1968). This gradually led to variances being developed around 1900 – information on variances was first published in 1918.
- *value stock*. Financial accountants saw its potential use in valuing stock, but standard costs were not legally accepted for this purpose until after the Second World War.

With the development of standard costing the cost analysis era had ended and the cost accounting era began. The CIMA definition of cost accounting in the *Official Terminology* is:

'The establishment of budgets, standard costs and actual costs of operations, processes, activities or products; and the analysis of variances, profitability or the social use of funds.'

The first modern accounting system

The rise of du Pont in the USA at the very beginning of this century proved to be a landmark in the development of 'management accounting systems'.

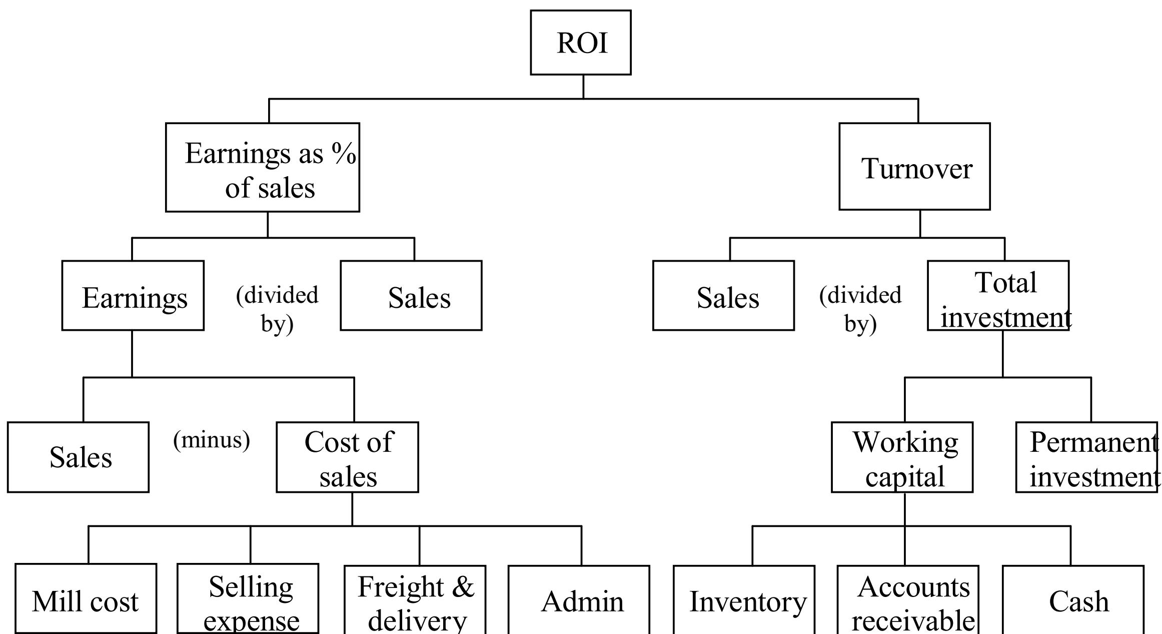
The 'management accounting system' allowed:

- the allocation of new investment between competing activities
- financing of new capital requirements
- physical asset accounting systems

Du Pont used virtually all the planning and control systems that we know today, including the new budgeting and ROI systems. Return on investment was used for investment decisions – rather than to evaluate managers' performance as is common today. Prices were set to earn a target ROI.

The following figure shows the ROI and ratio analysis developed at Du Pont.

Ratio analysis from ROI



Post-war development – the emergence of management accounting

The term management accounting was not coined until 1950.

There were few developments in management accounting during the 1950s and 1960s. It was a period of consolidation – that is it was a time when the majority of medium-sized companies caught up with the developments of earlier years and employed a qualified management accountant for the first time. However, there was one very important exception to this – discounted cash flow.

By the 1970s it had become the most popular method of appraising capital investments in the UK and USA and many other parts of the world replacing ROI, although payback still remains a popular technique today.

Research also developed in the 1950s. It was developed in the UK by a group of physicists and mathematicians. By the 1960s and 1970s a number of operational research techniques had crept into use.

- Mathematical models for optimising product mix with limiting or constraining factors.
- Use of probability and decision theory for analysis of cost volume profit decisions under uncertainty.
- Statistical models for instructing when to investigate variances.
- Mathematical models used for spreading overheads, joint products, etc.
- Regression analysis for separating and estimating fixed and variable costs.

The behavioural side of management accounting began to be recognised for the first time. The words 'responsibility centres' were coined to refer to cost, revenue, profit or investment centres. A manager is accountable for the performance of each centre and when performance is measured the manager tends to act in his own self-interest.

1970s – Agency theory and zero-based budgeting

The 1970s brought a new approach to the firm and to management accounting, which was called agency theory. It was argued that the interests of shareholders and managers diverge significantly from the behaviour of the entrepreneur-run firms of the neo-classical model.

Zero-based budgeting was the other new technique of the 1970s.

It is a technique that requires the organisation to budget from scratch each year and justify every single activity anew. Its main aim is to cut out the non-value added parts of the business that have proliferated due to bad management. It is, however, very costly to implement on an annual basis and so like most things from the 1970s it has almost vanished into oblivion today.

Strategic management accounting

The CIMA *Official Terminology* defines strategic management accounting as: *a form of management accounting in which emphasis is placed on information which relates to factors external to the firm, as well as non-financial information and internally generated information.*

For many years the inadequacy of traditional absorption costing, as practised in the UK and USA, had been known. Therefore, this was the first area to undergo reform with the development of more accurate methods of relating overheads to products, etc. via activity based costing (ABC). Soon however it was realised that ABC had the potential to change managers' thought processes, because of the different way costs were grouped; and so ABM was born. In other words costs can be grouped in a number of different ways so that the viewer can see the picture from a number of different angles if they so wish and, as a consequence, discover new aspects that had not been perceived before. Hopefully the ability to resist a fixed-mind set is the true legacy of many of the new developments of the 1980s.

The balanced scorecard is another technique that was developed in the 1980s to meet a desperate need. The need was to find a way of bridging the gulf between the annual budget and its monthly performance measurement system and longer-term strategic planning. It is also largely a system of non-financial performance measures which is much more in keeping with present needs.

7.2 The current position

Cost management

During the second half of the 1990s the focus changed to cost management.

New forms of cost management were needed to cope with the increased competition of the time and more people in the organisation became involved in reducing cost. The emphasis of management accounting shifted away from the management accountants and into the hands of engineers and functional managers. Management accountants moved from the finance office towards project teams and manufacturing processes.

What of the future?

- **Information systems and technology**

E-commerce and e-business have the potential to speed up an organisation's internal processes and to spread these benefits back along the industry's value chain linking manufacturers, distributors, retailers, customers, etc in a fast cycle chain. The result is that efficient internal systems will not only impact on the company that installs them but on a number of other organisations linked in that industry.

There are two main areas where a management accountant can help with e-commerce or e-business. The first is in providing expertise in making sure that the structural and financial needs to support e-trading are in place.

The second area where a management accountant can assist with e-trading is in project appraisal. Risk, uncertainty, intangible costs and benefits all have to be estimated with a reasonable degree of accuracy.

- **Management accounting techniques and systems**

Budgeting is one of the traditional areas of management accounting that has been much discussed and criticised in recent years.

Controversy still surrounds some of the 'accepted' techniques, as well as newer approaches and ideas. The arguments over whether to relate non-volume related costs or fixed costs to products is as strong as ever but its focus has now changed to ABC.

7.3 The distinction between management and financial accounting

The development of management accounting during the twentieth century was heavily influenced by financial accounting requirements i.e. keeping records to produce data for published accounts. Long after the need for this influence had disappeared due to the development of modern information systems it still remained, providing a strong financial accounting slant to the management accounting ratios and measures used in the UK and USA.