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ACCOUNTANTS ROLE IN MANAGEMENT

By

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Bachelor of Science in Accounting

University of North Dakota 1969

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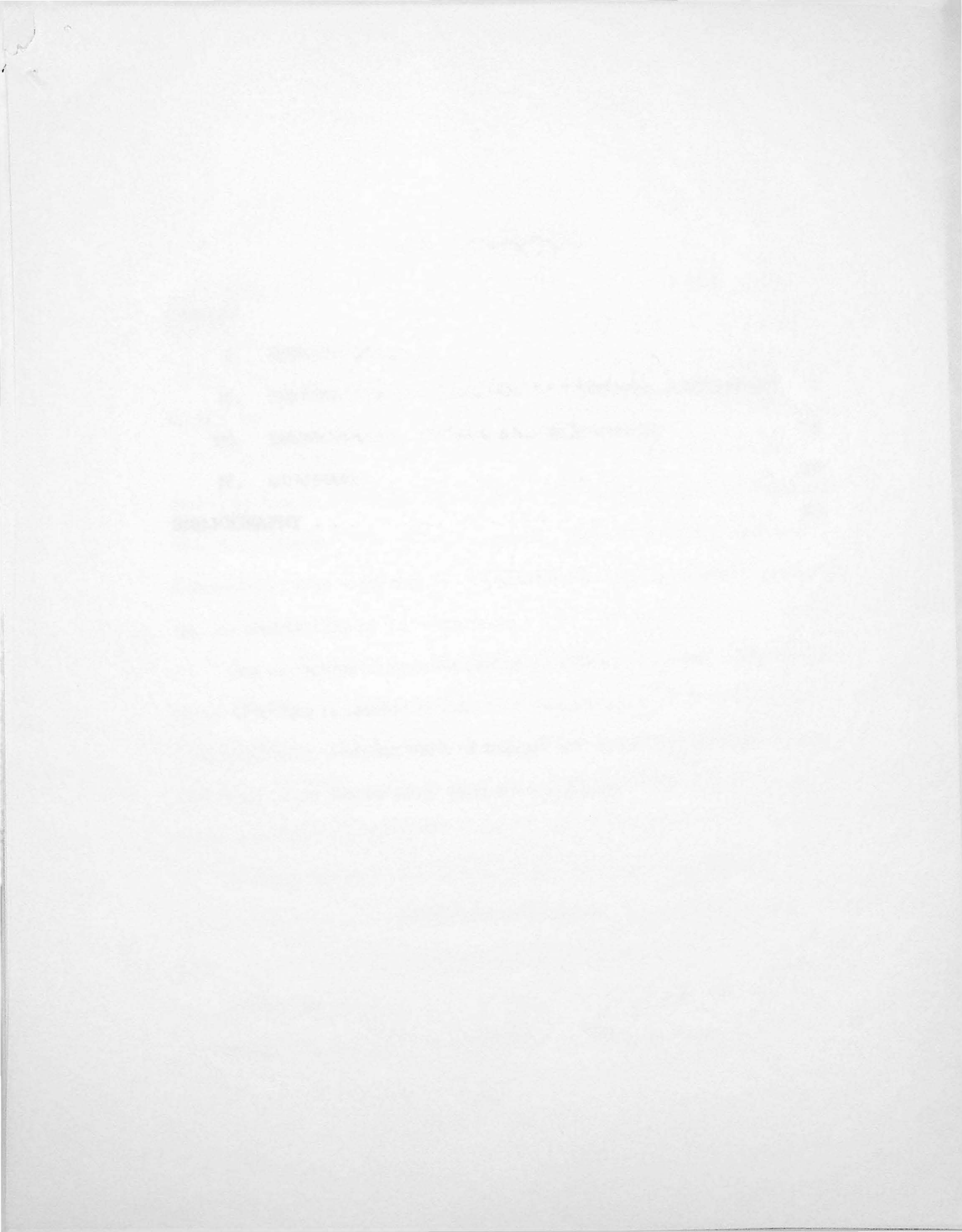

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I. THE INTRODUCTION

Management was not simple 50 years ago, but the problems at that time were far less complicated than they are today. Firms today are not only larger but more complex. (With computers and other sophisticated equipment, management needs more information at a faster rate.)

Fundamentally, accounting is an information system by which financial data is recorded, accumulated, and communicated for decision-making purposes.[1] For the enterprise that plans to continue business indefinitely, it is vital that the accountant provides information concerning the profitability of that enterprise.

The accountants function can be viewed as two parts. The first of these functions is related to fiduciary responsibility.[2] It is primarily concerned with "keeping track of things" and answering such questions as: What items did we get? How much did they cost? And were the items worth the cost?

The second major function is to furnish information which is useful as a basis for decision-making at all levels of the organization. This includes providing managers with the data required for planning, coordinating and controlling activities. It also includes the operation of a system which assists in motivating individuals to make and

implement those decisions that will lead to the accomplishment of the goals of the organization.

Although many enterprises, such as governmental agencies, do not attempt to produce profits, we will be primarily concerned with the commercial enterprise that is interested in profits. Management is judged according to its ability to earn profits. Owners and potential investors are primarily concerned with the rate of return on their investments. How well management has accomplished its goal will be measured through accounting reports.

Large sums of money are entrusted to management by investors. When a firm is publicly held, most of the investors are not active in the business activities and therefore must rely on the financial reports of the company as to how well management has used their investments. It is the accountants responsibility to insure that adequate records are kept.

Underlying accounting are several basic concepts which are not explicit in the ordinary financial report. Some of these concepts are open to criticism.[3] Although they are presently being studied and evaluated, they are still basic tenets of financial reporting. Of course, any report based on these concepts is open to the same criticisms as the concepts themselves; thus, the concepts must be understood if financial reports are to be interpreted correctly.

Two of the basic accounting concepts are the concept of a separate entity and the concept of a going concern. Once a business is formed, it is expected to continue in business indefinitely. Therefore, the records that are maintained are to be that of the business. In other words, the affairs of the stockholders personal assets and liabilities are kept separate from the business in which he has part ownership. An example would be the purchase of furniture. If it is used in the stockholder's home, it would be an expense to his personal budget; but if it is used at the office of the corporation, it would be an expense to the firm.

The accounting reports are intended to convey information. Management must be informed of the firm's current profitability and financial position in order to properly plan and control the operations. If financial reports are to assist management and other interested parties, they must present information that is applicable to the period covered by the report.

Therefore, the expenses incurred during the period must be matched with the revenues earned during the same period. This is known as the matching concept. This concept of matching revenues against expenses can become quite difficult.

(For example, for items that are to be depreciated, such as machinery, the cost for the period has to be estimated.) How long will the machine last will decide on how much of the original cost

is to be expensed during the period. How accurate one estimates the life of the machine is how accurate the financial reports are.

Another problem in this area is determining the time revenue is received but not earned or revenue is earned but not received. Consider a manufacturer of trucks who is on the calendar-year basis for financial reporting, and has participated in the following transactions regarding the same revenue item:[4]

Nov.	1	Received an order for 5 trucks at $20,000 each
Nov.	15	Received a deposit of $25,000 on this order
Dec.	15	Completed trucks
Jan.	5	Delivered trucks to customer
Jan.	31	Billed customer for $100,000 less $25,000 deposit
Feb.	28	Received $25,000 from customer
Mar.	31	Received $50,000 from customer

The problem, of course, is specifying the date on which the revenue was realized (earned). If the revenue is recognized as of December 31, it will appear on the current income statement; if it is recognized later, it will be shown in the next period. Accountants have adopted the rule that revenue is recognized when a legal right to payment is created--when the firm has fulfilled its obligation and has a claim against the customer. The terms of the contract of sale may vary, but usually a claim is created when the goods are delivered. Thus, in our example, the sale is recorded as of January 5, not as of November 1.

It is at this time that title to the vehicles is transferred and the manufacturing firm receives a legal right to payment. The billing date and actual receipt of cash are immaterial in determining when revenue is actually earned.

Since the revenue was recognized on January 5, it will be shown as part of the new year's income. But the cost incurred before January 1 is applicable to this revenue, and should be charged in the new year despite the fact that it was incurred in the old. Suppose the trucks cost $70,000 to manufacture. It would be incorrect to show a cost of $70,000 in one period with no applicable revenue and a profit of $100,000 in another period with no applicable cost. This treatment would entirely conceal the fact that a single transaction took place yielding a $30,000 profit. Instead, revenue and cost are allocated to the proper periods of time. Thus, revenues are recognized in the period in which they are actually earned and costs are matched to the applicable revenue.

Footnotes to Chapter I

[1]James H. Rossell and William W. Frasure, Financial Accounting Concepts (Columbus, Ohio: Charles E. Merrill Books, Incorporated, 1967), p. 1.

[2]Edwin H. Caplan, "Management Accounting and the Behavioral Sciences," Management Accounting (June, 1969), 41-45.

[3]S. Winton Korn and Thomas Boyd, Accounting for Management Planning and Decision Making (New York: John Wyley and Sons, Incorporated, 1969), p. 15.

[4]An example taken from S. Winton Korn and Thomas Boyd, Accounting for Management Planning and Decision Making (New York: John Wyley and Sons, Incorporated, 1969), p. 45.

II. PREPARATION AND ANALYSIS OF FINANCIAL STATEMENTS

The business world today is constantly being tested by economic, social, and technological changes. The management and staff must understand each other in order to cope with these changes. They will work together with maximum effectiveness to minimize the effects of adverse conditions and take optimum advantage of favorable ones. The decisions the president and board of directors must make are dependent upon information provided by lower echelons of management.

The internal accountant usually is the most important source of information. The financial statements that he prepares contains the information vital to a going concern. [1]For example, accountants can compare costs of a job or period with those of other periods. They analyze and interpret trends. They can spot problem areas and suggest corrective action. They are working with what costs are and not what costs should be.

The accountant can analyze and interpret variances from the standard and make his reports to management. With the use of the computer, this information can be provided in very little time.

Another example is the budget. The old budgets used to bring

pressure on the foremen. The accounting staffs were the watchdogs and reported to top management any deviations from the budget. This created feelings of hostility and conflict between foremen and accountants. Today the budget is used (or should be used) not as a pressure device but as a type of control. It should be prepared by the foremen or lower echelons of management. However, before it is prepared, the foremen should be informed of the firms goals and objectives for the coming period.

Once it is prepared, the budget should be reviewed periodically. Who, other than the accountant, would be better qualified to make the review.

The accountant and foreman could compare the actual costs with the budget. If there is a need for corrective action, the accountant could make the recommendation to the foreman. If the problem is too large for the foreman to handle or out of his jurisdiction, the accountant could make the necessary reports or recommendations to higher management.

Of course, the most important reports furnished by the accountant are the periodic financial statements: balance sheet, income statement, funds statement, statement of retained earnings, and other special reports. These statements are made in order to measure the success or <u>failure</u> a firm has in attaining its objectives. Since the financial statements are reports concerning management's performance, management

is vitally interested in reflecting a favorable image of the company. A favorable financial picture stimulates public confidence and acceptance. It also creates a source of funds which may be essential to the company's operations. Therefore, it is important that the internal accountant keep top-level management posted on the financial operations and conditions of the company.

Once the information is furnished, it must be analyzed. The analysis will give management an overall view of the financial operations and conditions of the company which will enable them to plan and control the company's activities more effectively. Management may spot weaknesses in the company's operations, such as poor turnover in accounts receivable or inventories.

One of the best procedures to spot weaknesses is the use of ratio analysis. However, it should be remembered that ratios are only guides in the analysis of financial statements and not conclusive in themselves.

If a ratio is to be important, it must not only represent a true relationship, but must also aid the analyst in making his immediate decision.[2] If management is interested in determining whether accounts receivable are excessive, the turnover ratio (which is determined by dividing the sales for the period by the average balance in accounts receivable) and the average collection period (which is the number of

days in the period (365 days for a calendar year) divided by the turnover ratio) would both be important since both have a direct bearing on the problem; but the current ratio (ratio of current assets to current liabilities) would be of no use at all although it is of great importance when other decisions are made. Thus, an important step in analysis is determining which ratios are applicable to the immediate problem.

In order to analyze ratios, certain standards should be established. Assume that the average balance in accounts receivable is $40,000, while credit sales for the year amount to $200,000. We can state that accounts receivable turned over five times during the year ($200,000 ÷ $40,000) and that it takes an average of 73 days (365 ÷ 5) to collect on the accounts receivable. But whether 73 days represents a favorable or unfavorable collection period has to be determined. In order to determine whether 73 days is favorable or unfavorable there must be some standard against which the collection period can be compared.

The standards for comparison can be derived from various sources. The most probable would be from historical data of the firm. If the three preceding years were 65 days, 67 days, and 70 days, respectively, than collection is getting longer. Management should try to obtain information to determine the reason for the trend.

Another standard for comparison may be the company's own goals or policies. If the company has established in advance that their

collection period should be between 62 and 65 days, this period should be the standard against which actual performance should be measured.

Another comparison might be to ratios of other companies operating in the same field or of the same size. Usually, these comparisons are made when the companies are publicly owned and a few dominate the industry. For example, it is not unusual to see comparative statistics on the four leading automobile producers.

Ratios should only be considered as guides. They can be vital to both the stability and the operations of the company. However, ratios can be abused. No single ratio should be the basis of any decision. Generally, one employs several ratios and comparisons, one supporting the other, before a decision is made. For example, the current ratio, which is useful in judging a company's ability to meet its current obligations, should be supplemented by the accounts receivable turnover and the merchandise inventory turnover which give some means of determining the movements of the current assets of the business. These supplementary ratios improve the reader ability to evaluate the current ratio.

Another method, and probably the most common, of analyzing financial statements is by the use of comparative statements. Usually, comparative statements include comparative data for one year preceding the current year but the trend is changing towards two or three years

prior to the current year.

This data should include percentage comparisons. The comparisons are useful in showing whether there is a favorable or unfavorable trend in the business. If there is an indication that something is wrong, the manager or reader can investigate the cause of the difficulty.

Difficulties can arise when using comparative statements. When using comparative statements one should use statements that were prepared with the same accounting principles for all periods being compared.

Also, when comparing statements of other firms, one must be careful. No reasonable person would expect a 9 year old boy to run as fast as a 19 year old athlete; in judging the boy's performance, we attempt to compare his speed with that of other boys of the same age and with similar training. Differences in factors that affect one company's performance this year as compared with those that affect the same company's performance last year, or the performance of another company, are complex and difficult to evaluate. Nevertheless, some attempt must be made to allow for these differences. In general, this task is least difficult when all the figures being compared pertain to the same company.[3]

Footnotes to Chapter II

[1]I. Wayne Keller, "The Link Between Accounting and Management," Management Accounting (June, 1969), 36-40.

[2]S. Winton Korn and Thomas Boyd, Accounting for Management Planning and Decision Making (New York: John Wyley and Sons, Incorporated, 1969), p. 173.

[3]Robert N. Anthony, Management Accounting Principles (Homewood, Illinois: Richard D. Irwin, Incorporated, 1970), p. 227.

Although a corporation wants to make a profit, it must make enough profit in order to survive. A multimillion dollar corporation can have a profit of $1,but it will not continue in business too long if it continues to earn only $1 above expenses. To know how much profit is needed for the investors can be obtained from the financial statements. This can be obtained from the working capital schedule. Any firm, in the short run, can operate at a loss or low profit margin, but in the long run, it will need profit for working capital. This is due to increasing costs for inventories, machinery, and other operating expenses.

Another factor in profit is that net profit tells how the firm is doing as a whole, but there may be weaknesses or strengths within certain product lines or other various areas. The accountant, as he goes through the preparation of the statements, may spot such strong points or weaknesses. He can then make or recommend special reports or investigations, thus assisting management in control. These special reports would enable management to make a decision whether to continue or discontinue a product, expand a product line, increase or decrease a market area, or other decisions.

Budgeting is an important part of the management control process. It sets up guidelines which can appraise the performance of the firm. Stated in the previous chapter are some guidelines to follow in preparing and using a budget.

Today, fewer and fewer decisions are made on an intuitive basis. Mathematical models are used in making decisions. In many instances, these models are made with the use of the computer and help evaluate the the course of action. The accountant can, with his overall view of the firm's position, assist management in deciding which course of action should be taken with the use of the models.

Establishing effective performance evaluation aided by financial reports is a cooperative accounting-management project. Internal financial statements should correspond with control objectives.

A most important type of management control is internal control. In order for the financial statements to be reliable, there must be adequate internal control. Management has the responsibility for devising, installing, and currently supervising a system of internal control adequate to:

1. Safeguard the assets of an organization
2. Check the accuracy and reliability of accounting data
3. Promote the operational efficiency, and
4. Encourage adherence to prescribed managerial policies

and, for these purposes, to provide an appropriate plan of organization; an adequate system of authorization and record procedures; sound practices; and, lastly, personnel of appropriate number and capabilities.[4]

The accountant can make recommendations to management in either installing a system of internal control, if needed, or currently supervising a system of internal control.

Since no one system of internal control will provide all the safeguards and meet the requirements of every company irrespective of size and type, each company must establish a system which will meet the needs and requirements of that company. The accountant has to insure that the firm has an excellent system of internal control. A firm with an excellent system of internal control will run much smoother and more efficiently than a firm that has a weak internal control system.

Since management control involves human beings, from the lowest worker on the firms ladder to top management levels, there must be motivation. Without motivation, a firm will not survive. Management has to induce people into doing certain things and to refrain from others. A management that controls the actions of the people who are responsible for incurring costs with the least amount of friction will be the most successful.

Some of the factors in the employees' job should include the following to keep the problems to a minimum. The job should allow for achievement opportunities. Opportunity for increased responsibility, which improves the understanding of the overall assignment's significance. The job description should be open-ended so that there is an opportunity for creativity. There should be advancement that presents orders of tasks to the employee and gives him the opportunity to experience successful decision-making. The job should be of direct interest to the

employee so that it will stimulate a sense of individuality. Also, the area surrounding the working area should be clean, well lighted, and well ventilated to obtain a good working condition.

Although the accountant probably will not be directly responsible for the above factors, he should be aware of them. Communication is the basic tool of human relations. It consists of two basic elements: talking and listening. The accountant should be able to do both very well. By communicating with employees while doing his job, one can possibly make recommendations to management on certain problems. A good accountant that can spot psychological problems can be invaluable to a firm.

Footnotes to Chapter III

[1] I. Wayne Keller, "The Link Between Accounting and Management," Management Accounting (June, 1969), 36-40.

[2] Ibid.

[3] Robert N. Anthony, Management Accounting Principles (Homewood, Illinois: Richard D. Irwin, Incorporated, 1970), p. 306.

[4] Special Report by the Committee on Auditing Procedure--Internal Control, American Institute of Certified Public Accountants, p. 17.

IV. SUMMARY

Yes, the field of accounting has expanded in the last 50 years, and it will continue to expand. The accountant has improved and added to his skills. Management has shifted from intuition to information for decision making and is increasing demands for information and are better trained to use it.

Management is judged according to its ability to earn profits. How well management earns profits depends upon the communication between the accountant and management.

The accountant must first determine the purposes to be served by accounting and related data. Then he develops concepts, practices, and principles, which will achieve these purposes. He constructs an information system based on these fundamentals. He administers the system. He decides when changes in the system shall be made, either to meet permanent changes in uses of the data or temporary special requirements. He devises the format of the output. Only when all of these responsibilities have been met, does he reach, as stated by Keller, "the final link of the chain--interpretation."[1] This is the link which joins accounting to management.[2]

To be of maximum service, the accountant must have a working knowledge of the areas of management in which the users of his product are working. With this knowledge, the accountant can provide information vital to a going concern. This information can include budgets, financial statements, ratio analysis, comparative statements, and other special reports.

The accountant can then help management analyze the statements in order to assist management in making decisions. Managerial decisions are never simple to make. There is always a multitude of data essential in making a decision. Although not every business decision involves accounting information, whenever such information is involved it is an extremely important consideration.

After the information is provided and analyzed, it must be put to good use. The information must be used to provide management control. This control must assure that the resources are obtained and used effectively and efficiently in accomplishing the firm's goals and objectives.

For control to be effectively used, there must be proper motivation. Although the accountant will not be directly involved in motivation, there are many opportunities to be involved indirectly. Proper motivation can be very valuable in making a successful firm.

The accountant's role in management can be unlimited. When all his responsibilities are met, he can be the final link that joins

accounting and management. Yes, the possibilities of the future are infinite.

Footnotes to Chapter IV

[1]I. Wayne Keller, "The Link Between Accounting and Management," Management Accounting (June, 1969), 36-40.

[2]Ibid.