15.963 Management Accounting and Control
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Prof. Mozaffar Khan

MIT Sloan School of Management

Financial and Management Accounting: Basic Features

- Some key differences between financial and management accounting are as follows:
  - Audience
    - Financial – External (and Internal): Stockholders, creditors, tax authorities….
    - Management – Internal: managers
  - Purpose
    - Financial – valuation and stewardship assessment.
    - Management – to make decisions, communicate strategy, evaluate performance, control/align behavior.

Financial and Management Accounting: Basic Features

- Some key differences between financial and management accounting are as follows:
  - Timeliness
    - Financial –historical or ex post; at regular intervals; relatively long reporting periods
    - Management – Current, and future oriented, but also historical for control; reporting periods depend on need
  - Regulation
    - Financial – regulated; rules driven by generally accepted accounting principles and government authorities
    - Management – no regulations; systems and information determined by management to meet strategic and operational needs; not required by law

Financial and Management Accounting: Basic Features

- Some key differences between financial and management accounting are as follows:
  - Type of Information
    - Financial – financial measurements only
    - Management – financial plus operational and physical measurements on processes, technologies, suppliers, customers, and competitors
  - Qualitative Characteristics of Information
    - Financial – auditable, reliable
    - Management – not subject to audit, could be more subjective

Financial and Management Accounting: Basic Features

- Some key differences between financial and management accounting are as follows:
  - Scope
    - Financial – highly aggregated; report on entire organization
    - Management – not aggregated; informs local decisions and actions
  - Behavioral distortions
    - Financial – primarily reports economic events but also influences behavior because, e.g., manager's compensation is often based on reported financial results
    - Management –could distort the behavior of managers and other employees, because of link to performance evaluation and reward system

Managerial Accounting

- Managerial accounting is broad.
  - It straddles competitive strategy, organizational economics, finance, operations management and organizational behavior.
  - It also provides useful knowledge for all organizational settings:
    - for-profits,
    - non-profits,
    - government agencies,
    - etc.

Managerial Accounting

- Here are some topics we will cover.
- As they will illustrate, the demand for managerial accounting info stems from its use in:
  - Decision Making and Planning
  - Cost Management
  - Strategic Cost Management
  - Management Control

Decision Making and Planning

- Managers make decisions, and therefore need information. Some common decisions we will study are:
  - suppose your company makes medical probes.
    - In July, you receive a call from a company that is not a regular customer.
    - They would like to purchase 5000 probes this month only, and the price they offer is below your production cost.
    - Should you accept this one-time special order, and under what circumstances?
    - What information do you need to make this decision?
  - suppose each probe costs $10 to produce, and 70% of this cost is due to one part, a fibre optic wire, that you also manufacture.
    - Should you continue to make this costly part, or should you buy it from an outside vendor, and under what circumstances?
    - What information do you need?

Decision Making and Planning

- Managers make decisions, and therefore need information.
  Some common decisions we will study are:
  - suppose you manufacture five other types of medical devices.
    - Should you add another product line, or drop a line, and under what circumstances?
    - What information do you need?
  - suppose you are planning for the upcoming year, and you need to determine how many units to sell to breakeven, or to make a target profit figure.
    - What information do you need?

Decision Making and Planning

- In public policy debates, an example of a decision might be:
  - palliative care or not for cancer patients – what is the cost;
  - what is the objective, to minimize cost or something else?

Cost Management

- We used cost estimates to make the decisions illustrated above.
- But how are these costs determined or measured.
  - Understanding cost measurement helps us manage costs.
  - Managing cost is especially important today because of:
    - global competition, that requires better knowledge of costs.
      - Some companies choose a low cost leadership strategy.
      - Measuring and managing costs is the lynchpin of this strategy;

Cost Management

- global competition also requires focus on quality.
    - Improved quality can result from process improvements made during the course of identifying cost drivers, since streamlined process generally improves quality;
    - It can also come from reduction of waste, which comes from better measurement of waste;

- some companies choose a product differentiation strategy, which requires analysis of costs from customers viewpoint.
    - What features are worthwhile to customers?
    - This requires looking at cost from customers' viewpoint, and eliminating costs that are not valued;

Cost Management

- Managing cost is especially important today because of:
  - shorter – 2 to 3 years – product life cycles, which require more accurate up-front projections about profitability of proposed investment, and leave less room for error in production planning and product costing;
  - increasing automation, which means that labor is no longer the only major overhead cost driver.
    - This requires more care in identifying, measuring and managing cost drivers.

Cost Management

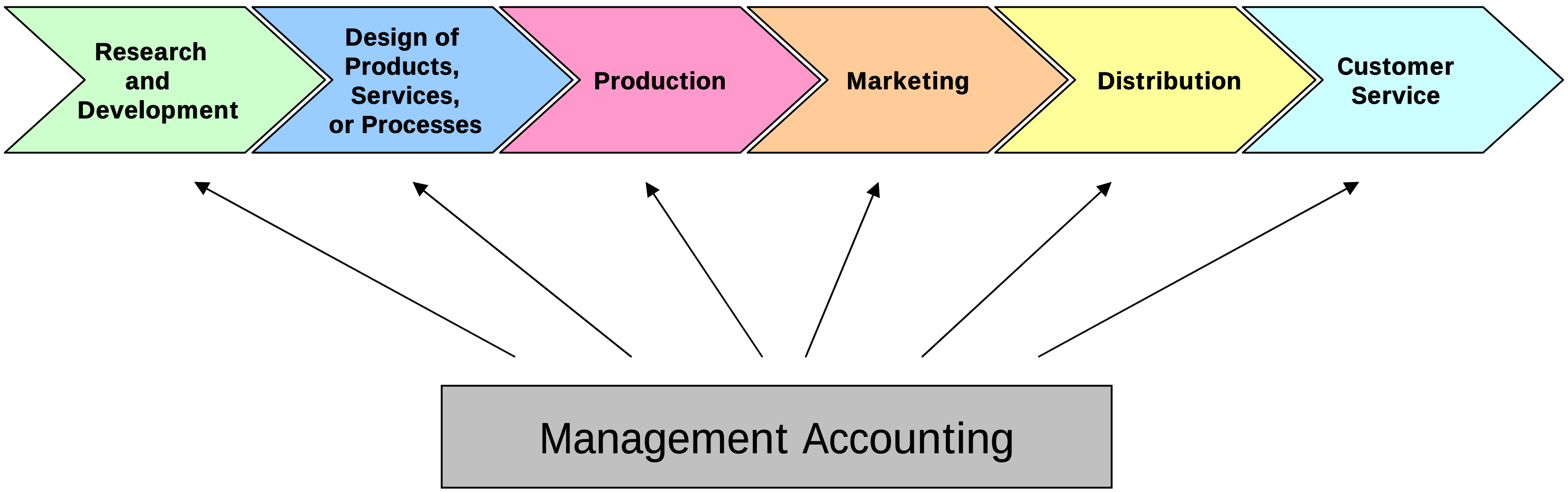
- In product costing, we will shed light on some of the following issues:
  - What is the true cost of a product?
    - This is not as straightforward as it seems.
    - For example, Roberts vs. GSA and cost of federal courts – why the half billion dollar discrepancy?
  - Reported cost is malleable, and can be exploited.
    - E.g., Stanford yacht.
    - Cost-plus contracts vulnerable, therefore carefully specify which costs qualify.
  - How can we refine cost estimates?
  - What is the cost of excess capacity?
    - How much is optimal?
    - Who should bear this cost?

Strategic Cost Management

- This requires finding and eliminating non-value-added activities, structures, etc. in the business ecosystem, rather than just within the business itself.
  - It requires understanding of ecosystem, the value chain and supply chain.
  - The supply chain is the sequence activities that transform the raw materials into finished goods delivered to the consumer.
  - The value chain is the portion of the supply chain within the company.

Management Accountant's Role in Implementing Strategy

- Different Parts of the Value Chain



Strategic Cost Management

- Strategic cost management requires going beyond providing information demanded by specific decisions, to proactively identifying, measuring and managing key cost drivers within the entire supply chain.
  - Examples of strategic cost management initiatives include measuring customer profitability, and working with suppliers to implement JIT.
  - Incorporate cost into product design : controlling parts proliferation; target costing

Management Control

- This refers to performance evaluation, incentive alignment and minimizing divergence of actual results from desired results.
  - In the discussion above, we assumed neutrality of information (i.e., freedom from bias).
  - Now we introduce bias, by recognizing the presence of agency issues.
    - These arise because the interests of the business owners are not perfectly aligned with the self interest of the owners' agents – firm managers and employees.
    - Decentralized organizations require the assignment of decision rights to points (people) further away from the owner.

Management Control

- To control, or minimize, agency issues requires measuring or evaluating performance and rewarding agents appropriately.
  - How do we measure both organizational and individual performance – which metrics should we use and what are their implications?
    - Measure should be ‘hard’ or verifiable. E.g., RAF bomber command.
    - Performance metrics determine rewards, and therefore behavior, which in turn influences profits.
    - Inappropriate metrics can have costly consequences. E.g., CMS uses timing of pneumonia-related antibiotic therapy as performance measure.

Management Control

- One of the concepts we will highlight is that using a piece of information for control impairs its use for decision making.
    - For example, getting projected sales from salespeople when preparing the budget.
        - This problem is especially salient in large, decentralized organizations, in organizations where specialized knowledge is required for decision making and where decision timeliness is critical.

Management Control

- We will study some of the following management control tools and concepts:
  - (a) budgets (aid in control not just planning);
  - (b) transfer prices, or internal prices which aid in control of resource usage;
  - (c) the controllability principle and relative performance evaluation (RPE may be older than suspected – Hammurabi's code)
  - (d) responsibility accounting and responsibility centers;
  - (e) variance analysis;
  - (f) multiple performance measures and non-financial performance measures.

External Environment and Management Accounting

- Shocks in the external environment feed through and affect management accounting, e.g.,
  - manufacturers using just-in-time inventories

Summary

- The role of managerial accountants is
    - identification,
    - measurement, and
    - management
  - of key operational and financial value drivers (Institute of Management Accountants, 1999).
- Managerial accountants are
    - problem solvers (e.g., providing information for decision making),
    - scorekeepers (e.g., measuring performance of individuals, groups and processes), and
    - attention directors (e.g., strategic cost management).