CHAPTER 1: INTRODUCTION OF MANAGEMENT ACCOUNTING

DEFINITION OF MANAGEMENT ACCOUNTING

Management accounting is not a specific system of accounting. It could be any form of accounting which enables a business to be conducted more effectively and efficiently. It is largely concerned with providing economic information to mangers for achieving organizational goals. It is an extension of the horizon of cost accounting towards newer areas of management. Much management accounting information is financial in nature but has been organized in a manner relating directly to the decision on hand.

Management Accounting is comprised of two words ‘Management’ and ‘Accounting’. It means the study of managerial aspect of accounting. The emphasis of management accounting is to redesign accounting in such a way that it is helpful to the management in formation of policy, control of execution and appreciation of effectiveness. Management accounting is of recent origin. This was first used in 1950 by a team of accountants visiting U. S. A under the auspices of Anglo-American Council on Productivity.

- Anglo-American Council on Productivity defines Management Accounting as, “the presentation of accounting information in such a way as to assist management to the creation of policy and the day to day operation of an undertaking”
- The American Accounting Association defines Management Accounting as “the methods and concepts necessary for effective planning for choosing among alternative business actions and for control through the evaluation and interpretation of performances”.
- The Institute of Chartered Accountants of India defines Management Accounting as follows: “Such of its techniques and procedures by which accounting mainly seeks to aid the management collectively has come to be known as management accounting”

From these definitions, it is very clear that financial data is recorded, analyzed and presented to the management in such a way that it becomes useful and helpful in planning and running business operations more systematically.

OBJECTIVES OF MANAGEMENT ACCOUNTING

The fundamental objective of management accounting is to enable the management to maximize profits or minimize losses. The evolution of management accounting has given a new approach to the function of accounting. The main objectives of management accounting are as follows:

- **Planning and policy formulation**: Planning involves forecasting on the basis of available information, setting goals; framing polices determining the alternative courses of action and deciding on the programme of activities. Management accounting can help greatly in this direction. It facilitates the preparation of statements in the light of past results and gives estimation for the future.
- **Interpretation process:** Management accounting is to present financial information to the management. Financial information is technical in nature. Therefore, it must be presented in such a way that it is easily understood. It presents accounting information with the help of statistical devices like charts, diagrams, graphs, etc.
- **Assists in Decision-making process:** With the help of various modern techniques management accounting makes decision-making process more scientific. Data relating to cost, price, profit and savings for each of the available alternatives are collected and analyzed and provides a base for taking sound decisions.
- **Controlling:** Management accounting is a useful for managerial control. Management accounting tools like standard costing and budgetary control are helpful in controlling performance. Cost control is effected through the use of standard costing and departmental control is made possible through the use of budgets. Performance of each and every individual is controlled with the help of management accounting.
- **Reporting:** Management accounting keeps the management fully informed about the latest position of the concern through reporting. It helps management to take proper and quick decisions. The performance of various departments is regularly reported to the top management.
- **Facilitates Organizing**: "Return on Capital Employed" is one of the tools of management accounting. Since management accounting stresses more on Responsibility Centers with a view to control costs and responsibilities, it also facilitates decentralization to a greater extent. Thus, it is helpful in setting up effective and efficiently organization framework.

- **Facilitates Coordination of Operations**: Management accounting provides tools for overall control and coordination of business operations. Budgets are important means of coordination.

NATURE AND SCOPE OF MANAGEMENT ACCOUNTING

Management accounting involves furnishing of accounting data to the management for basing its decisions. It helps in improving efficiency and achieving the organizational goals. The following paragraphs discuss about the nature of management accounting.

- **Provides accounting information:** Management accounting is based on accounting information. Management accounting is a service function and it provides necessary information to different levels of management. Management accounting involves the presentation of information in a way it suits managerial needs. The accounting data collected by accounting department is used for reviewing various policy decisions.
- **Cause and effect analysis:** The role of financial accounting is limited to find out the ultimate result, i.e., profit and loss; management accounting goes a step further. Management accounting discusses the cause and effect relationship. The reasons for the loss are probed and the factors directly influencing the profitability are also studied. Profits are compared to sales, different expenditures, current assets, interest payables, share capital, etc.
- **Use of special techniques and concepts:** Management accounting uses special techniques and concepts according to necessity to make accounting data more useful. The techniques usually used include financial planning and analyses, standard costing, budgetary control, marginal costing, project appraisal, control accounting, etc.
- **Taking important decisions:** It supplies necessary information to the management which may be useful for its decisions. The historical data is studied to see its possible impact on future decisions. The implications of various decisions are also taken into account.
- **Achieving of objectives**: Management accounting uses the accounting information in such a way that it helps in formatting plans and setting up objectives. Comparing actual performance with targeted figures will give an idea to the management about the performance of various departments. When there are deviations, corrective measures can be taken at once with the help of budgetary control and standard costing.
- **No fixed norms:** No specific rules are followed in management accounting as that of financial accounting. Though the tools are the same, their use differs from concern to concern.

The deriving of conclusions also depends upon the intelligence of the management accountant. The presentation will be in the way which suits the concern most.

- **Increase in efficiency:** The purpose of using accounting information is to increase efficiency of the concern. The performance appraisal will enable the management to pin-point efficient and inefficient spots. Effort is made to take corrective measures so that efficiency is improved. The constant review will make the staff cost — conscious.
- **Supplies information and not decision:** Management accountant is only to guide and not to supply decisions. The data is to be used by the management for taking various decisions. 'How is the data to be utilized' will depend upon the caliber and efficiency of the management.
- **Concerned with forecasting:** The management accounting is concerned with the future. It helps the management in planning and forecasting. The historical information is used to plan future course of action. The information is supplied with the object to guide management for taking future decisions.

LIMITATIONS OF MANAGEMENT ACCOUNTING

Management Accounting is in the process of development. Hence, it suffers from all the limitations of a new discipline. Some of these limitations are:

- **Limitations of Accounting Records**: Management accounting derives its information from financial accounting, cost accounting and other records. It is concerned with the rearrangement or modification of data. The correctness or otherwise of the management accounting depends upon the correctness of these basic records. The limitations of these records are also the limitations of management accounting.
- **It is only a Tool:** Management accounting is not an alternate or substitute for management. It is a mere tool for management. Ultimate decisions are being taken by management and not by management accounting.
- **Heavy Cost of Installation**: The installation of management accounting system needs a very elaborate organization. This results in heavy investment which can be afforded only by big concerns.
- **Personal Bias:** The interpretation of financial information depends upon the capacity of interpreter as one has to make a personal judgment. Personal prejudices and bias affect the objectivity of decisions.

- **Psychological Resistance**: The installation of management accounting involves basic change in organization set up. New rules and regulations are also required to be framed which affect a number of personnel and hence there is a possibility of resistance from some or the other.
- **Evolutionary stage:** Management accounting is only in a developmental stage. Its concepts and conventions are not as exact and established as that of other branches of accounting. Therefore, its results depend to a very great extent upon the intelligent interpretation of the data of managerial use.
- **Provides only Data:** Management accounting provides data and not decisions. It only informs, not prescribes. This limitation should also be kept in mind while using the techniques of management accounting.
- **Broad-based Scope:** The scope of management accounting is wide and this creates many difficulties in the implementations process. Management requires information from both accounting as well as non-accounting sources. It leads to inexactness and subjectivity in the conclusion obtained through it.

Difference between Cost Accounting and Management Accounting:

Basis	Cost Accounting	Management Accounting
Meaning	Cost accounting is an accounting system that aspires to capture an enterprise's costs of manufacturing by evaluating the input costs of every step of manufacturing as well as the fixed costs, namely, depreciation of capital equipment.	Management Accounting refers to the outlining of financial and non-financial data for the utilisation of management of the enterprise. It is also known as managerial accounting.
Data type	Quantitative	Both Quantitative and Qualitative
Scope	Focused on distribution, allocation, determination and accounting factors of the cost	Convey (impart) and effect factor of the cost
Objective	Determined in cost production	Furnishing data to the managers to fix goals and anticipate strategies

Specific procedure	Yes	No
Planning	Short term planning	Both Short and long term planning
Recording	Records both past and present data	Focuses more on scrutinizing for future projects
Interdependency	Can be installed without a Management accounting	Cannot be installed without cost accounting

Difference between Financial Accounting and Management Accounting:

BASIS FOR COMPARISON	FINANCIAL ACCOUNTING	MANAGEMENT ACCOUNTING
Meaning	Financial Accounting is an accounting system that focuses on the preparation of a financial statement of an organization to provide financial information to the interested parties.	The accounting system which provides relevant information to the managers to make policies, plans and strategies for running the business effectively is known as Management Accounting.
Orientation	Historical	Future
Users	Both internal and external users	Only internal users
Nature of statements prepared	General-purpose financial statements	Special purpose financial statements
Rules	Rules of GAAP are followed	No fixed rules for the preparation of reports
Reports	Only financial aspects	Both financial and non-financial aspects
Time Span	Financial statements are prepared for a fixed period, i.e. one year.	Management Reports are prepared whenever needed.
Objective	To create periodical reports	To assist internal management in planning and decision-making process by providing detailed information on various matters.
Publishing and auditing	Required to be published and audited by statutory auditors	It is not meant to be published or audited. It is for internal use only.
Format	Specified	Not Specified

Definition of Cost Control

Cost Control is a process in which we focus on controlling the total cost through competitive analysis. It is a practice which works to align the actual cost in agreement with the established norms.

It ensures that the cost incurred on production should not go beyond the pre-determined cost. Cost Control involves a chain of various activities, which starts with the preparation of the budget in relation to production.

Thereafter we evaluate the actual performance. After that we compute the variances between the actual cost & the budgeted cost and further, we find out the reasons for the same. Finally, we implement the necessary actions for correcting discrepancies.

The major techniques which used in cost control are standard costing and budgetary control. It is a continuous process which helps in analyzing the causes for variances. For example- control wastage of material, any embezzlement and so on.

It involves:

1. Determination of standards;
2. Ascertaining actual results comparing the standards;
3. An analysis of the variances;
4. Establishing the action that may be taken.

Characteristics of a Good Cost Control System

According to backer and Jacobson, effective cost control should have the following characteristics :

(a) Delineation of centers responsibility, i.e., deciding responsibility centers;

(b) The delegation of prescribed authority;

(c) Various cost standards;

(d) The relevance of controllable cost;

(e) Cost reporting; and

(f) Cost reduction

Definition of Cost Reduction

Cost Reduction is a process, which aims to lower the unit cost of a product manufactured or service rendered without affecting its quality. It can be done by using new and improved methods and techniques. It ascertains substitute ways to reduce the production cost of a unit.

Thus, cost reduction ensures savings in per unit cost and maximization of profits of the enterprise. Cost Reduction aims at cutting off the unnecessary expenses which occur during the production Process, storage, selling and distribution of the product. To identify cost reduction we should focus on the following major elements:

- Savings in per unit production cost.
- The quality of the product should not be affected.
- Savings should be non-volatile in nature.

Tools of cost reduction focus on Quality operation and research, Improvement in product design, Job Evaluation & merit rating, variety reduction, etc.

Difference between Cost Control and Cost Reduction

The following are the main differences between Cost Control and Cost Reduction:

1. Cost Control focuses on decreasing the total cost of production while cost reduction focuses on decreasing per unit cost of a product.
2. Cost Control is a temporary process in nature. Unlike Cost Reduction which is a permanent process.
3. The process of cost control will be completed when the specified target is achieved. Conversely, the process of cost reduction is a continuous process. It has no visible end. It targets for eliminating wasteful expenses.
4. Cost Control does not guarantee quality maintenance of products. However, cost reduction assured 100% quality maintenance.
5. Cost Control is a preventive function because it ascertains the cost before its occurrence. Cost Reduction is a corrective function.

What is cost management?

Cost management is the process of planning and controlling the budget of a business. Having a good cost management system in place makes it easier for an organization to estimate and allocate its budget.

Cost management is a form of management accounting that helps a business reduce the chance of going over budget with more accurate forecasts of impending expenditures. Many businesses use cost management tactics for specific projects and for the overall business.

When applied to a project, expected costs are calculated while the project is being planned and are approved beforehand. All project expenses are recorded and monitored to ensure they align to the cost management plan. After the project is finished, the actual total costs are compared to the predicted costs. This analysis enhances future cost management predictions and cost budgeting.

While *cost management* is a general term relating to project cost management in any industry, it also often refers to estimating and managing cloud services costs to reduce cloud waste.

4 steps of cost management

Cost management is an integral part of project planning and management. Cost management strategies are developed alongside the project plan.

The following are the four main steps to cost management.

1. Setup

The setup phase determines what's included in the cost management plan. It identifies who the stakeholders in the plan are, the tools used to manage costs and the data structure needed to track costs.

2. Resource planning

This planning phase identifies the resources needed to complete a project. These could be physical materials, information assets, staff and cloud computing resources. Resource planning determines resource allocation, including how much of a resource is needed, for how long and how it will be allocated.

3. Budgeting and cost estimation

In this stage, project teams develop a project budget. Budgeted cost estimates get more specific as the project scope is refined. A picture of the full project costs emerges as resources are allocated.

Project managers compare the current project to earlier ones to gain insight. They can use top-down and bottom-up estimation methods. In the top-down approach, upper management in an organization determines the project duration, the tasks and project activities involved and the estimated costs for each of them. In a bottom-up approach, each team estimates the duration and allocated budget of their individual tasks. Management uses that information to determine the project's duration and estimated budget.

4. Cost control

This phase involves monitoring and controlling costs as the project progresses, using data from different project teams. Managers track how costs differ from the estimated budget and take action to accommodate cost overruns, reduce deviations from the budget and cap the budget when necessary.

Effective cost management processes require accurate cost reporting. This involves access to real-time cost data and insight using data visualization. Variances from budgeted costs must be measured, and corrective measures taken.

Benefits of cost management

The benefits of cost management include the following:

- **Reduces overspending.** Cost controls help project managers keep their budget on track and not let costs get out of control.
- **Encourages planning.** Cost management helps identify what is and isn't working. It provides insight into resources and processes that helps managers make faster and better decisions about the current project and future ones.
- **Facilitates financial health.** Continuous monitoring, cost control and cost reporting contribute to a company's long-term financial health. These efforts provide the data necessary for good decision-making. Implementing a cost management structure for projects helps a business keep its overall budget under control.
- **Mitigates risk.** Cost management typically involves setting a risk allowance for unforeseen costs, a useful step to prevent overspending.
- **Supports standards.** Consistent cost control, analysis and reporting help organizations adopt standards for assessing future cost data and productivity levels.
- **Improves visibility.** Many cost management tools for cloud services give real-time visibility into cost management metrics, like savings. They also provide a list of the users' assets, and some use machine learning to provide suggestions on areas where users can change behaviors to save money.

Challenges of cost management

Common challenges of cost management include the following:

- **Change management.** Project changes are inevitable. Teams must be able to adapt to changing circumstances and manage the budget accordingly.
- **Effective communication.** Reporting can be perceived in different ways, depending on who sees it. A project manager may view results differently than project stakeholders.
- **Tool sprawl.** Lack of a dedicated project management or cost management tool can make managing cost over multiple tools difficult and complex. This can cause data integrity issues and hamper reporting and visualization capabilities.

- **Project scope.** Poorly defined project scope can lead to cost overruns from inaccurate estimates.
- **Underestimation.** If a project manager underestimates costs that go into a budget, it can lead to a lack of resources and project delays.
- **Vendor lock-in.** Some cloud vendors offer proprietary tools to help IT teams calculate the cost of using their service. The downside of this is that the tool only works with their service, and this locks the client into using the service.

Cost management tools

While cost management software is useful, it's not imperative for executing a cost management plan. These tools commonly include the following functions:

- budgeting
- time tracking
- reporting
- analytics

Several business intelligence programs offer cost management software to help organizations monitor costs and increase profitability. Some of these include Google's Looker, Microsoft Power BI and Oracle Analytics Cloud.

Cloud vendors also offer proprietary cost management tools to help users track and optimize costs. Two such tools are the following:

1. **Azure cost management tools.** The Azure cloud computing service includes a pricing calculator, alerts and dashboards that let Azure users optimize their spending and clearly monitor use. Cloud users are charged per use, sometimes per second, so using these tools is important for keeping costs down. These tools integrate with Azure budgets for planning and cost optimization. Azure cost alerts aid monitoring and tracking, and Azure cost analysis can suggest potential adjustments based on monthly cost breakdowns. The tool also integrates with other third-party tools, such as VMware Aria Cost and Apptio Cloudability.

2. **Amazon Web Services (AWS) Cost Management.** This tool set provides dashboards and billing reports that help users track AWS cloud use and set budget goals. AWS Cost Management tools included are AWS Budgets, AWS Cost Explorer, AWS Cost and Usage Report, and AWS Cost Anomaly Detection, which uses machine learning to monitor cloud use and detect unusual spending.