

MANAGEMENT ACCOUNTING FOR DECISION MAKERS

TENTH EDITION

Peter Atrill
Eddie McLaney

 Pearson

MANAGEMENT ACCOUNTING FOR DECISION MAKERS



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Peter Atrill and
Eddie McLaney



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PEARSON EDUCATION LIMITED

KAO TWO
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Harlow CM17 9NA
United Kingdom
Tel: +44 (0)1279 623623
Web: www.pearson.com/uk

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Lecturer Resources

For password-protected online resources tailored to support the use of this textbook in teaching, please visit go.pearson.com/uk/he/resources

ON THE WEBSITE



Preface

Welcome to the tenth edition of *Management Accounting for Decision Makers*. This book is directed primarily at those following an introductory course in management accounting. Many readers will be studying at a university or college, perhaps majoring in accounting or in another area, such as business studies, IT, tourism or engineering. Other readers, however, may be studying independently, perhaps with no qualification in mind.

The book is written in an ‘open learning’ style, which has been adopted because we believe that readers will find it more ‘user-friendly’ than the traditional approach. Whether they are using the book as part of a taught course, or for personal study, we feel that the open learning approach makes it easier for readers to learn.

In writing this book, we have been mindful of the fact that most readers will not have studied management accounting before. We have tried to make the topic accessible to readers in a number of ways. This includes avoiding unnecessary jargon. Where technical terminology is unavoidable, we have given clear explanations. At the end of the book (in Appendix A) there is a glossary of technical terms, which readers can use to refresh their memory if they come across a term whose meaning is in doubt. In the book, we also introduce topics gradually, explaining everything as we go. We have included frequent questions and tasks of various types to try to help readers to understand the subject fully, in much the same way as a good lecturer would do in lectures and tutorials. These questions and tasks have been framed in a way that is designed to encourage readers to help improve their critical thinking. Many of the questions and tasks require readers to think beyond the material in the text and/or to link the current topic with material covered earlier in the book. More detail on the nature and use of these questions and tasks is given in the ‘How to use this book’ section immediately following this preface.

A note to students from the authors

Management accounting is concerned with providing information to those who need to make financial/economic decisions about their organisation. Such decisions could involve such things as:

- assessing how much inventories (stock) a retail outlet should hold for optimal profitability;
- deciding whether to abandon a particular product by a manufacturing business on the basis of its profitability;
- appraising the economic desirability of investing in new equipment that would enable a business to provide a new service to its customers; and
- a government weighing the costs and benefits of building a high-speed rail link from London to Birmingham and the North.

It should be clear that these types of decision have a real impact on businesses, those who work for them and for their customers. Getting these decisions wrong could have profound effects, perhaps leading to a business collapsing, throwing its employees out of work and

depriving customers of a product or service that they wish to buy. In the case of the rail link, the impact is felt by the taxpayer who will fund the project, people who live on or near the proposed route and, eventually, those who will travel on the line.

To relate the subject matter of the book to real life, each chapter includes a number of 'Real world' examples. These are generally short case studies that examine how a particular business has approached a particular management accounting issue. In some cases, they are presentations of research evidence as how organisations, in general, deal with such issues. Evidence from students who have used past editions indicates that these can help to bring the subject to life.

When you have completed your studies and are working in an organisation, you will need to have the ability to solve problems. It is also crucial for you to be able to communicate your solutions to colleagues and to customers. To do this you will need to develop a capacity to think critically. 'Critical thinking' can be defined as the analysis of facts to form a judgement. In analysing the facts, it is important that factual evidence is used in a logical way. It is also important that a sceptical and questioning approach to the evidence is applied. When recruiting, organisations are increasingly looking for evidence that potential employees can think critically when seeking to solve problems.

In writing this book, we have been aware of the need to encourage critical thinking. The 'Activities' (typically short questions) that are interspersed throughout the book are designed, among other things, to try to develop the appropriate critical thinking skills. This is also true of the 'Critical review questions' at the end of each chapter. Similarly with many of the end-of-chapter 'Exercises'.

We hope that students will find the book readable and helpful.

A note to lecturers and tutors from the authors

In this edition, we have taken the opportunity to improve the book. We have expanded on the changing role of management accountants to enable them to retain their place at the centre of the decision-making and planning process. In Chapter 1, we have included the recently developed statement of Global Management Accounting Principles. These principles have been identified (by the leading management accounting professional bodies in the UK and US) as those to be followed when determining the information that managers need. In Chapter 7, we have brought in a discussion of current thinking and practice in the area of management control. Throughout this new edition, we have included additional, and more up-to-date, examples of management accounting in practice. We have also added more in-chapter questions and diagrams.

This text is supported by its own MyLab Accounting which is an environment that gives unlimited opportunities for practice using a range of questions, and which provides timely feedback. Updates to MyLab Accounting for the 10th edition include the enhancement of over 45 previously static questions so that these are now algorithmic, which means that each student is able to work on a numerical problem that is individual to him or her. In addition to the Case Studies, useful self-study suggestions in the Study Plan, and vast range of exercises (over 940) to select from, better feedback has been incorporated in MyLab Accounting for this edition, providing a greater quality of response to help students learn from their incorrect answers and make progress in their learning.

For access to MyLab Accounting, students need both a course ID and an access card (see the advert on the inside back cover of the book).

*Peter Atrill
Eddie McLaney*

How to use this book

Whether you are using the book as part of a lecture/tutorial-based course or as the basis for a more independent mode of study, the same approach should be broadly followed.

Order of dealing with the material

The contents of the book have been ordered in what is meant to be a logical sequence. For this reason, it is suggested that you work through the book in the order in which it is presented. Every effort has been made to ensure that earlier chapters do not refer to concepts or terms which are not explained until a later chapter. If you work through the chapters in the ‘wrong’ order, you may encounter points that have been explained in an earlier chapter which you have not read.

Working through the chapters

You are advised to work through the chapters from start to finish, but not necessarily in one sitting. Activities are interspersed within the text. These are meant to be like the sort of questions which a good lecturer will throw at students during a lecture or tutorial. Activities seek to serve two purposes:

- To give you the opportunity to check that you understand what has been covered so far.
- To try to encourage you to think beyond the topic that you have just covered, sometimes so that you can see a link between that topic and others with which you are already familiar. Sometimes, activities are used as a means of linking the topic just covered to the next one.

You are strongly advised to work through all the activities. Answers are provided immediately after each activity. These answers should be covered up until you have arrived at a solution, which should then be compared with the suggested answer provided.

Towards the end of Chapters 2–12, there is a ‘self-assessment question’. This is rather more demanding and comprehensive than any of the activities. It is intended to give you an opportunity to see whether you understand the main body of material covered in the chapter. The solutions to the self-assessment questions are provided in Appendix B at the end of the book. As with the activities, it is very important to make a thorough attempt at the question before referring to the solution. If you have real difficulty with a self-assessment question you should go over the chapter again, since it should be the case that careful study of the chapter will enable completion of the self-assessment question.

End-of-chapter assessment material

At the end of each chapter there are four ‘critical review questions’. These are short questions that require you to analyse a topic discussed in the chapter and to form a judgement. In providing that answer you will need to apply some critical thinking skills (see ‘Note to students

from the authors' in the Preface). The questions attempt to raise many of the key issues in the chapter concerned. Suggested answers to these questions are provided in Appendix C at the end of the book. Again, a serious attempt should be made to answer these questions before referring to the suggested answers.

At the end of each chapter, there are normally eight exercises. These are more demanding and extensive questions, mostly computational, and should further reinforce your knowledge and understanding. We have attempted to provide questions of varying complexity.

Answers to five out of the eight exercises in each chapter are provided in Appendix D at the end of the book. These exercises are marked with a coloured number, but a thorough attempt should be made to answer these questions before referring to the answers. Answers to the three exercises that are not marked with a coloured number are given in a separate teacher's manual.

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Chapter 1

INTRODUCTION TO MANAGEMENT ACCOUNTING

INTRODUCTION

Welcome to the world of management accounting! Management accounting is concerned with collecting and analysing financial and other information and then communicating this to managers. This information is intended to help managers within businesses and other organisations make better decisions. In this introductory chapter, we examine the role of management accounting within a business. To understand the context for management accounting, we begin by examining the nature and purpose of a business. Thus, we first consider what businesses seek to achieve, how they are organised and how they are managed. Having done this, we go on to explore how management accounting information can be used within a business to improve the quality of managers' decisions. We also identify the characteristics that management accounting information must possess to fulfil its role. Management accounting has undergone significant advances in response to changes in the business environment and to the increasing size and complexity of business entities. In this chapter we shall discuss some of the more important changes that have occurred.

Learning outcomes

When you have completed this chapter, you should be able to:

- identify the purpose of a business and discuss the ways in which a business may be organised and managed;
- discuss the issues to be considered when setting the long-term direction of a business;
- explain the role of management accounting within a business and describe the key principles upon which management accounting rests; and
- explain the changes that have occurred over time in both the role of the management accountant and the kind of information provided by management accounting systems.

WHAT IS THE PURPOSE OF A BUSINESS?

Peter Drucker, an eminent management thinker, has argued that *'The purpose of business is to create and keep a customer'* (see Reference 1 at the end of the chapter). Drucker defined the purpose of a business in this way in 1967, at a time when most businesses did not adopt this strong customer focus. His view therefore represented a radical challenge to the accepted view of what businesses do. Now, more than 50 years later, his approach forms part of the conventional wisdom. It is now widely accepted that, in order to succeed, businesses must focus on satisfying the needs of the customer.

Although the customer has always provided the main source of revenue for a business, this has often been taken for granted. In the past, too many businesses assumed that the customer would readily accept whatever services or products were on offer. When competition was weak and customers were passive, businesses could operate under this assumption and still make a profit. However, the era of weak competition has passed. Today, customers have much greater choice and are much more assertive concerning their needs. They now demand higher quality services and goods at cheaper prices. They also require that services and goods be delivered faster with an increasing emphasis on the product being tailored to their individual requirements. If a business cannot meet these criteria, a competitor often can. Thus, the business mantra for the current era is *'the customer is king'*. Most businesses now recognise this fact and organise themselves accordingly.

Real World 1.1 describes how the Internet and social media have given added weight to this mantra. It points out that dissatisfied customers now have a powerful medium for broadcasting their complaints.

Real World 1.1

The customer is king

The mantra that the 'customer is king' has gained even greater significance among businesses in recent years because of the rise of the Internet and social media. In the past, a dissatisfied customer might tell only a few friends about a bad buying experience. As a result, the damage to the reputation of the business concerned would normally be fairly limited. However, nowadays, through the magic of the Internet, several hundred people, or more, can be very speedily informed of the poor service.

Businesses are understandably concerned about the potential of the Internet to damage reputations, but are their concerns justified? Do customer complaints, which wing their way through cyberspace, have any real effect on the businesses concerned? A Harris Poll survey of 2,000 adults in the UK and US suggests they do and so businesses should be concerned. It seems that social media can exert a big influence on customer buying decisions.

The Harris Poll survey, which was conducted online, found that around 20 per cent of those surveyed use social media when making buying decisions. For those in the 18 to 34 age range, the figure rises to almost 40 per cent. Furthermore, 60 per cent of those surveyed indicated that they would avoid buying from a business that receives poor customer reviews for its products or services.

The moral of this tale appears to be that, in this Internet age, businesses must work even harder to keep their customers happy if they are to survive and prosper.

Source: Based on information in Miesbach, A. (2015) *Yes, the Customer Is Still King*, 30 October, www.icmi.com

HOW ARE BUSINESSES ORGANISED?

Nearly all businesses that involve more than a few owners and/or employees are set up as limited companies. Finance will come from the owners (shareholders) both in the form of a direct cash investment to buy shares (in the ownership of the business) and through the shareholders allowing past profits, which belong to them, to be reinvested in the business. Finance will also come from lenders (banks, for example) as well as through suppliers providing goods and services on credit.

In larger limited companies, the owners (shareholders) tend not to be involved in the daily running of the business; instead they appoint a board of directors to manage the business on their behalf. The board is charged with three major tasks:

- setting the overall direction for the business;
- monitoring and controlling the activities of the business; and
- communicating with shareholders and others connected with the business.

Each board has a chairman who is elected by the directors. The chairman is responsible for the smooth running of the board. In addition, each board has a chief executive officer (CEO) who leads the team that is responsible for running the business on a day-to-day basis. Occasionally, the roles of chairman and CEO are combined, although it is usually considered to be good practice to separate them. It prevents a single individual having excessive power.

The board of directors represents the most senior level of management. Below this level, managers are employed, with each manager being given responsibility for a particular part of the business's operations.

Activity 1.1

Why doesn't just one manager manage larger businesses as a single unit? Try to think of at least one reason.

Three common reasons are:

- The sheer volume of activity or number of employees makes it impossible for one person to manage them.
- Certain business operations may require specialised knowledge or expertise.
- Geographical remoteness of part of the business operations may make it more practical to manage each location as a separate part, or set of separate parts.

The operations of a business may be divided for management purposes in different ways. For smaller businesses offering a single product or service, separate departments are often created. Tasks are grouped according to functions (such as marketing, human resources and finance) with each department responsible for a particular function. The managers of each department will then be accountable to the board of directors. In some cases, a departmental manager may also be a board member. A typical departmental structure, organised along functional lines, is shown in Figure 1.1.

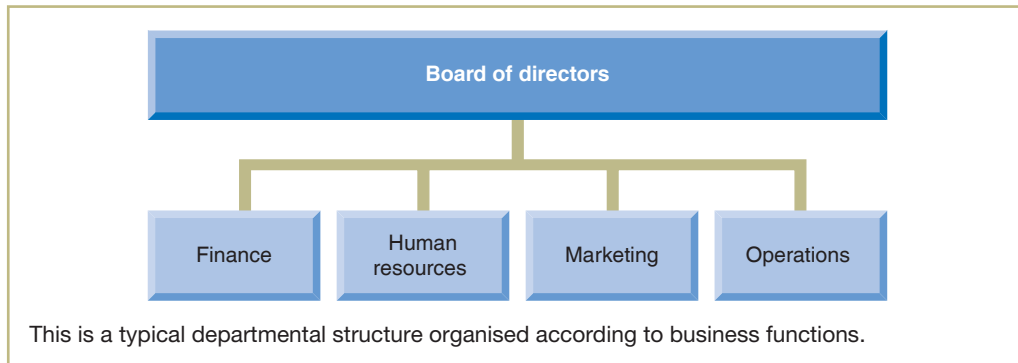


Figure 1.1 A departmental structure organised according to business functions

Departments based around functions permit greater specialisation, which, in turn, can promote greater efficiency. The departmental structure, however, can become too rigid. This can lead to poor communication between departments and, perhaps, a lack of responsiveness to changing market conditions.

The structure set out in Figure 1.1 may be adapted according to the particular needs of the business. Where, for example, a business has few employees, the human resources function may not form a separate department but rather form part of another department. Where business operations are specialised, separate departments may be created to deal with each specialist area. Example 1.1 illustrates how Figure 1.1 may be modified to meet the needs of a particular business.

Example 1.1

Supercoach Ltd owns a small fleet of coaches that it hires out with drivers for private group travel. The business employs about 60 people. It could be departmentalised as follows:

- *Marketing department*, dealing with advertising, answering enquiries from potential customers, maintaining good relationships with existing customers and entering into contracts with customers.
- *Routing and human resources department*, responsible for the coach drivers' routes, schedules, staff duties and rotas as well as problems that arise during a particular job or contract.
- *Coach maintenance department*, looking after repair and maintenance of the coaches, buying spares, and giving advice on the need to replace old or inefficient coaches.
- *Finance department*, responsible for managing cash flows, costing business activities, pricing new proposals, measuring financial performance, preparing budgets, borrowing, paying wages and salaries, billing and collecting amounts due from customers, and processing and paying invoices from suppliers.

For large businesses with a diverse geographical spread and/or a wide product range, the simple departmental structure set out in Figure 1.1 will usually have to be adapted. Separate divisions are often created for each geographical area and/or major product group. Each division will be managed separately and will usually enjoy a degree of autonomy. This can produce more agile responses to changing market conditions. Within each division, however,

departments are often created and organised along functional lines. Those functions that provide support across the various divisions, such as human resources, may be carried out at head office to avoid duplication. The managers of each division will be accountable to the board of directors. In some cases, individual board members may also be divisional managers.

A typical divisional organisational structure is set out in Figure 1.2. Here the main basis of the structure is geographical. Thus, North Division deals with production and sales in the north and so on.

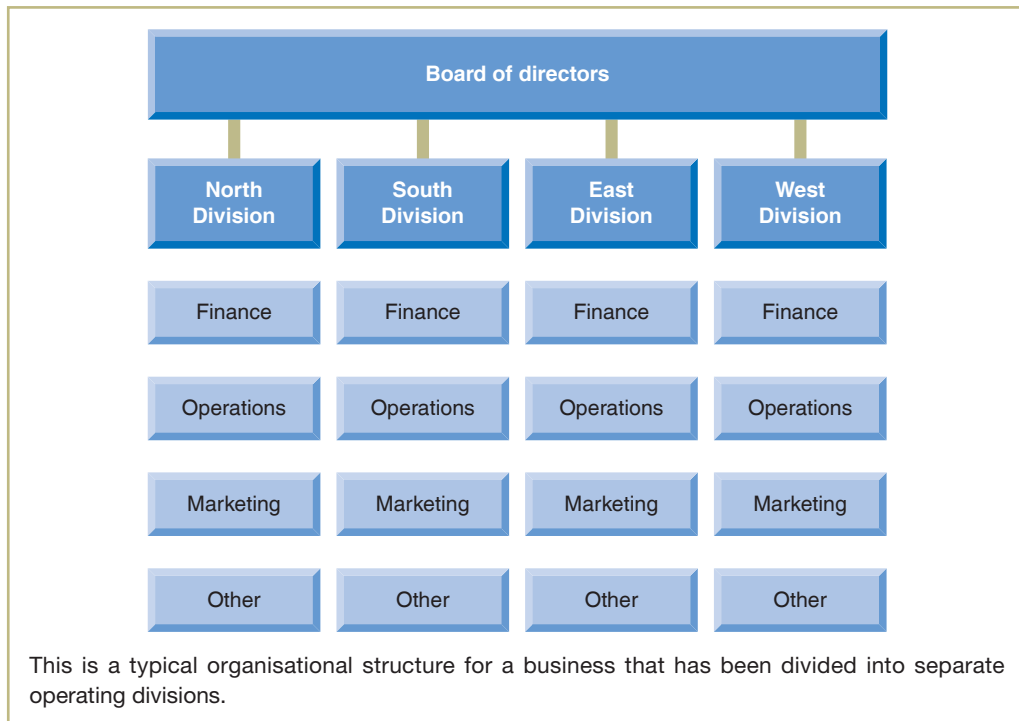


Figure 1.2 A divisional organisational structure

Once a particular divisional structure has been established, it need not be permanent. Successful businesses constantly strive to improve their operational efficiency. This could well result in revising their divisional structure. **Real World 1.2** includes an extract from a press release that describes how one well-known business restructured in order to simplify operations and to reduce costs.

Real World 1.2

Engineering change

Rolls-Royce plc, the engineering business, announced in 2018 that it would simplify its business operations. This involved consolidating its five operating divisions into three core units based around Civil Aerospace, Defence and Power Systems.

Chief Executive Warren East justified the restructuring of the business as follows:

Building on our actions over the past two years, this further simplification of our business means Rolls-Royce will be tightly focused into three operating businesses, enabling us to act with much



greater pace in meeting the vital power needs of our customers. It will create a Defence operation with greater scale in the market, enabling us to offer our customers a more integrated range of products and services. It will also strengthen our ability to innovate in core technologies and enable us to take advantage of future opportunities in areas such as electrification and digitalisation.

The business made the restructuring announcement not long after reporting a massive pre-tax loss of £4.6 billion. It is expected that the move towards a simpler structure will generate significant cost savings.

Source: Extract from Rolls-Royce (2018) Rolls-Royce announces further simplification of business, strategic review of Commercial Marine operation and plans to restructure support and management functions, Rolls-Royce.com Press Release, 17 January.

While both divisional and departmental structures are very popular in practice, it should be noted that other organisational structures will be found.

HOW ARE BUSINESSES MANAGED?

Over the past three decades, the environment in which businesses operate has become increasingly turbulent and competitive. Various reasons have been identified to explain these changes, including:

- the increasing sophistication of customers (as we have seen);
- the development of a global economy where national frontiers have become less important;
- rapid changes in technology;
- the deregulation of domestic markets (for example, electricity, water and gas);
- increasing pressure from owners (shareholders) for competitive economic returns; and
- the increasing volatility of financial markets.

The effect of these environmental changes has been to make the role of managers more complex and demanding. This, along with the increasing size of many businesses, has led managers to search for new ways to manage their businesses. One important tool that has been developed in response to managers' needs is **strategic management**. This is concerned with establishing the long-term direction for the business. It involves setting long-term goals and then ensuring that they are implemented effectively. To help the business develop a competitive edge, strategic management focuses on doing things differently rather than simply doing things better.

Strategic management provides a business with a clear sense of purpose along with a series of steps to achieve that purpose. The steps taken should link the internal resources of the business to the external environment of competitors, suppliers, customers and so on. This should be done in such a way that any business strengths, such as having a skilled workforce, are exploited and any weaknesses, such as being short of investment finance, are not exposed. To achieve this requires the development of strategies and plans that take account of the business's strengths and weaknesses, as well as the opportunities offered and threats posed by the external environment. Access to a new, expanding market is an example of an opportunity; the decision of a major competitor to reduce prices is an example of a threat.

Real World 1.3 provides an indication of the extent to which strategic planning is carried out in practice.

Real World 1.3

Strategic planning high on the list

A recent survey investigated the use of various management tools throughout the world. It found that strategic planning is used by 48 per cent of those businesses that took part in the survey. This made it the most popular management tool. The survey, which is conducted annually, has ranked strategic planning highly, in terms of both usage and satisfaction, over many years. Figure 1.3 reveals the level of usage and satisfaction concerning this technique.

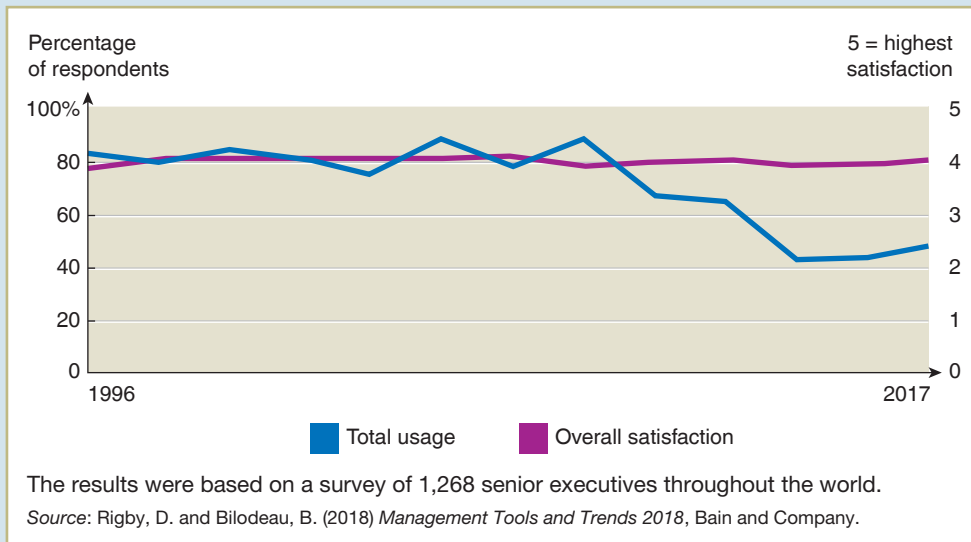


Figure 1.3 The level of satisfaction with, and usage of, strategic planning

We can see that the level of satisfaction with this technique has remained remarkably stable over time. However, there has been a decline in usage in recent years.

The strategic management process may be approached in different ways. One popular approach, involving five steps, is described below.

1 Establish mission, vision and objectives

The first step is to establish the mission of a business, which may be set out in the form of a **mission statement**. This is a concise declaration of the overriding purpose of the business. It addresses the question 'What business are we in?' To answer this question, managers should focus on those customer needs that the business seeks to satisfy rather than on the products currently produced. Thus, a publisher of novels might, for example, conclude that it is really in the entertainment business. The **vision statement** is closely connected to the mission statement and declares the business's aspirations. It addresses the question 'What do we want to achieve?' Once again, it should be in as concise a form as possible. By answering both questions, managers are provided with a clear focus for decision making. Unless managers are clear as to what is the overall aim of the business, they have no basis for setting out plans and making decisions.

Activity 1.2

Can you think why mission statements and vision statements should be concise?

Having to produce concise statements will force managers to think very carefully about the essential nature of their business and the aspirations that they have for it. In practice, this can prove more difficult than it may sound. Concise statements have the added advantages that they are easier to remember and to communicate to employees, owners and others.

The mission and vision of a business will often adorn its website. **Real World 1.4** provides an example of these strategic statements for one large business.

Real World 1.4

On a mission

Spire Healthcare plc is a leading independent hospital group operating in the UK. Its mission is:

To bring together the best people who are dedicated to developing excellent clinical environments and delivering the highest quality patient care.

Its stated vision is:

To be recognised as a world class healthcare business.

Source: Spire Healthcare plc, <https://investors.spirehealthcare.com/about/>, accessed 10 November 2019.

Having established the purpose and aspirations of the business, objectives must be developed in order to translate these into specific commitments. Objectives help to bring real discipline into the strategy process. They should provide clear targets, or outcomes, which are both challenging and achievable. They should also provide the basis for assessing actual performance. Although quantifiable objectives provide the clearest targets, some areas of performance, such as employee satisfaction, may be capable of only partial quantification. Other areas, such as business ethics, may be impossible to quantify.

In practice, the objectives set by a business are likely to range across all key areas and might include a commitment to achieve:

- a specified percentage share of the market in which the business competes;
- a high level of customer satisfaction;
- a high degree of employee involvement;
- a specified percentage of sales revenue being generated from newly developed products;
- high standards of ethical behaviour in business dealings;
- a specified percentage operating profit margin (operating profit as a percentage of sales revenue); and
- a specified percentage return on capital employed.

Businesses do not normally make their statement of objectives public.

Activity 1.3

Can you think why they may not wish to do so?

It is often because they do not wish to make their intentions clear to their competitors.

2 Undertake a position analysis

The **position analysis** seeks to discover how, given its attributes, the business is placed in relation to its environment (customers, competitors, suppliers, technology, the economy, political climate and so on). This will be carried out in the context of its mission, vision and objectives. The position analysis is often approached within the framework of the business's strengths, weaknesses, opportunities and threats (a **SWOT analysis**). It involves identifying the business's strengths and weaknesses as well as the opportunities provided and threats posed by the external environment. Strengths and weaknesses are internal attributes of the business, whereas opportunities and threats are present in the environment within which the business operates.

Activity 1.4

Ryanair Holdings plc is a highly successful 'no-frills' airline. Can you suggest some factors that could be strengths, weaknesses, opportunities and threats for this business? Try to think of two for each of these (eight in all).

Strengths could include such things as:

- a strong, well-recognised brand name;
- a modern fleet of aircraft requiring less maintenance;
- reliable customer service concerning punctuality and baggage loss; and
- an Internet booking facility used by virtually all passengers, which reduces administration costs.

Weaknesses might include:

- limited range of destinations;
- use of secondary airports situated some distance from city centres;
- poor facilities at secondary airports; and
- poor customer service concerning complaints.

Opportunities might include:

- new destinations becoming available, particularly in eastern Europe;
- increasing acceptance of 'no-frills' air travel among business travellers; and
- the development of new fuel-efficient aircraft.

Threats to the business might come from:

- increased competition – either new low-fare competitors entering the market or traditional airlines reducing fares to compete;
- increases in fuel prices and airport charges;
- increasing congestion at airports, making it more difficult to turn aircraft around quickly;
- changes in the regulatory environment (for example, changes in regulations concerning the maximum monthly flying hours for a pilot) making it harder to operate; and
- vulnerability to a downturn in economic conditions and foreign currency movements.

You may have thought of others.

The SWOT framework is not the only way to carry out a position analysis; nevertheless, it seems to be very popular. A 2009 survey of businesses covering different industry sectors, geographical locations and size found that about 65 per cent of the total used SWOT analysis (see Reference 2 at the end of the chapter).