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In Defense of Management Accounting

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In Defense of Management Accounting

We do not believe management accounting is currently facing a cataclysm at Armageddon.

BY GROVER L. PORTER AND MICHAEL D. AKERS

A few individuals in academe and practice are charging that management accounting as currently taught and practiced is antiquated. The most vocal of the current critics are Dr. H. Thomas Johnson and Dr. Robert S. Kaplan in "The Rise and Fall of Management Accounting" (MANAGEMENT ACCOUNTING, January 1987) and Dr. Kaplan in an earlier series of articles.¹ While some of the charges made by our eloquent colleagues may be valid, we do not believe management accounting is currently facing a cataclysm at Armageddon.

More specifically, we question the following charges recently leveled at management accounting: the NAA definition restricts the domain of management accounting, and management accounting practices are driven by an external reporting mentality.

Is there adequate objective evidence to support these specific charges? According to a review of the accounting literature, a survey of chief financial officers, and our own professional accounting experience, the answer is "NO!"

TOO RESTRICTIVE?

Management has used financial performance measures for evaluation purposes during the past 60 years. Dr. Kaplan states that changing this practice will be difficult to do because of the restrictive nature of the definition of management accounting as developed by the NAA Management Accounting Practices (MAP) Committee.

In attempting to prove his point, Dr. Kaplan does not include the full definition of management accounting. He based his arguments on only part of the definition and claimed that the MAP Committee definition restricts the domain of management accounting to: "The process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of *financial* information used by management to plan, evaluate, and control within an organization"

(emphasis added). We believe that the complete definition in Statement on Management Accounting No. 1A would have better communicated the breadth of the definition intended by the MAP Committee.

Although Dr. Kaplan emphasizes that the management accountant deals with financial information, he does not explain what actually comprises financial information. According to Statement on Management Accounting No. 1B, "... financial information comprises broadly that information, monetary or *nonmonetary*, necessary to interpret the cause and effect of actual or planned business activities, economic circumstances, and asset and liability valuations" (emphasis added).

The NAA statements do not indicate that the management accountant would deal strictly with financial numbers. The statements indicate that the management accountant will handle a broad spectrum of information, financial and nonfinancial in nature, in various capacities. Dr. Kaplan indicates that the management accountant would not be involved in the following aspects of planning and control (measures of product quality, product innovation, employee morale, or customer satisfaction) because of the restrictive nature of the NAA definition of management accounting.

Objective number two of the Statement on Management Accounting No. 1B is: "Management accountants at appropriate levels are involved actively in the process of managing the entity. This process includes making strategic, tactical, and operating decisions and helping to coordinate the efforts of the entire organization." This objective definitely does not indicate that the management accountant deals strictly with financial numbers nor does it restrict the duties to be performed.

In fact, Statement on Management Accounting No. 1B states that "Management accountants interpret *all forms* of internal information pertinent to the various segments of the organization and communicate the implications of the information being reviewed, including its relevance and reliability" (emphasis added). Further, Statement on Management Accounting No. 1B

states that "The reports (prepared by management accountants) may concern financial, physical, and human resources."

A thorough analysis of Statements 1A and 1B, in combination, reveals that the definition of management accounting promulgated by the NAA is indeed a broad one. In fact, the definition of management accounting includes items that are normally used in defining financial accounting and other disciplines.

Based on our own professional experience, a number of leaders in management accounting consider the definition to be too broad in scope rather than too restrictive. If Dr. Kaplan, after an in-depth analysis of Statements 1A and 1B, believes that the definition is too restrictive, we would like to know how he would change the definition of management accounting to make it more appropriate and less restrictive.

ARE MANAGEMENT ACCOUNTANTS SUBSERVIENT?

Dr. Kaplan recently stated that "The internal management accounting function has now become subservient to the external reporting function in U.S. firms, contemporary U.S. practice is characterized by the internal use of accounting conventions that have been developed and mandated by external reporting authorities, and management accounting practices are now driven by an external reporting mentality."

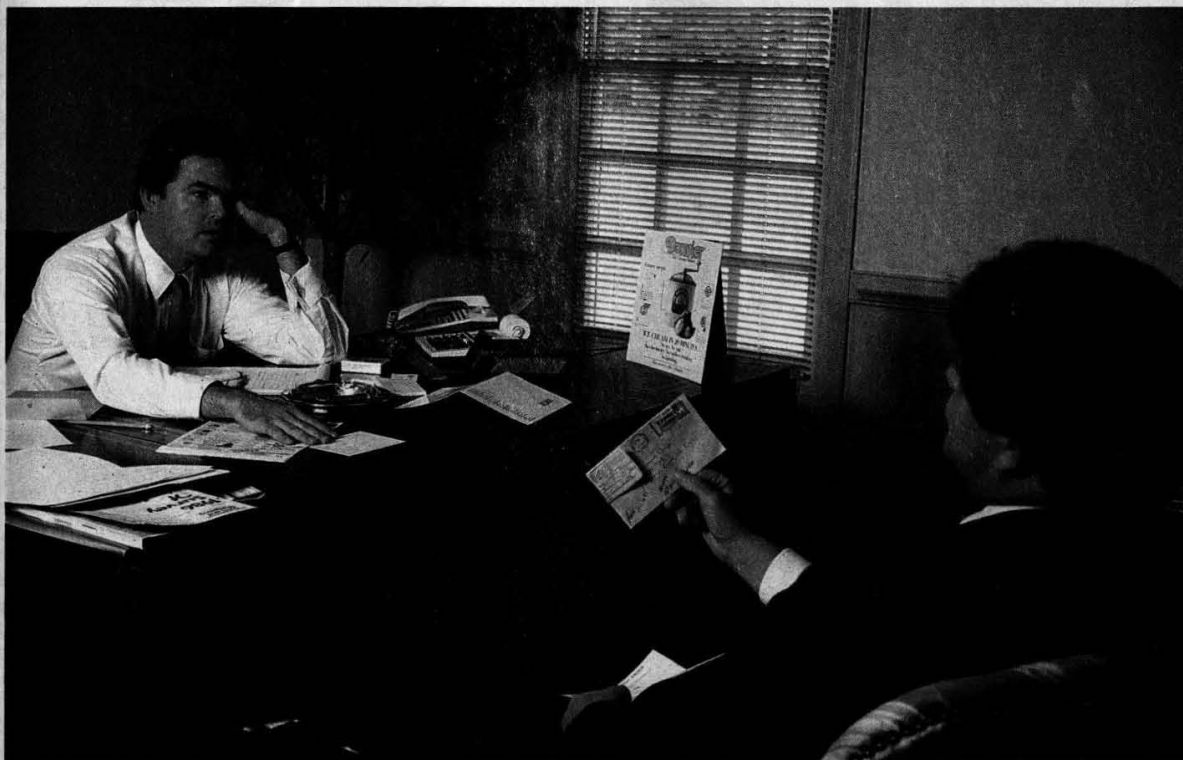
These are fairly bold statements to make in light of

the fact that they are largely undocumented with empirical research. Dr. Kaplan also believes that researchers have not been in the field enough. We question how he can make this charge without going into the field and determining if internal management accounting has actually become subservient to external financial reporting. If he has been in the field, Dr. Kaplan should use the evidence acquired through his field research to document the charge.

Dr. Kaplan goes on to say that firms use accounting conventions for internal planning and control, not because they support the corporate strategy, but because they have been chosen via an external political process by regulators at the Financial Accounting Standards Board (FASB) and the Securities & Exchange Commission (SEC).

Once again, it is clear he does not use empirical research to adequately document his statements. How does he really know that this is actually taking place? The FASB and SEC do not require accounting conventions to be used for internal purposes. And, as FASB member Victor H. Brown said in the May 1987 issue of *MANAGEMENT ACCOUNTING*, "FASB is sensitive to the need to provide accounting data useful for both external financial reporting and management decision-making purposes." Yet, Dr. Kaplan would have us believe that because the FASB and the SEC are *influential*, they also *dictate* internal management accounting practices.

In fact, if there is a consensus among management accountants, it is that the managers who buy an internal accounting system can have anything their hearts



Rod Mann/Globe Press

"Many managers perceive the costs of more elaborate management accounting systems exceed prospective benefits."

desire as long as they are willing to pay the price.² The price is, of course, that the accounting data used to provide appropriate information for internal management decision-making purposes may need to be modified for external reporting.

It is our experience that a number of large firms do report accounting information based upon different conventions for internal and external purposes. Furthermore, recent empirical research indicates that internal management accounting practices are not dictated by the FASB or the SEC.

Dr. Kenneth Rosenzweig conducted a study to determine the impact of FAS 33, an external reporting requirement at the time, on internal management decision-making and reporting, and concluded that: "The study provides some evidence that top management commonly failed to encourage the use of the information by not working it into the internal reporting system, not adopting a policy that the information be used, and not committing resources (preparation man hours and costly adjustment methods) to developing high quality information suitable for decision-making."³

If the external reporting mentality charged by Dr. Kaplan does exist, then it would be expected that companies would use information for internal purposes because of the external reporting requirements. This is inconsistent with what Dr. Rosenzweig found.

The fact that information prepared for management is not inherently different from an entity's published financial statements does not by itself indicate that an

external reporting mentality exists. Former FASB Chairman Donald Kirk⁴ and Eugene H. Flegm⁵ of General Motors Corporation believe that the development of internal cost accounting systems are not as cost beneficial as Dr. Kaplan indicated.

The cost-benefit relationship also has been addressed by Dr. Charles T. Horngren. He notes that: "Many companies do not find an investment in a detailed cost accounting system worthwhile. The cost-benefit theme is the foundation for judging whether cost accounting systems should be reviewed. There is a cost of keeping the costs. Many managers perceive, rightly or wrongly, that costs of more elaborate systems exceed prospective benefits. Moreover, the costs of implementing changes are seldom trivial."⁶

Dr. Milton F. Usry agrees with the cost-benefit concept concerning the use of external required conventions for internal purposes. He states that: "Anytime that we spend dollars on an accounting information system beyond the minimum cost necessary to satisfy these legal requirements, the sole justification is the value of that information to internal management."⁷

Dr. Robert N. Anthony notes that, "... in most respects, management accounting practices are consistent with external financial reporting standards. The reasons for this are the standards that are useful in reporting to external bodies are also useful in relaying information to management and that the objectives and reports on performance of the entity as a whole should be consistent with individual segments."⁸ In addition to the common base concept, Dr. Anthony also



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"Classic" management accounting practices are still needed in firms like this leather company in New York.

alludes to the cost-benefit relationship: "Unless there is good reason to do so, an entity will therefore avoid the extra effort involved in maintaining a management accounting system that is inconsistent with its financial accounting system."

Therefore, it can be seen that the external reporting mentality charge made by Dr. Kaplan is not widely supported in the accounting literature. A recent review of the literature indicates that companies either do not use external reporting conventions for internal purposes or, if they do, it is primarily because of a cost-benefit relationship.

We have questioned the external reporting mentality charge made by Dr. Kaplan because of the literature previously cited and a lack of documented evidence. We believe the question of whether external reporting requirements dictate internal management accounting practices can be answered through empirical research.

CFOS SURVEYED

We mailed a questionnaire to the CFOs of the top 50 *Fortune* 500 companies for 1984. Our response rate was 52% (26 usable responses). Nearly 77% of the respondents (20) did not agree with the external reporting mentality charge. However, 23% (6) did agree with the external reporting mentality view expressed by Dr. Kaplan.

The CFO of a leading consumer electronics company, for example, stated that Dr. Kaplan's comments are "overly simplistic". He further noted that "in many cases the situation is vice versa" and internal accounting influences external reporting. This agrees with the comment by Mr. Kirk that management accounting practices have had a beneficial impact on generally accepted accounting principles and financial reporting.

In responding to our survey, a major oil firm CFO said: "We agree that most companies monitor the performance of their operation by their contribution to earnings as defined by the generally accepted accounting principles which govern external reporting. We do not agree, however, with Professor Kaplan's thesis that the use of external GAAP for stewardship induces managers to act in contradiction of, or without regard to, corporate strategy."

The CFO of a leading food products company noted that "subservient" is too strong a word to describe the relationship between the internal management accounting function and the external financial reporting function in U.S. firms. This CFO, however, noted that their internal management accounting was importantly affected by external reporting, because "both are based on the same 'bottom line' net earnings." This comment is consistent with what Dr. Anthony said.

Even CFOs who generally agreed with the external reporting mentality view qualified their responses. For example, one CFO agreed that, "on balance, the answer is yes. But we use different inventory accounting for internal (direct costing) vs. external (full absorption) purposes."

Another CFO said: "Our reporting conforms with requirements promulgated by the FASB and SEC. We believe it would be impractical to maintain one reporting system for internal purposes and a different system for external reports."

A third CFO commented: "There is no question of

There is no objective evidence to support recent charges that management accounting practices are driven by an external reporting mentality.

subservience on either part. A common base is used but is varied to conform to all sorts of alternative internal policies and external regulations."

These comments by CFOs support the cost-benefit theme and the concept that a common base is used for internal and external purposes. This evidence indicates that firms either use different reporting methods for internal and external purposes or, if they are consistent, it is due primarily to a cost-benefit relationship.

PRACTICES FOUND USEFUL

It has not been proven that management accountants have an "external reporting mentality". That does not mean, however, that accountants' time is properly distributed between financial accounting and management accounting activities. In fact, statistics recently compiled by a major international CPA firm revealed that in a "traditional" manufacturing company, accountants spend approximately 70% of their time on financial accounting and only 30% of their time on management accounting. Whereas, in a "world-class" manufacturing company*, you are more likely to find accountants spending only 30% of their time on financial accounting and 70% of their time on management accounting. And the size of the total accounting budget in comparable sized firms is usually smaller in a "world-class" manufacturing company.⁹

Accountants, in general, are staff rather than line people. Thus, accountants do not have the authority to tell line management the type of information they need in order to most effectively and efficiently manage the company, division, or department. The accountant may only recommend to line management regarding their information needs and wants, and consult with them regarding the uses thereof in the management process.

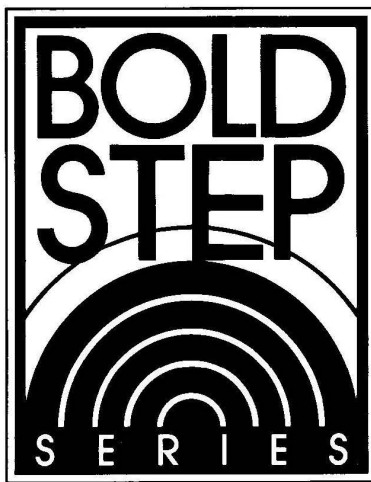
This is by-and-large what accountants have done in the past and what they are doing in the present. In general, accountants have done an above-average job of providing the information requested by line management. One way to assure that line managers request the right information, perhaps, would be for them to complete a college or professional education course in management accounting. And, if their role is expanded and enhanced in a "world-class" manufacturing environment, accountants may be allowed in the future to make the greater contribution to the management process of which they are capable. In the meantime, however, accountants will be expected to continue to provide the information requested by line management in

"traditional" and "world-class" manufacturing companies.

In "traditional" manufacturing companies, as documented by two empirical surveys,¹⁰ the following "classic" information listed in order of importance has been and still is being found useful in order of importance by executives in the management decision-making process:

- Cost-Volume-Profit Analysis
- Product Pricing
- Budgeting (Profit Planning)
- Capital Equipment Analysis
- Inventory Control
- Make or Buy Analysis

The small manufacturers surveyed were using what the critics would generally call antiquated "classic" management accounting practices in the designated decision areas. And, while a number of Fortune 500 firms may be installing a management accounting system that will successfully monitor the operations of a "world-class" manufacturing company, there are still a lot of small manufacturing firms where the implementation of "classic" management accounting practices alone would assure their survival and growth.¹¹ The executives with these small manufacturing firms must learn to walk before they can run.



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FUTURE DIRECTIONS

Our research indicates that Mr. Allen H. Seed, III, is probably correct in asserting that, "... the solutions to the problems that we have to face (in management accounting) can be done within the framework of the system."¹² And, while we may not agree with the critics regarding the validity of some specific charges leveled at management accounting, we agree with our eloquent colleagues that field-based research should be used "to discover the innovative (management accounting) practices introduced by organizations successfully adapting to the new organization and technology of manufacturing."

The results of this field-based research should provide better insight into the challenges facing management accounting which have been brought into sharper focus recently by several articles published in *MANAGEMENT ACCOUNTING*. The results of this field-based research also should allow us to better recognize the many opportunities for professional service that lie

ahead for management accountants. In recognition of this, for example, we are currently working on a field-based research project that will provide the accounting profession additional insight into the "external reporting mentality" issue.

Of course, the "Bold Step" series of research projects launched by NAA is a step in the right direction. If the future viability of management accounting is to be assured, however, this "Bold Step" must be recognized as only the first step toward determining the usefulness of various management accounting practices for management decision-making purposes in a "world-class" manufacturing environment.

We urge that in order to successfully serve in the dual role of managers/accountants, management accountants must be prepared to face the challenges of providing management with "classic" and "tailor-made" financial and nonfinancial information. They also must take advantage of the opportunities to expand and enhance their participation in the management process in "traditional" and "world-class" organizations. This certainly is the only way we can fulfill our destiny to become true **MANAGEMENT ACCOUNTANTS!**

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*A "world-class" manufacturing company is defined as a firm with a total quality control system, a computer integrated manufacturing system, and a just-in-time inventory system.

¹R.S. Kaplan, "The Evolution of Management Accounting," *The Accounting Review*, July 1984, pp. 390-418.

²"Yesterday's Accounting Undermines Production," *Harvard Business Review*, July-August 1984, pp. 95-101.

³"Cost Accounting: A Revolution in the Making," *Corporate Accounting*, Spring 1985, pp. 10-16.

⁴C.T. Horngren, *Introduction to Management Accounting*, Prentice-Hall, Inc., 1984, p. 15.

⁵K. Rosenzweig, "Companies Are Not Using FAS 33 Data," *Management Accounting*, April 1985, p. 56.

⁶D.J. Kirk, "The Impact of Management Accounting on GAAP," *Management Accounting*, July 1985, pp. 26-29.

⁷E.H. Flegm, *Accounting: How to Meet the Challenge of Relevance and Regulation*, Ronald Press, John Wiley & Sons, Inc., 1984.

⁸C.T. Horngren, "Cost and Management Accounting: Yesterday and Today," Unpublished Working Paper, Graduate School of Business, Stanford University, October 1984, pp. 11-13.

⁹M.F. Usry, "Some Fundamentals of Cost/Managerial Accounting," in *The May Ball Washington Forum Series in Accounting Education*, University of West Florida, April 1985, p. 56.

¹⁰R.N. Anthony, *Tell It Like It Was: A Conceptual Framework for Financial Accounting*, Richard D. Irwin, Inc., 1983, p. 208.

¹¹R.D'Amore, "Installing a World-Class Accounting System," an excellent NAA professional education program on the management accounting practices required for the effective and efficient management of a world-class manufacturing company presented in Chicago on May 21-22, 1987.

¹²G. L. Porter, *The Uses of Accounting Information for Decision-Making Purposes by Small Manufacturers in Mississippi*, Mississippi Research and Development Center, 1983.

G. A. Luoma, *Accounting Information in Managerial Decision-Making for Small and Medium Manufacturers*, National Association of Accountants, 1967.

¹³"A Special Report on Technology in the Workplace," *The Wall Street Journal*, Section 4, June 12, 1987, pp. 1D-48D.

¹⁴A.H. Seed, III, "Cost Accounting in the Age of Robotics," in *Cost Accounting for the 90's: The Challenge of Technological Change*, National Association of Accountants, 1986, p. 45.