ACCOUNTING TECHNIQUES IN BUSINESS MANAGEMENT

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The main function of management is the leadership towards the attainment of the most efficient use of economic and human resources in the interest of both the business unit and the general society as a whole. Management works by setting up a plan based on policies and then directing resources available towards its actuation. Henri Fayol writes that the function of control in business is to verify that everything occurs in conformity with the plan adopted, the instructions issued and the principles established. Those who exercise control are an integral part of the system providing a regulator. It is not adequate to regard control as being exclusively a matter of the accounting system, budgeting and standard costs, although business control and accounting practice are near relations. All control draws its lifeblood from a flow of information.

Though accounting is not the whole of control, accounting records provide most of the data, their advantage being that facts of great diversity can be represented in the common denominator of money. From its accounts management acquaints itself with the financial position of the business and gauges the amount of any profit made. Accountants have always been the historians of the business, but today they are much more, dealing with the financial and legal complications of investments, taxation, the granting of credit, and the prevention of error and fraud. Management accounting is described as a system of standards, orders, records and reports. Facts emerge from reports on current operations, revealing deviations, leading swiftly to investigation and remedy. Where traditional accounting emphasises the analysis of transactions, management accounting is concerned with the detection and isolation of areas of special difficulty and with the diagnosis of emerging trends. Top executives are bound to use forecasts and budgets extensively.

In the best of practice these top executives bring the industrial accountant into consultation early, as it is to his skill in the presentation of accounting information that they are entitled to look for reports which make control effective. Familiarity with management problems and to some extent with technical processes, can make the accountant an invaluable member of the management team. But accounting information is best imparted in simple, easily understood terms, distinguishing between facts and opinion, being intelligible beyond accounting and banking circles.

ORDINARY AND PREFERENCE SHARES

One of the first decisions in the launching of a business is to fix the amount of capital to be raised, as the proposed scale of operation bears strongly on it. Overhead expenses must also be realistically estimated. When the amount of capital has been estimated, there comes the question of how it shall be raised. The most common form of capital issue is through ordinary and preference shares. The ordinary share appeals to an investor prepared to shoulder uncertainty in the expectation of high dividends. Where the element of speculation is very great, a company would in practice be forced to rely on the issue of ordinary shares. Preference shares, on the other hand, earn a fixed rate of dividend. Preference shares have a claim on divisible profits for that percentage return, prior to any payment to ordinary shareholders. A preference shareholder could not claim dividends if insufficient profit had been made, although if such shares were given cumulative rights, they would have the right to receive arrears of dividends in subsequent years when profits are again available. However, many preference shares have no voting rights.

The right proportion must be found between the amounts of ordinary and preference shares. The larger the proportion of the total capital in ordinary shares the safer the preferential shares will be. If the proportion of fixed dividend capital grows unduly, it will be difficult to maintain solvency during periods of bad trading. A further form of capital may be issued as debentures, a bond acknowledging the indebtedness of the company,bearing a fixed interest. It is raised on the security of some or all of the assets of the company but debenture does not form a part of the share capital. Over and under-capitalisation are both dangers to the workings of the company although the most common tends to be overcapitalisation. This burdens the management with heavy payments of dividend out of profit thus seriously hindering the process of further growth. In such cases reconstruction is usually suggested before matters deteriorate.

Having found the proper measure and types of capital, the management accountant now looks at the use of such capital and introduces such terms as working capital and capital employed besides the already established invested capital. The existence of working capital level can be ascertained simply by finding the amount of the surplus of current assets over current liabilities even though this may not be an infallible yardstick of solvency. This is possible if the current assets of the business might be in the form of trade debtors and stock rather than of cash and as a result the liquid position of the company would be unsatisfactory. The structure of the working capital will highlight the trading activities of the company and one must remember that over-trading is as bad as under-trading.

The raising of further capital is a common decision thrown into the lap of the management accountant. Additional funds can be obtained by retaining profits and depreciation allowances, the safest methods in the long run, because the company financed in that way assumes no further external obligations. Alternatively, further issues or even bank loans can be resorted to. Trade credit is another way of financing business. The board of directors is influenced in considering the ways and means, by the purpose for which funds are to be raised, and for short term financing they may well seek accommodation from their bankers.

PROFITABILITY AND BREAK-EVEN ANALYSES

Profitability is yet another management accounting feature to note. To plan profits is to control volumes of products, prices and costs. The exercise devises a standard of action to yield a stated profit and in doing so, it appraises manufacturing and distributive costs, profit margins, the level of sales, the comparative profitability of products, the optimum use of fixed assets, and the amount of capital tied up in stocks of materials. If profit is the first figure to be examined, one can start by working out the total required for dividends on issued capital, interest on loan capital, general reserves and specific reserves. Profitability can be demonstrated on a graph of Break-Even Analyses where fixed costs, variable costs and sales are represented. Such a chart is very useful in studying the interactions between these variables. The basic concept on which it is drawn is that every business has a break-even point, representing a state of affairs at which the total cost incurred is just recovered and no more by the total value of the sales made; a point at which there is no profit or loss.

If sales rise above the Break-Even point, a profit is earned; below it a loss is incurred. Even so, the circumstances which actually prevail in many businesses make any attempt to establish a break-even point a very complex project. The company in which costly capital equipment has been invested will tend to have a high break-even point and may work at less than total costs as long as variable costs are met and something is contributed to fixed costs.

The Break-Even chart is a model of costs, sales and prices as associated variables, but it is a much simplified one and not a safe guide over a period of time without revisions. Even so it can show an enterprise where and how its activities can be more profitably coordinated; it would also demonstrate to management the effects of movements in prices and their effects on total profits. Break-Even analysis is not as often introduced into firms as budgetary control standard costing, or internal auditing nevertheless it provides a convenient means of demonstrating quickly price-cost-sales relationships.

A business which, on the other hand, makes use of budgeting is applying scientific management to the financial side of its enterprise. A budget states in terms of quantities and money, the work to be done in a specific period of time and when adopted it is a means of measuring progress. By means of a budget, the programme of each department is adjusted to the policy of the business yet there must be a clear-cut underlying policy. The budget is not self-operating and it cannot replace executive action although it surely complements it highly. Departmental budgets are prepared within an overall business budget and departmental heads submit detailed estimates of expenses, based on the agreed sales figures. Through these the master budget can then be constructed. A system of periodical reports during the currency of the budget will bring to light divergencies from the planned expenditure and remedial measures can be taken. Budgetary control attempts to co-ordinate the productive and financial operations according to a predetermined plan and a potential threat to its success is lack of adaptability. The whole system is based on anticipation and unexpected developments can hardly be avoided. Thus modern budgeting is even made flexible and attention is concentrated on those items which can be affected by management action.

COSTING

Another contribution to business management can be found in the form of costing. Costing systems show the expenses incurred in doing the various jobs, analysed by categories of expense. As they are essentially analytical, cost accounts cannot be devised as a universal system to fit every business. There are many types of cost accounts that can be kept like marginal, standard, batch, job, multiple, process and departmental costing, each offering a particular set of advantages when fitted to the particular need of the business unit. The advantage of each type will vary with the type of business and the period of operations at which it is applied; for example job costing would best be applied where there were quite distinct jobs and contracts, as undertaken by builders and engineers for clients. Expenses would be allocated to each contract as incurred.

Having chosen the best method of costing to apply, the management accountant will choose a set of cost centres to which primary costs can be allocated. Where an item of costs has to be subdivided, it can be apportioned to the various cost centres on an agreed basis. While the allocation of direct materials and wages could cause few uncertainties, overheads tend to call for more complex reasoning. Yet unless overheads expense is wisely apportioned, the calculation of a true selling price for a product will be impossible. Of particular importance is standard costing which tries to meet the need not only to predict costs more closely but to exercise more control. Where standards are used the costs of production are predetermined and in due course actual costs are compared to the standard costs. Any differences are analysed by causes. Standard costs are related to a particular period; they should also be related to processes and operations rather than products so that variances from standards can more readily be traced.

The use of standard costing takes budgetary control into more detail and gives management more control of the cost of the individual process and product rather than a number of summary totals. Apart from this it is invaluable in estimating, price fixing, and in determining sales policy. The practice of control of costs involves departmental operating statements which show the standard and the actual cost of direct labour, analysed by cost centre, showing also the amount of the difference between the two, the cause of it and how, when and why the variance occurred. Management would expect to receive reports on variances from the cost accountant but to exercise proper managerial control both favourable and adverse variances must be examined.

Costings reports represent but part of the operating statements supplied by accounting officers to management. In general reports will cover purchases, production, sales, finance and personnel; these supplement the financial accounts. Reports and tabulated or charted figures are best presented in standardised forms and layout so as to enable instantaneous grasp of the more important information. Such statements allow comparisons to be made. Through this the efficiency of the business unit can be measured against pre-set yardsticks. One main criterion is the rate of return on capital employed, capital in this context being understood to mean the value of the fixed assets and the working capital of the firm, although intangible assets are excluded. Other yardsticks can be used to measure the particular firm's efficiency.

Management ratios present perhaps, the most obvious link between management and accounting. Many members of top management draw conclusions from ratios between balance sheet items which may be considered under financial, or expense ratios, or under operating ratios. The first group, the expense ratios express relationships between income and expenditure and as such can be specially valuable to shareholders, financial controllers, and creditors. Operating ratios are more likely to be watched with interest by the functional heads of a business. The more important ratios include the net profit to capital employed, profit to turnover, sales to capital employed, rate of turnover, stock of finished goods to production costs and many others. Last but not least one may mention inter-firm comparisons which enable businesses to match their own performance with that of others in the same industry. The Centre for Interfirm Comparison which is associated with, although independent of, the British Institute of Management provides a service whereby firms in an industry can compare their own performance with other firms in the industry.

Management accounting does have a definite contribution to management control and management is becoming more aware of the valuable contribution of this vital and dynamic subject. To manage without accountancy is like sending a motorist to a destination without a map. Like a map, management accountancy provides management with the starting point and destination, together with the most suitable route, for all the journeys to be taken by the firm.

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