Financial Information - Financial Accounting and Management Accounts

Editorial:

Over the next few months the members' newsletter will feature a number of management accounting techniques to enhance your Continuing Professional Development (CPD). These will I am sure be of great interest to those of you in practice as Certified Bookkeepers as you may often be called upon to supply management information to your clients. Others will find this a useful aid to widening their skills and competence to the benefit of their employer

This overview deals with the characteristics of such information and its uses. The concluding mini case study compares and contrasts Financial Accounting with Management Accounting.

Next month we will feature an introduction to Budgets and Budgetary Control.

Regards

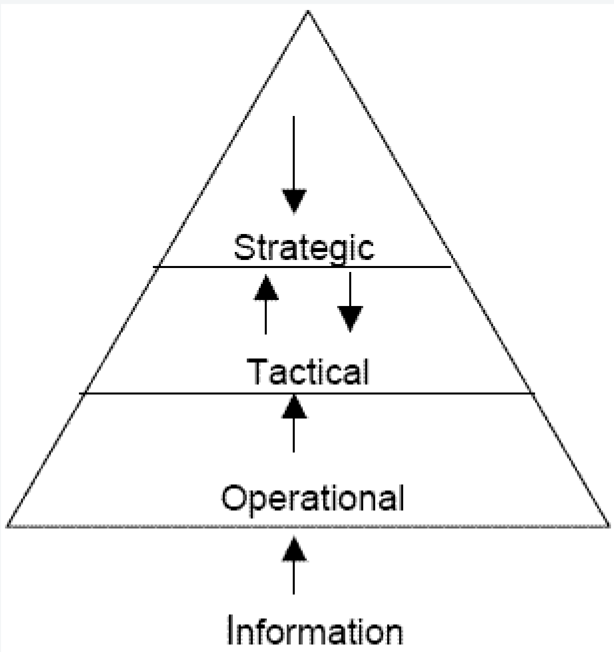
Philip Dunn

Editor

Over the next few months the members' newsletter will focus on management accounting techniques that I believe will add to your continuing professional development, whether you are employed or are in practice as a certified bookkeeper.

Bookkeepers are providers of information. Information is defined as "data that has been processed in such a way that it is meaningful to the end user".

Within organisations information has a defined hierarchy:



Information is classed as:

- **Strategic** that information relating to the longer term planning and strategic focus of the business

• **Tactical** that used in short term planning and decision making within an organisation

• **Operational** that relevant to day-to-day decision making

From bottom up, the following example refers to capital equipment utilisation:

• Operational information would include a current week's report for a cost centre on the capacity of the plant utilised in the period. Such a measure may include:

$$\frac{\text{Actual Machine Hours}}{\text{Budgeted Machine Hours}} \times \frac{100}{1}$$

i.e. the percentage capacity utilised

•Tactical information could include the short-term budget for 12 months and would show the budgeted machine utilisation in terms of machine hours for each item of plant. The total machine hours being predetermined from the production budget for the period.

• Strategic information would relate to the longer-term strategy on the company's market share, which in turn informs the production plan. This plan would be used to predetermine the level of investment required in capital equipment in the longer term. This process which 'compels planning' would lead to investigating new methods and technology.

Attributes of Information

Quality information is that, which when used, 'adds value'. Research suggests that information should possess numerous attributes which include:

• relevant for its purpose

• complete enough for the issue in question

• accurate for the purpose

• from a reputable source

• communicated to the right person

• timely in communication

• communicated in an appropriate channel

• the volume should be manageable

• must be understandable by the end user

• must be cost effective

The attributes that 'add value' and together underpin quality of information are examined further below.

Relevant for Purpose

Information should always be relevant to the issue being considered. It is often the case that memos, reports and schedules contain irrelevant sections which can have an adverse effect on the understanding of the issue by the user.

Completeness

It is desirable that all information required for decision making is made available. There must be close co-operation between the information provider and the end user. Therefore, all factors influencing decision making should be included.

Accurate for Purpose

Managers rely on information to effectively manage their 'value-adding' activities. For example, to satisfy the VAT regulations, a VAT invoice must be accurate to the nearest penny. However, the aged debtors list would contain rounding to the nearest '£'.

Reputable Source

For information to be used effectively by managers, the users must have confidence in its source.

This would be supported by the fact that the source was reliable in the past and that there is a good and clear channel of communication between the provider and the user of the information.

Communicated to the Right Person

Where responsibility accounting is used in practice, managers have a clear and defined level of responsibility and must achieve their predetermined objectives.

Managers should therefore receive information to carry out their defined tasks. Such information should be communicated to the right person at the right level within the organisation.

Timely

For effective decisions to be taken, information needs to be reported to management on a timely basis.

For example, a budgetary control or standard costing report containing adverse variances would need to be timely for managers to take immediate corrective action. Likewise if a favourable position was reported 'late', the reward and recognition to employees may be delayed and effect morale.

Communicated in an Appropriate Channel

For a manager to use information effectively it must be transmitted in the communication process. The process takes many forms and the channel selected must take account of nature, purpose, speed and requirement of the user.

Volume

The detail and volume of the information communicated should be that consistent with the need of the user.

The information should focus clearly on the issue and the main points highlighted and not 'clouded' by superfluous and excessive volume.

Understandable

Managers can only use information to good effect if they understand its purpose.

The level and skill of the manager is important here. Managers need to continually update their skills and therefore, Continuing Professional Development (CPD) is important. For example, for managers to fully understand their role in a responsibility accounting environment and to interpret the management accounting reports they need training.

"Training aids understanding"

The provider also needs to choose the style and language appropriate to the user.

Cost-effective

The costs of providing the information must not outweigh the ‘value-added’ benefits derived from its use.

In addition to the above attributes the International Accounting Standards Board (IASB) in their "Regulatory Framework" state that the characteristics of financial information are:

• relevance

• reliability

• understandability; and

• comparability

and quality information should possess these characteristics.

Having defined information and considered its characteristics we need to examine further the role of the Certified Bookkeeper as a provider of quality information.

Bookkeeping is clearly part of the function of financial accounting whereas our forthcoming features will focus on management accounting.

We need therefore to distinguish between these activities.

CIMA terminology defines Financial Accounting as: "The classification and recording of monetary transactions of an entity in accordance with established concepts, principles, accounting standards and legal requirements and presentation of a view of the effect of those transactions during and at the end of an accounting period."

It is clear that the definition portrays three distinct objectives:

• classification and recording of monetary transactions

• the use of established concepts, principles and standards

• presentation and interpretation of the outcome of past transactions so as to assess performance over a period of time

A principle objective is the preparation of a periodic set of final accounts in the form of a profit and loss account and balance sheet for the benefit of a number of user groups which include:

• owner managers

• investors

• loan creditors

• suppliers

• employees

• analysts

• public

• government departments

Management Accounting is defined in CIMA terminology as: "An integral part of management concerned with identifying, presenting and interpreting information used for:

• formulating strategy

• planning and controlling activities

• decision taking

• optimising the use of resources

• disclosure to shareholders and others external to the entity

• disclosure to employees

• safeguarding assets."

It has been said that management accounting is simply: A tool of management used for PLANNING and CONTROL.

Case Study

Having considered the above objectives let us now compare and contrast these two fundamental accounting perspectives.

The following is the abbreviated profit and loss account of Crescent Feeds, a manufacturer of animal feeds.

Northcliffe Feeds Ltd Profit and Loss Account for Year Ended 31 December 2005

	£
Sales	850,000
Cost of Sales:	
Materials	300,000
Labour	200,000
Overheads	100,000
	600,000
Gross Profit	250,000
Selling, Distribution and Administrative Costs	150,000
Net Profit	£100,000

The above financial statement would provide user groups with a general overview of the business's trading position for the period.

However for decision making, planning and control, managers within the business would require more information. One such view would be product profitability and the management accounts would provide such information. Let us assume that Northcliffe Feeds has three main product groups NF1, NF2, NF3.

The accounting technician responsible for producing management accounts prepared the following report:

Northcliffe Feeds Ltd Management Accounts for Year Ended 31 December 2005

Product Groups	NF1	NF2	NF3	Total
	£	£	£	£
Sales	250,000	290,000	310,000	850,000
Cost of Sales:				
Materials	90,000	116,000	94,000	300,000
Labour	63,000	75,000	62,000	200,000
Overheads	30,000	34,000	36,000	100,000
	183,000	225,000	192,000	600,000
Gross Profit	67,000	65,000	118,000	250,000
Selling, Distribution and Administrative Costs				150,000
Net Profit				£100,000

The above analysis is more useful to management in planning and controlling business activity. They can identify the profitability of each product group, comparisons of budget to actual for each group can be made and therefore controls can be exercised. Such information can be used for setting management targets and objectives.