

Financial accounting v management accounting

Historically, and rather unkindly, accountants have often been referred to as 'bean counters'. This suggests that all they do is add up figures. The reality is that there are many different types of accountant, as is highlighted by the different qualification routes.

A useful starting point for considering these differences is the distinction between what is known as financial accounting and management accounting. Accountants, especially in larger organisations, will tend to work in one or the other of these areas. That is because the whole emphasis of financial accounting is very different to that of management accounting. Financial accounting is all about what companies must do by law.

One important legal requirement is the production by companies of financial accounting statements. These are the documents that include, among other data, a profit and loss account, a balance sheet and a cash flow statement. Suffice, to say at this stage that companies must produce these financial reports, which are distributed to shareholders and made available to the public. The law also requires companies to comply with accounting standards, which are issued by a regulatory body for the accounting profession. This is highly topical, as companies in the UK are currently being required to switch from UK accounting standards to International Accounting Standards – requiring the financial accounting community to develop additional skills and knowledge.

Financial accountants prepare these statements for the outside world. They form part of the annual report and accounts, which is prepared for shareholders of the company. Although the report is addressed to shareholders, it is used by a much wider group of interested parties or 'stakeholders' – for example, suppliers, customers, competitors, staff, government and analysts.

When reporting externally, a financial accountant must therefore have the technical skills to ensure that the financial statements comply with:

- statutory requirements
- professional requirements (that is, they adopt appropriate accounting standards)
- Stock Exchange requirements (if the company is 'listed' on the stock market).

The contents of the reports themselves are very tightly defined, in terms of exactly what has to be produced. The statements must be drawn up in line with what are known as Generally Accepted Accounting Principles (GAAP for short). For companies above a certain size (currently those with a turnover of over £5.6 million) the accounts have to be externally audited. The audit process requires that the accounts are signed off by an independent firm of external auditors. The auditors must be satisfied that the accounts represent what is known as 'a true and fair view' of the business. However, what constitutes 'true and fair' has always been a matter of some debate and the term has never been defined in UK legislation.

Financial accounts have to be filed at Companies House – where the information becomes publicly available – within seven months of the financial year end for a public limited company (PLC) or within 10 months of the financial year end for a private limited company (LTD). The reports themselves describe what has already happened, with very little reference to future events. They cover a particular financial period – normally a year – and they describe the activities of the whole company, with little if any reference to departmental or divisional data.

How useful such financial accounting reports actually are is a regularly debated issue. Some recent initiatives have tried to widen the usefulness by, for example, considering more fully the needs of parties other than shareholders and by trying to introduce some legally required forward-looking data.

In summary, financial accounting is mainly concerned with what is legally required to be communicated to external parties. It has to conform to various principles and standards. It is historic, covering a period of time that has passed, and it is concerned with the whole of a company rather than individual parts of it.

Effectively, management accounting is the opposite of this. There are no legal requirements, no set formats, no rules or regulations. The data produced tends to be forward-looking and involve smaller parts of a business rather than the whole entity.

Recent developments in financial accounting

Financial accounting, as we have already discussed, is driven by legislation and the setting of accounting standards. The most significant recent development in financial accounting has been the transition to International Accounting Standards (IAS). (You will also come across the abbreviation IFRS International Financial Reporting Standards. This describes more recently developed standards.) All EU-listed companies now report using international standards, with the likelihood that non-listed companies will eventually follow. It is perhaps too early to say whether the switch has been successful.

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There have been practical difficulties, and some of the new standards are controversial. However, the logic of having an international set of standards is well founded. It is important that users of accounts can make direct comparisons between companies around the world, and it is also sensible that global companies can prepare their accounts against a single set of rules. From a purchasing perspective, and in particular in the area of supplier appraisal, it should in theory represent a useful development.

Management accountants also produce financial reports, but because there are no statutory reporting constraints the reports can be tailored to the needs of the organisation and to the recipients of reports. Thus the reports need to be:

- relevant to the user
- presented in a timescale that allows decisions to be made
- reliable, complete and fair.

The interface between users and providers of management accounting is an important one. Users need to identify what information they need, and what decisions they might base on the information. They need to discuss this with the information providers, the management accountants, who in turn need to design an appropriate and understandable report, which uses measurable information.

Management accounting, then, involves the provision of accounting data to management, in order to facilitate managerial activity.

The UK business environment has changed radically in recent years. There is less manufacturing industry, and far more service businesses. Technological developments have allowed ever more sophisticated data to be available instantaneously.

Many organisations have also placed greater emphasis than before on non-financial factors in the measurement of performance, and a commonly used model is the 'balanced scorecard'. This considers performance against a range of indicators, which are not necessarily financial in nature.

The role of the management accountant has not, however, been diminished by this development – rather it has been expanded to include involvement in the development and measurement of more wide-ranging performance indicators.

Some observers therefore draw a distinction between 'traditional' and innovative' management accounting practices. Traditional aspects tend to focus on cost control and, in particular, what is known as 'variance analysis' which involves comparing forecast outcomes with actual outcomes – for example for costs such as materials and labour. The types of activity, therefore, that management accountants have traditionally involved themselves with include:

- cost analysis
- cost control
- budget preparation
- budgetary control processes
- cost/benefit analysis
- investment appraisal.

More modern, 'innovative' approaches include initiatives such as:

- business process re-engineering: which is about re-thinking and re-designing business processes as a means of reducing costs and improving delivery
- zero-based budgeting: re-thinking budgets in a way that involves justifying and prioritising all items of expenditure
- activity-based management: looking at what actually causes costs to be incurred, and being better able to forecast and control costs
- life cycle costing : considering a product's costs over its entire life cycle (rather than just, for example, the initial building costs)
- total quality management: the process of continuous quality improvement
- 'beyond budgeting': a challenge to traditional budgeting techniques via the use of more flexible and wide-ranging processes
- balanced scorecards: the use of key performance indicators within four different perspectives – financial, customer, internal business process and learning/growth.

You may have come across some of these in your own work experience in the purchasing and supplies world. They all have direct links with management accounting and the way information is reported, presented and used.