SUMMARY

A major function of management accounting information is to support managerial decision making, for a main criterion for rational decision making in business organizations is the maximization of financial benefits. However, the estimation of financial costs and benefits involves the combination of historical data with subjective estimates concerning future events.

This chapter reviews the accounting techniques used in both short- and long-term decision-making to illustrate that they are based on a few, powerfully simplifying assumptions. A linear programming approach is used to elucidate these assumptions and to indicate how many issues in management accounting, including transfer pricing, can be modelled using this technique. The linear programming model also illustrates the role of optimization techniques in management accounting. However, when the assumptions required to operationalize optimizing models become too heroic, the management accountant has to fall back on to simulation models, of which financial planning models are the most widely used.

INTRODUCTION

Management accounting is often defined (Arnold and Hope, 1983, p. 3) as being concerned with the provision of information to those responsible for managing businesses and other economic organizations to help them in making decisions about the future of the organization and in controlling the implementation of the decisions they make.

Indeed, many management texts define the task of management itself in terms of decision making, for decisions are the only obvious output of managerial activity.

Strictly, decision making is only one aspect of the wider process of management control; objectives need to be defined before rational decisions can be made, the need to make a decision has to be brought to a manager's attention and, once made, the decision has to be implemented and its implementation monitored. Nevertheless, decision
making is a vital aspect of the overall control process involving the
identification of alternative courses of action, the prediction of their
likely effects and the selection of the best alternative.

Traditional textbook approaches to decision making emphasize
the evaluation of alternatives, but have little to say about the first,
and perhaps most important stage of decision making (King, 1975;
Harrison, 1975). The identification of alternative possibilities is a
vital first step and one involving creative and innovative thought.
Subsequent steps aimed at discovering the optimum course of action
can deal only with those possibilities previously identified; if an
alternative is not suggested, no formal decision-making process can
ensure that it is considered. The second stage, the prediction of out­
comes that will follow from each alternative, has also received rather
sparse treatment. Apart from discussion of the application of statistical
forecasting techniques, the prediction of the consequences of actions
is assumed to be possible, but the process by which this is achieved
is left vague. We have noted in Chapter 1 that at the heart of every
control system there is a predictive model and this model is central
to effective decision making. Before a choice between alternatives
can be made, their likely outcomes must be predicted and values
attributed to each aspect of them.

It is the process of attaching values to predicted outcomes and
choosing between them that has been the focus of attention of economic
theory and, thus, management accounting. Economic theory has
settled on ‘profit maximization’ as the fundamental objective guiding
the activity of business firms; accounting has followed this lead
although, being more aware of the practical problems of measuring
profit, it has operationalized this concept in various ways; the more
modern approaches have suggested the maximization of the present
value of future cash flows as a suitable operational surrogate for
profit maximization. We shall necessarily eventually have to take a
more complex approach, involving multiple criteria, but the objective
of present value maximization will serve as an initial criterion of
choice.

Accounting texts usually distinguish between long-term and short-
term decisions. Long-term decisions are those where the time value
of money becomes significant and decision making techniques based
on the maximization of the net present value of expected future cash
flows are recommended. Short-term decisions are those that can be
altered within a time span where the effect of the time value of money
can be neglected (say, up to a time horizon of one year). Such short-
term decisions would often include output, product mix, inventory
level and pricing decisions, whereas long-term decisions usually
involve capital investment.