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 outcomes 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.