How Managerial Accounting Supports Operational and Financial Performance

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Organizations of all types and sizes across every industry utilize accounting procedures to ensure appropriate acknowledgement of assets, liabilities, owner's equity, and measures of operational performance. While some small organizations do not follow generally accepted accounting principles, most larger (and all public) firms follow standardized procedures for creating financial statements that reflect the financial position of an organization at a point in time. This practice is often done in concert with another form of accounting that helps to determine the costs and revenues associated with measuring financial transactions in pursuit of organizational goals rather than for purposes of presenting financial position for external parties. These two types of accounting practices are known as financial and managerial accounting and serve two different purposes. This paper presents a comparison of financial and managerial accounting for purposes of delineating similarities and differences and presents a real-life scenario in which managerial accounting helps managers improve operational performance.

Financial Accounting

Financial accounting is a type of accounting that records the transactions of an organization in a standardized format (Schroeder, Clark, & Cathey, 2019). This type of accounting is concerned with the summarization of transactions for purposes of creating a set of financial statements – usually an income statement, a balance sheet, a statement of owner's equity, and a statement of cash flow – that can be utilized by a variety of stakeholders with interests in the organization itself. Financial accounting is cyclical in nature with the associated transactions for a period being summarized on a routine basis (generally monthly) and accounts "closed" to present the financial position of the organization as of a specific moment in time (Caruana, Brusca, Caperchione, Cohen, & Rossi, 2018). This standardization is what makes financial accounting a cornerstone of publicly-traded companies and those organizations with stakeholders for whom financial disclosure is necessary (i.e., for investment and credit purposes).

The purpose of financial accounting is not to arrive at a valuation of an organization, although outside parties may utilize financial statements as one component of valuation (Schroeder, Clark, & Cathey, 2019). Rather the purpose is to standardize disclosure of financial information that allows those who choose to create valuation to do so. This underlying purpose is the driving force behind the use of generally accepted accounting standards, or GAAP, in financial accounting. GAAP, promulgated by the Financial Accounting Standards Board (FASB), sets out processes for recording assets, liabilities, expenses, and revenues in a way that makes them comparable to similar organizations operating in similar fashions in the same industries (Schroeder, Clark, & Cathey, 2019).

Financial accounting is founded on the premise of double-entry accounting, or a system of recording transactions that requires transaction to equally impact at least two accounts (or accounts in equal amounts with both debit and credit balances). Financial accounting is also conducted under the accrual method wherein revenues are recorded not when received but when earned and expenses are similarly recognized when incurred (Caruana, Brusca, Caperchione, Cohen, & Rossi, 2018). This standardization results in a matching of revenues and expenses that experts believe more appropriately represents the financial position of an organization.

Managerial Accounting

Managerial accounting, as opposed to financial accounting, is not intended to address standardized reporting of financial information but rather to provide information to organizational decision-makers regarding specific business metrics that may include cost of goods sold, margin information, and other metrics specific to the way an individual organization conducts its operations (Appelbaum, Kogan, Vasarhelyi, & Yan, 2017).

Managerial accounting encompasses many topics but is largely considered for internal use in an organization rather than external reporting of performance.

Cost accounting is perhaps the most well-known subset of managerial accounting. Cost accounting's objective is to provide information to managers with respect to the fixed and variable costs of production and providing information that can help with decisions to invest in production machinery and human resources or to make or buy specific components of a product, among other things (Marota, Ritchi, Khasanah, & Abadi, 2017). The primary benefit of cost accounting, as with most elements of managerial accounting, is that companies are able to analyze performance metrics at such detail that decisions about efficiency can be made, costs minimized, and profits maximized. This is not always the case in financial accounting where accrual-based accounting may not reveal those elements at a level of detail necessary for such performance-related decisions.

Because managerial accounting is intended to serve the needs of individuals internal to an organization, it can be highly customized and may even differ from department to department within an organization (Marota, Ritchi, Khasanah, & Abadi, 2017). This is the key difference between financial and managerial accounting and the aspect of accounting that must be disclosed whenever financial and operational information is reviewed. It is important to disclose which type of accounting was used so that stakeholders understand what they are seeing and the ability to generalize that information to other situations.

Example of the Benefit of Managerial Accounting

Managerial accounting is used across industries by a variety of organizations interested in determining areas where operational efficiencies and cost savings may be achieve. However, the practice is more common in manufacturing industries where product costing and the understanding of fixed versus variable costs can impact the decision of an organization to continue making a particular product or even to commence its manufacture entirely. One example of such benefit can be seen in the case of Armstrong World Industries, an American flooring company with more than one hundred sixty years of experience manufacturing prefabricated walls, ceilings, and flooring. Over nearly two centuries of operations, managerial accounting has supported decisions to enter and leave specific market segments, particularly those in the flooring industry, and has shaped the direction of a company that continues to be a leader in the construction industry.

A subsidiary of Armstrong World Industries once known as Armstrong Flooring was known for the manufacture of composite vinyl tile utilized in a myriad of commercial operations. This tile was the first flooring product made by Armstrong and was recognizable by its distinct appearance, being manufactured from shredded vinyl pellets, asbestos, lime, and pigments held together with adhesive fused through high pressure and heat. Over time, as commercial applications began to seek more sophisticated types of flooring with a less institutional appearance, Armstrong began to see sales of their vinyl flooring products decline. However, because the vinyl flooring tiles had been a stalwart of organizational operations, the company was reticent to discontinue or even reduce production of a familiar product they were known to be expert at producing.

Over a period of time in the early 21st century, Armstrong employed managerial accounting concepts to cost the production of vinyl tile and analyze it against the production costs and margins of other flooring products. This work determined that the costs associated with the manufacturing plants where vinyl tile was created (including credits purchased for toxic waste byproduct, raw materials, and shipping) were higher than the company had originally believed. The tile, while seen as a cornerstone of the company’s profitability, was actually costing more than the revenues it was generating. The decision was made to discontinue manufacturing of the vinyl tiles in many geographic locations, shuttering plants that had been in operation for a century and converting others to manufacture different components for the company's more profitable lines. Now, while the vinyl tiles can still be purchased, they are not the central component of Armstrong's flooring business that they once were.

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