Managerial vs. Financial Accounting

Rowan Bittner

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Todd Truax

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There are two types of accounting that are used, Managerial and Financial. Financial accounting involves recording and summarizing business operations over a set period for the public to review. Financial accounting is bound by Generally Accepted Accounting Principals (GAAP), to ensure that all the information is standard across the industry. On the other hand Managerial accounting is utilized internally, and not reported to the public. Because the data is only used internally, Managerial accounting is not restricted by GAAP. Managerial accountants can use the best system available for their company as it is important to be able to present data to their company. For example, a publicly traded company must follow the GAAP to easily compare between companies. If there were no uniform rules for reporting accounting information it would be nearly impossible to correctly compare companies promptly, and would be much easier for a company to misinform its investors. On an individual basis, a spreadsheet that is made to track an individual's spending would be an example of Mangerial accounting, as it is just for that individual's use and is not reported and required by any outside source. However, when that individual reports their taxes every year, that would be considered Financial accounting because it is required by the government every year. Financial accountants focus on monetary information while managerial accounting can include a variety of monetary and nonmonetary information.

There are numerous ways that costs can be defined; Behavior, Traceability, Controllability, Relevance, and Function are all cost classifications. Behavior costs are how the cost could vary or change depending on activity. There are two types of behavior costs; variable and fixed. Variables costs are costs that change depending on the activity, for example, the cost of wood to produce pencils is variable as it depends on the amount of pencils produced. A fixed cost is a cost that doesn't change, in the pencil example, this could be the rent of the pencil factory as the rent would stay the same whether no pencils were being made or one million pencils were being made.

Another way to classify costs is through traceability. Traceability is how the cost can be followed back to the product. Direct costs are costs that are directly involved with the product, with one specific cost object (Krug, 2014). For example, the cost of the wood to make pencils would be a direct cost. Indirect costs are something that can not be easily pointed out on the product to identify the cost. For example, the utility costs for the factory would be an indirect cost for the pencil.

Contrability costs measure how easily a cost can be controlled. Some costs can be controlled completely by the company itself while with others a company may have little to no choice in its cost (Tamplin, 2023). An example of something with little controllability is the rent price of the factory, as this is usually controlled by a third party. A cost that could have a lot of control would be the benefits to employees, for example, the decision to cut back on providing lunches to workers. While a middle-of-the-road controllability could be the quality of materials used in the production. Quality wood and graphite could be used in pencils which would raise the cost, or worse, but cheaper, materials could be used which would lower the total cost. This is not a totally controllable cost because materials still have to be made.

Classifying by relevance can also be referred to as opportunity cost and sunk cost. Opportunity cost is the potential cost of choosing one thing over another. In the pencil factory example, this could be the opportunity cost of closing down the factory for a day to give your workers a break. You will gain respect from your employees and improve morale at the cost of losing a day's profit from closing down. Another example is the opportunity cost of using lower-quality materials. You may save money using lower-quality materials but at the cost of having a lower-quality product. A sunk cost would be a cost that cannot be changed as it happened in the past. An example of this would be the pencil company ordering the wrong type of wood for their pencils but to not waste the product they use it and create a worse quality pencil, potentially damaging their reputation to not lose money on the materials.

Function is the final way to classify costs, which would be product and period costs. Product costs are costs that are incurred during the manufacturing of the product while period are not. There are three types of Product Costs; Direct Materials, Direct Labor, and Manufacturing Overhead. A direct material would be the materials that are integral to the product and can be easily traced, this would be the wood or graphite of a pencil. Direct Labor would be the labor costs of producing the material, the wages of the pencil factory. Manufacturing overhead are factory costs that do not have a direct role, this could be cleaning of the factory or the electric bill to run the factory. Period Costs would be general and administrative, executive costs, and selling costs, costs needed to deliver the product.

Knowing these different types of costs and being able to correctly classify them is an integral part of Managerial accounting. This is because it assists the company in planning, directing, and controlling the company and its products. Planning, for example, is the first step in launching a new product. To launch a new Pencil 2.0, for example, the manager must develop a budget for this new product. They would then need to analyze the budget and set a proper selling price to ensure that a profit is made on the new product and direct the company correctly. Once the new pencil is in production and on the sales floor the real-world results must be analyzed and the manager must control the production or price to ensure it is staying as expected. None of this can happen without managerial accounting. If a new pencil was made with no information on it, it would most likely fail and cost the company greatly.

In 2002 the Sarbanes-Oxley (SOX) Act was introduced. This act was meant to help protect investors from fraudulent financial reporting by corporations (Kenton, 2022). This act amended the previous Securities Exchange Act of 1934, reforming the areas of corporate responsibility, punishment, regulation, and protection. While Managerial accounting does not have to follow the GAAP, it does need to follow the laws from the SOX if it is for a US public company. Part of this act that must be followed is that the company’s auditor must report an opinion on how well the managerial accounting is being reported and presented to the

managers. In my opinion, while this act does not focus on Managerial accounting it does provide a good incentive to dispel or deter internal unethical behavior. With an auditor's review of the documents, they provide input on the annual report of the company's Managerial accounting. This annual report is then signed off, under punishment of criminal penalties and prison terms. While this may deter some, according to a recent report from the New York Times fraud is "disturbingly common" throughout the business world (Livni, 2023). This means that while SOX has helped reduce instances of fraud there is still much work that can be done on the subject.

In conclusion, Managerial accounting is quite different from Financial accounting. There are fewer rules and regulations against Managerial accounting, as it is not reported to any outside figures. There are also many ways to classify costs that can make it easier for Managerial accounting to track the costs of a product or business. The SOX Act of 2002 put more restrictions on accounting, however many were aimed towards the Financial accounting and not Managerial. This leaves room for fraud to still occur in corporations and more restrictions or rules could be put in place.

References

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