

Management Accounting: Decision-Support Tools, Performance Measurement and Strategic Relevance

*A Critical Evaluation of Costing, Budgeting and Contemporary
Management Accounting Practice*

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1. INTRODUCTION

Management accounting provides the internal analytical infrastructure through which organisations plan, control and make strategic decisions. Unlike financial accounting, which is primarily retrospective and externally orientated, management accounting is prospective, flexible and serves the informational needs of internal decision-makers across all organisational levels (Drury, 2021). Horngren et al. (2015) define management accounting as the process of identifying, measuring, accumulating, analysing, preparing, interpreting and communicating information to assist managers in fulfilling organisational objectives.

In a contemporary environment characterised by digital disruption, cost pressure and heightened stakeholder accountability, the discipline has evolved substantially beyond its origins in cost determination and budget control. Contemporary management accounting encompasses Activity-Based Costing (ABC), throughput accounting, the Balanced Scorecard, strategic management accounting and Beyond Budgeting — each contesting the adequacy of traditional paradigms. This report critically evaluates these developments, drawing on peer-reviewed scholarship and practical illustration to assess their applicability and limitations in current organisational contexts.

2. COSTING SYSTEMS: TRADITIONAL VS CONTEMPORARY APPROACHES

2.1 Absorption Costing and Marginal Costing

Traditional costing systems bifurcate into two foundational approaches: absorption (full) costing and marginal (variable) costing. Absorption costing allocates all manufacturing costs — both fixed and variable — to units of production, providing a comprehensive picture of unit cost that satisfies external financial reporting requirements under IAS 2 (IASB, 2022). Marginal costing, by contrast, charges only variable costs to

products, treating fixed overheads as period costs; it is thus prohibited for inventory valuation under IFRS but widely used for internal decision-making, particularly in short-run pricing and output decisions (McLaney and Atrill, 2020).

The critical difference emerges when production and sales volumes diverge. Under absorption costing, a period of inventory build-up inflates reported profit relative to marginal costing, because fixed overheads are carried forward in closing inventory rather than expensed immediately. This phenomenon — documented by Horngren et al. (2015) as the "inventory effect" — creates incentives for dysfunctional over-production in bonus-driven environments, a well-documented behavioural distortion of absorption costing systems (Baldenius, Melumad and Reichelstein, 2000).

2.2 Activity-Based Costing (ABC)

Cooper and Kaplan (1988) identified a fundamental flaw in traditional overhead absorption: the use of single volume-based cost drivers — such as direct labour hours or machine hours — to allocate overheads that are, in reality, driven by diverse and non-volume-related activities. In modern manufacturing and service environments, where overhead costs can constitute 70–80% of total costs, this distortion renders traditional costing systems strategically misleading (Kaplan and Anderson, 2007). Activity-Based Costing addresses this by identifying cost pools for each significant activity and assigning costs to products or services using activity cost drivers that more accurately reflect resource consumption.



Figure 1: Illustrative Overhead Allocation Accuracy — Comparative Overview of Costing Systems. Adapted from Kaplan and Anderson (2007).

2.3 Throughput Accounting

Throughput Accounting (TA), derived from Goldratt's Theory of Constraints (1990), offers a radically different perspective: rather than

reducing costs, it prioritises maximising throughput — the rate at which the system generates revenue less totally variable costs (material costs) — by identifying and exploiting the binding constraint within the production system. TA classifies all costs except direct materials as "operating expenses" (period costs), rejecting the conventional distinction between fixed and variable costs as inadequate for short-run decision-making (Corbett, 1998).

Critically, TA is most powerful when a single binding constraint exists and can be clearly identified — conditions that may not hold in complex, multi-constraint environments. Balderstone and Keef (1999) demonstrated that TA and ABC can yield conflicting product mix recommendations even when applied to the same dataset, highlighting that the choice of costing system is not merely technical but strategically consequential. The complementarity of ABC (for long-run cost management) and TA (for short-run throughput optimisation) is increasingly recognised in the literature (Corbett, 1998).

Table 1: Comparative Analysis of Costing Systems — Key Characteristics and Applicability

Costing System	Cost Driver	Fixed Cost Treatment	Best Suited To	Key Limitation
Absorption Costing	Volume (DLH / Machine Hrs)	Included in product cost	External reporting; stable production	Distorts profit when inventory levels change; incentivises over-production
Marginal Costing	Variable costs only	Period cost (expensed)	Short-run pricing; make-or-buy decisions	Prohibited for external reporting (IAS 2); ignores fixed cost recovery
Activity-Based Costing	Multiple activity drivers	Traced to activities	Complex / diverse product mix; service firms	High implementation cost; requires robust data infrastructure
Throughput Accounting	Constraint throughput rate	Operating expense (period)	Short-run product mix with single constraint	Limited applicability in multi-constraint; ignores long-run cost behaviour

3. COST-VOLUME-PROFIT (CVP) ANALYSIS

3.1 Break-Even Analysis and Margin of Safety

Cost-Volume-Profit analysis provides a framework for examining the relationships between costs, volume, selling price and profit, enabling managers to determine the break-even point (BEP) — the volume at which total revenue equals total costs — and to evaluate the sensitivity of profit to changes in key variables (Drury, 2021). The contribution per unit (selling price minus variable cost per unit) and contribution to sales ratio (C/S ratio) are the central analytical constructs.

Table 2: Illustrative CVP Analysis — Fictitious Product Alpha (Annual Data)

Item	Value	Formula / Note
Selling Price per Unit	£80.00	Given
Variable Cost per Unit	£48.00	Given
Contribution per Unit	£32.00	SP – VC
C/S Ratio	40%	Contribution / SP × 100
Total Fixed Costs (Annual)	£640,000	Given
BREAK-EVEN ANALYSIS		

Item	Value	Formula / Note
Break-Even Point (Units)	20,000 units	Fixed Costs ÷ Contribution per Unit
Break-Even Point (Revenue)	£1,600,000	BEP Units × SP
MARGIN OF SAFETY (Budgeted Sales: 26,000 units)		
Margin of Safety (Units)	6,000 units	Budgeted Sales – BEP Units
Margin of Safety (%)	23.1%	MoS Units ÷ Budgeted Sales × 100
Budgeted Profit	£192,000	MoS Units × Contribution per Unit

Note: All figures are fictitious and produced solely for educational illustration.

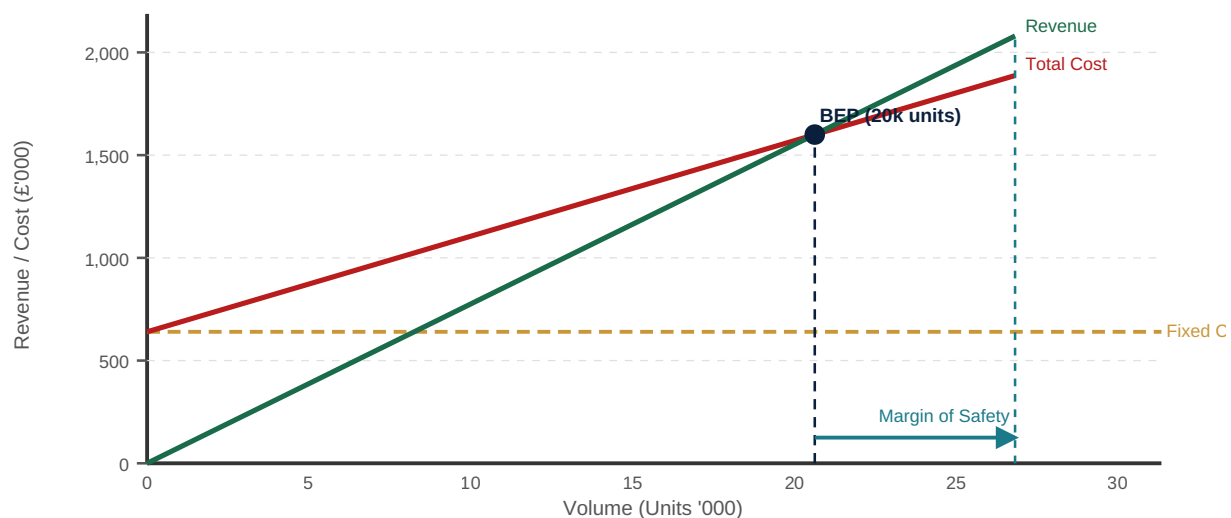


Figure 2: Illustrative Break-Even Chart — Product Alpha. Fictitious data for educational purposes only.

3.2 Critical Limitations of CVP Analysis

Despite its pedagogical utility, CVP analysis rests upon a set of simplifying assumptions that significantly limit its real-world applicability. The model assumes linearity of both revenue and cost functions across the relevant range — an assumption that ignores volume discounts on materials, economies of scale and non-linear selling price-demand relationships (Drury, 2021). It assumes that all costs can be cleanly bifurcated into fixed and variable components, overlooking the substantial category of semi-variable (mixed) costs and step-fixed costs that characterise most organisations. Furthermore, in multi-product firms, CVP requires a constant sales mix assumption — a condition rarely satisfied in practice. Kee and Schmidt (2000) demonstrated that ABC-based CVP analysis, which allocates overheads using activity cost drivers rather than a single volume measure, yields

materially different and more accurate break-even and profit projections, suggesting that traditional CVP analysis can systematically mislead strategic pricing and product-mix decisions.

4. BUDGETING: TRADITIONAL APPROACHES AND BEYOND

BUDGETING

4.1 Traditional Incremental Budgeting

Budgeting serves multiple managerial functions: planning, resource allocation, performance evaluation, coordination and communication (Otley, 1999). Traditional incremental budgeting — whereby the current period's budget is derived by adjusting the prior year's actuals by an increment for inflation or anticipated volume changes — remains the dominant approach in practice (ICAEW, 2020). Its principal virtue is simplicity and low administrative cost. However, it perpetuates existing resource allocations regardless of strategic relevance, institutionalises inefficiency through the well-documented "spending the budget" phenomenon, and provides weak incentives for cost innovation (Hope and Fraser, 2003).

4.2 Zero-Based Budgeting (ZBB)

Zero-Based Budgeting (ZBB), pioneered by Pyhrr (1973) and subsequently implemented across US federal agencies and major corporations including Unilever and Kraft Heinz, requires each budget holder to justify every expenditure from a zero base, rather than from the prior year. ZBB forces explicit prioritisation of activities, eliminates embedded waste and aligns resource allocation with strategic objectives. However, the administrative burden of comprehensive zero-basing is substantial — PricewaterhouseCoopers (2016) estimated implementation costs of 10–20% of annual savings for large organisations — and the process is susceptible to political gaming within organisations, as powerful departments leverage internal influence to protect budget allocations (Wildavsky, 1978).

4.3 Beyond Budgeting

Hope and Fraser (2003) mounted a fundamental critique of the annual budget as an organisational control mechanism, arguing that it locks organisations into rigid annual cycles ill-suited to a turbulent

competitive environment, promotes short-termism, encourages earnings manipulation and consumes disproportionate managerial time. Their Beyond Budgeting framework advocates replacing fixed annual budgets with rolling forecasts, relative performance targets, decentralised decision-making and a culture of accountability oriented toward value creation rather than variance minimisation. Implementing firms — including Handelsbanken, Svenska Handelsbanken and Borealis — have reported substantial improvements in organisational agility and cost efficiency (Hope and Fraser, 2003).

Critically, however, the Beyond Budgeting prescription has been contested. Ekholm and Wallin (2000) surveyed 168 Finnish firms and found that the vast majority retained traditional budgets despite acknowledging their limitations, suggesting that the behavioural and institutional barriers to budget abandonment are considerable. Neely et al. (2003) argued that the approach conflates the budget's planning and control functions, and that adaptive forecasting can improve the former without necessarily abandoning the latter. The practical conclusion, for most organisations, is that budget reform — through rolling forecasts, driver-based planning and relative benchmarks — rather than wholesale abandonment represents the more achievable path.

5. STANDARD COSTING AND VARIANCE ANALYSIS

Standard costing establishes predetermined unit costs for materials, labour and overheads, against which actual costs are subsequently compared. Variance analysis decomposes the difference between actual and standard performance into constituent causes, enabling targeted managerial investigation and corrective action (Drury, 2021).

Table 3: Illustrative Standard Cost Variance Analysis — Fictitious Product Beta (Month Ending June 2026)

Variance	Formula	£	F / A	Likely Cause
MATERIAL VARIANCES				
Material Price Variance	$(SP - AP) \times AQ$ Purchased	£8,400	FAV	Bulk purchase discount negotiated
Material Usage Variance	$(SQ \text{ for } AP - AQ \text{ Used}) \times SP$	(£3,200)	ADV	Higher-than-standard material waste

Variance	Formula	£	F / A	Likely Cause
LABOUR VARIANCES				
Labour Rate Variance	$(SR - AR) \times AH \text{ Paid}$	(£5,600)	ADV	Overtime premium due to demand surge
Labour Efficiency Variance	$(SH \text{ for AP} - AH) \times SR$	£4,100	FAV	Improved workflow from process redesign
OVERHEAD VARIANCES (Fixed)				
Fixed OH Expenditure Variance	Budgeted FOHC – Actual FOHC	(£2,100)	ADV	Unbudgeted maintenance expenditure
Fixed OH Volume Variance	$(AP - \text{Budgeted Output}) \times FOAR$	£3,800	FAV	Output above budgeted volume
Net Variance (Total)		£5,400	FAV	Net favourable — investigate material usage & labour rate

Key: SP = Standard Price; AP = Actual Price/Production; AQ = Actual Quantity; SR = Standard Rate; AR = Actual Rate; AH = Actual Hours; SH = Standard Hours; FOAR = Fixed Overhead Absorption Rate. All figures are fictitious.

Critically, standard costing and variance analysis have attracted sustained criticism in contemporary manufacturing contexts. Kaplan (1983) argued that standard costing systems — designed for labour-intensive batch production — provide dysfunctional signals in automated, JIT and lean manufacturing environments where the key performance drivers are quality, lead time and flexibility rather than labour efficiency. Johnson and Kaplan's (1987) *Relevance Lost* contended that management accounting had become subservient to financial accounting requirements, with standard costing variances offering too little, too late for operational managers. Furthermore, the use of standard cost variances as performance targets can incentivise perverse behaviours: favourable material price variances achieved through bulk purchasing may create excessive inventory and associated holding costs, whilst favourable labour efficiency variances may conceal quality defects that only manifest downstream.

6. THE BALANCED SCORECARD AND STRATEGIC MANAGEMENT ACCOUNTING

Kaplan and Norton's (1992) Balanced Scorecard (BSC) emerged as a direct response to the identified over-reliance on financial metrics in management control systems. By proposing that organisational performance be measured across four interconnected perspectives — financial, customer, internal business process, and learning and growth — the BSC sought to balance the retrospective, financial orientation of traditional control systems with forward-looking, non-financial indicators of sustainable competitive advantage.



Figure 3: The Balanced Scorecard — Four Perspectives. Adapted from Kaplan and Norton (1992, p. 72).

The BSC's transition from a measurement framework to a strategic management system — articulated in Kaplan and Norton (1996) — introduced the concept of strategy maps: causal chains linking learning and growth investments, through improved processes and enhanced customer value, to financial outcomes. This causal architecture was intended to align organisational activity with strategic intent and to communicate strategy throughout the organisation. Empirical evidence broadly supports the BSC's adoption: a survey by Bain and Company (2023) identified the BSC as among the most consistently used management tools globally, with adoption rates exceeding 50% in large organisations.

"What you measure is what you get. Senior executives understand that their organisation's measurement system strongly affects the behaviour of managers and employees."

— Kaplan and Norton (1992, p. 71)

Notwithstanding its influence, the BSC is subject to substantive critical evaluation. Nørreklit (2000) challenged the assumed causal logic underpinning the BSC's strategy maps, arguing that the relationships between perspectives are not causally deterministic but rather logically or temporally complex. Customer satisfaction does not mechanically produce financial results; the relationship is moderated by competitive intensity, pricing power and market structure. Ittner, Larcker and Randall (2003), in a study of 140 financial services firms, found that organisations using a "pure" balanced measurement approach — equally weighting financial and non-financial indicators — did not systematically outperform those using a financial-focused system, challenging the universality of the BSC's prescriptions. Furthermore, the BSC has been criticised for its neglect of stakeholder perspectives beyond shareholders and customers — notably employees, suppliers and society — a limitation partly addressed by Kaplan and Norton's later sustainability-orientated extensions but not comprehensively resolved (Figge et al., 2002).

Strategic management accounting (SMA) extends the management accounting function beyond internal cost management to encompass competitor intelligence, customer profitability analysis, strategic positioning and value chain analysis (Langfield-Smith, 2008). Tools such as lifecycle costing, target costing and attribute costing connect internal management accounting processes to competitive strategy. Customer Profitability Analysis (CPA), enabled by ABC, frequently reveals that a small proportion of customers generate the majority of profits — and that a significant subset of customers are actively loss-making when all service costs are allocated (Cooper and Kaplan, 1991). This insight has profound strategic implications for pricing, customer relationship management and channel strategy.

This report has critically evaluated the principal tools and frameworks of management accounting: costing systems spanning traditional absorption through ABC and throughput accounting; CVP analysis and its inherent simplifications; budgeting paradigms from incremental approaches to Beyond Budgeting; standard costing and variance analysis; and the Balanced Scorecard as a strategic performance management system. The overarching finding is that no single management accounting tool is universally superior; each framework embodies particular assumptions about organisational context, strategic priorities and the nature of costs and value creation that must be critically interrogated rather than unreflectively applied.

PRACTICAL RECOMMENDATIONS FOR MANAGEMENT ACCOUNTING PRACTICE

- 1. Deploy ABC for product and customer profitability decisions:** In organisations with diverse product/service portfolios and significant overhead costs, migrate from traditional absorption costing to ABC or Time-Driven ABC (TDABC) to obtain accurate cost information for pricing, product-mix and discontinuation decisions.
- 2. Reform rather than abandon budgeting:** Replace static annual budgets with driver-based rolling forecasts (12–18 month rolling horizon), supplemented by relative performance targets that decouple incentives from fixed budget commitments. This preserves coordination benefits while eliminating gaming incentives.
- 3. Use variance analysis diagnostically, not punitively:** Reframe standard costing variances as diagnostic signals requiring investigation, not automatic performance judgements. Distinguish between controllable and uncontrollable variance causes before attributing accountability.
- 4. Integrate non-financial KPIs via a strategy-linked BSC:** Develop a BSC that is explicitly linked to the organisation's strategy map, with a limited number of causally coherent KPIs per perspective. Avoid metric proliferation — Kaplan and Norton (1996) recommend no more than 25 measures in total.
- 5. Embed strategic management accounting:** Extend the management accounting function to encompass competitor cost benchmarking, customer

profitability analysis and value chain mapping, ensuring that internal cost intelligence is connected to external competitive dynamics.

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