

Teaching Notes

Introduction

It is now widely recognised that small firms are not only numerous, but constitute a vital force in modern information-based economies, such as Ireland. Researchers have suggested that the success of small businesses is dependent on the proper management of information, with particular regard to performance measurement and financial control. But it appears that a major barrier preventing owners of small businesses using management accounting information is that of cost. Closely related to the issue of cost is the fact that small business owners place a low value on the role of accounting information in their businesses. Given the factors mentioned above the provision of management accounting information within small businesses should not be viewed only as a technical exercise. The role of management accounting information will be influenced by the operational context of small businesses, a context that is strongly influenced by the owner's view of him/herself and by the involvement of family members in the business.

The case study deals with the founding and operation of a small family business. It looks at the rationale for establishing the business and how that rationale influenced the implementation and use of management accounting information systems. An important factor in the successful financial underpinning of a small business is that of the level of financial expertise of the owner. Sean, in common with many other owners of small businesses, was competent with regard to the business' core service provision, but was not possessed of an adequate level of financial expertise. There was also unwillingness on his part to acknowledge the role that management accounting information might play in business decision making. But, before students judge Sean's disinterest in financial decision making tools, students should ask themselves what is the role of management accounting information within a small business environment?

The case study highlights one of the dichotomies that face small businesses. Small businesses are constantly reminded of the importance of accounting information, yet the relevance of accounting information and the factors that influence the use of such information are rarely examined and explained. The case study encourages students and tutors to explore and evaluate the role of management accounting information in a small business context.

Set out below are several issues that will help students and tutors in their evaluation of the role of management accounting information in small businesses.

The Rationale for Founding the Business

In order to understand the role of management accounting information in Sean's business it is important to examine his rationale for founding the business. This understanding makes it possible for students to understand Sean's relationship with his business and with interested parties. The driving force for founding a business is rarely only that of cash generation. In Sean's case, and for many such businesses, he

could earn more and work fewer hours for an employer. There is of course the possibility of business growth, so that, eventually, the business might provide greater earnings than would employment. But, many small businesses do not grow and in many cases do not provide a reasonable standard of living. So why does Sean continue with a business that does not generate sufficient income and that may not do so for some time, if ever? The driving force, as with many of these businesses, is a wish, on the part of the owners, to take control of their own destinies, or at least their working lives. The lure of control tends to exercise a greater influence than that of future riches.

The Role of Accounting Information Systems

Sean's relationship with the recording and use of accounting information was complex. Sean did not totally disregard accounting information: he realised that he had to fulfil statutory requirements and that accounting information might have its uses. He ensured that he kept "good enough" accounting records, so that he could substantiate his Income Tax and VAT liability, and if possible reduce them. Sean made use of accounting terminology and information when he was negotiating with his bank and also in his dealings with the Inland Revenue and VAT Inspectors. Accounting terminology and information was recognised by Sean as important tools for interaction with third parties, but students should question if accounting information, and management accounting in particular, played a significant role in the reality that Sean had created.

Sean was reluctant to use his accountant to provide management accounting services. This reluctance was not primarily due to the costs involved in obtaining management accounting information, but a fear of loss of independence, of not being able to make decisions on his terms, however incorrect they might be. Sean set up his business to take control of his working life. He was fearful that he and his business would be managed by financial information, and its providers, rather than by him. Sean felt that he knew what was going on in the business and that he had no need of other sources of information.

The Use of Accounting Information

The type of accounting information that Sean made most use was that of financial accounting, but students should ask, is this type of accounting information useful for the decisions that faced Sean?

Sean faced a number of problems, most importantly an inability to generate sufficient turnover. And even when turnover increased it did not lead to increased income. Sean realised that jobs should not be priced, in the long run, using variable costs only. He had calculated an hourly absorption rate for overheads, but prices were made up and quoted on the spot. Therefore it is doubtful if the majority of prices quoted by Sean included the correct amount of overhead, yet given the nature of his cost structure, mainly fixed costs, an accurate calculation of overhead was vital. Students should consider the difficulties of calculating an accurate overhead absorption rate when it is difficult to estimate future demand. In theory each job could generate a profit, but erratic pricing, difficulties in estimating demand and consistent underestimation of time to complete jobs made it very difficult to realise potential profit.

When, evaluating Sean's decisions about pricing, students should consider the competitive pressures that affect small businesses. A small business, in a competitive market has to make decisions quickly and often without reference to accounting or competitor information. For small business the future is uncertain and cash flow is the 'lifeblood' of their businesses. Few business owners would feel that they could afford to reject, even unprofitable, orders, because such orders generate cash flow. Also such businesses would not be in a strong bargaining position. Students, given Sean's frequent problems with cash flow and the uncertainty inherent in the running of any small business, should evaluate Sean's position in relation to the acceptance or rejection of jobs.

To understand Sean's use of management accounting information, students must reflect on his view of control and how control is perceived in businesses of this size. Accounting information, in particular management accounting, is viewed as a necessary control mechanism for businesses. For Sean, control is located in the business function, editing magazines. Control is viewed in terms of editing quality, innovation in layout and meeting deadlines. The information that Sean made use of is grounded in the functions of the business, rather than the functioning of the business

Making Decisions: The New Business Venture

Students should critically evaluate the role of management accounting information in Sean's decision to enter into a business deal with Fergus. Questions need to be asked - Would the use of management accounting information have prevented Sean from entering into business with Fergus? What are the limitations of management accounting in conditions of uncertainty, particularly when that uncertainty is associated with a person, rather than an event? The proposed deal appeared to be financially sound, but can the same be said of Fergus? It is obvious that Fergus has credit and cash problems, and that there was a lack of information about his previous business dealings. How would Sean uncover details about Fergus' business situation and his dealings with other people? Would people that had worked with Fergus be willing to speak to Sean? Even if Sean's wife's suspicions about Fergus were confirmed, would the opportunity to do business with a prestigious supermarket be rejected?

Students should consider Sean's reaction to financial information about the venture. Would cash flow information about the venture dissuade Sean? To answer this question students have to evaluate the attractiveness of the venture for Sean. Consideration must be given to financial and non-financial factors, involved in the venture, and to the context within which decision-making takes place. Sean is making decisions in a small business context and in conditions of great uncertainty. In large organisations decisions are usually made by more than one person and often after considerable debate. What opportunities are there for Sean to discuss the venture with experienced people? And is Sean making what might be called a rational decision? Sean's rationale for the creation of the business is based on an emotional need, a need for control, with that underpinning, what guarantee is there that decision making is rational?

Decision-Making: For the New Venture

To properly advise Sean, Tom needs to take account of the issues discussed above and also to provide suitable financial data with regard to the new venture. Students should

evaluate the suitability of decision-making tools such as Net Present Value and Internal Rate of Return. Are such tools suitable for use by Sean? Do such tools suit the nature and size of Sean's business? Any suggestions made by Tom must be, for Sean, understandable and relevant. Given Sean's increasing indebtedness and cash flow problems, students must decide what is the priority for the venture, the generation of profit or cash flows?

To produce useful cash flow statements students will have to decide on the inclusion or exclusion of a number of factors. It is most useful if Tom produces cash flow statements that can be used in a 'what if?' analysis, as there are several unknowns in the new venture scenario.

The key factor in the success of this venture is the timing of cash flows, particularly receipts, as for Sean there are considerable up-front costs. Sean's fee is dependent on the timing of advertising receipts. The timing issue is affected in turn by the decision to accept Fergus', or Mary's estimation as to the timing and amounts of advertising revenues, or chose a middle route between the two opinions. Tom needs to be prepared to state his assumptions and to provide differing estimated cash flows to reflect changes to those assumptions. Sean may also, at the meeting, want to contribute his opinions about receipts and payments. Examples of a number of cash flows are provided, they represent best and worst case estimated cash flow scenarios for Fergus and Sean. Students should think carefully about the information provided in the case study and the assumptions made, in the examples referred to above, when generating their 'what if?' analysis for the new venture. For example, could, and would, Sean reconsider some of the new venture's start-up and running costs?

Tom must also provide Sean and Mary with some advice on how to improve their business' turnover. The following questions need to be addressed:

How can the current level of indebtedness be funded?

How can more business be generated?

How can pricing improve?

How can suitable control systems, that Sean will use, be designed and implemented?

What help and advice is available for small businesses and how might they be relevant for Sean's business?

The proposed answers to the questions, stated above, need to take into careful consideration the context in which the business operates and Sean's rationale for founding the business. In these types of scenarios - small, single-owner businesses - the personal context in which the business operates is as important as its competitive context. For example, any help and advice will have to take into account Sean's desire to feel in control.

Conclusion

The case study enables students to critically analyse the process of decision making within small business. In particular for students studying accounting, usually in a limited, or public company context, this case study provides a small business environment in which the roles and uses of management accounting information can be evaluated. And, more importantly, the case study encourages students to determine how owners of small businesses are to be convinced as to the usefulness of management accounting information. In convincing owners of the usefulness of

management accounting information, students should take into account the personal context in which small businesses are embedded. Students should also consider the possibility that the usefulness of management accounting information may be limited within small businesses, if this is found to be true, alternative systems of control must be designed and implemented. But, regardless of the source discipline that may underpin small business control systems, their usefulness lies in their ability to be dynamic, deliver speedy, ad hoc information and above all to ground that information in the founding and operational rationale of the business owner. Control systems that can not deliver the attributes mentioned above will not be accepted and implemented by small business owners.