A Call For Research: The Need For Development of Management Accounting Concepts For Professional Service Firms

Dr. Jerry D. Whitt, Accounting, Millsaps College
Dr. Sue Yeager Whitt, Accounting, Millsaps College
Dr. David H. Culpepper, Accounting, Millsaps College

Abstract

The results of a survey of recent managerial and cost accounting textbooks suggest that professional service firms have been largely ignored in cost and managerial accounting courses. With the purpose of identifying possible areas for research, this paper presents several managerial accounting concepts that are typically approached from a manufacturing orientation which could as easily be presented from a service viewpoint.

Introduction

Service industries have become a dominant segment of our economy. Of the 2.4 million jobs expected to be added to the United States labor force next year, more than 1.7 million will be in this segment while the manufacturing segment will add only 610,000 jobs [Madigan, 1988, p. 22]. All too often, the academic agenda--in the curriculum as well as in research--has not responded to this basic change in our economy. Cost and managerial accounting courses, in particular, still rely heavily on manufacturing as their main focus even though firms in the service industries have needs very similar to those in manufacturing. This paper will present some managerial accounting concepts that are typically approached from a manufacturing orientation which could as easily be presented from a service viewpoint as well as other aspects of services which cost/management accounting teachers should address.

Many elements in service industries, such as inventory control systems in wholesaling and retailing firms and cost analysis in fast food companies, are easily and readily adapted and are well understood. No change in the type of analysis is required to switch from manufacturing to services when considering these systems. Indeed, the management at Kentucky Fried Chicken thinks in manufacturing terms even though fast foods is counted as a service industry. A further illustration of the application of management accounting concepts to a services environment arose with deregulation of banking and airlines. Companies in these industries found it necessary to begin determining costs by individual product lines and market segments in order to ensure

competitive pricing.

Purpose

Rather than examine the management accounting concepts of these service firms, this paper will suggest that management accounting researchers should no longer ignore another component in the service industries, in particular, professional services firms (PSFs). Examples of these firms include legal, public accounting, consulting, engineering, advertising, medical and dental, and other businesses which are based upon the knowledge and professional certification of the principals in the organization. There is a paucity of coverage in management/cost accounting textbooks on PSFs indicating there has been little research to provide a base of knowledge about PSFs. The purpose of this paper is to identify possible areas for research into PSFs for management accountants. The payoff from such research would be in two areas: 1) the orientation of managerial/cost textbooks would expand beyond manufacturing, and 2) PSFs would be more efficiently managed.

PSFs are largely being ignored in the textbooks. A survey of recent managerial and cost accounting textbooks was conducted to determine the extent of coverage of accounting concepts applicable to PSFs. The survey method used was to scan the table of contents and glossary sections for any reference to PSF-related topics and then investigate the nature of the content once some reference was discovered. The results of this

survey are summarized in Table 1. As can be seen, three of the nine textbooks included in the survey had no reference to PSFs and four had only cursory reference. Two textbooks did cover PSFs in a substantive manner, devoting a chapter to the topic. One possible limitation of the survey: authors may have begun to integrate PSFs into their textbooks by using them in homework problems or in illustrations, and such a development would not appear in the search for indexes. In this vein, for example, one text uses a consulting firm as a basis for a homework problem dealing with compensation.

The second payoff identified above--the need for an improvement in firm management--was the initial impetus for this study. Recently, concern about firm management by practitioners in many of the industries identified above has been expressed to the authors. It became obvious that there was a substantial gulf between what we know and what we need to know about PSFs. Consequently, the method of study of this paper has been countless interviews and conversations with practitioners from a variety of firms. The observations made here are summarizations of their observations and provide a research agenda which could have a substantial impact on our economy.

TABLE 1
SURVEY OF CURRENT MANAGERIAL AND COST ACCOUNTING

Textbook	Comment
<u>Cost Accounting: A Managerial Approach</u> , 2nd ed., Cherrington, Hubbard, and Luthy	One-half page devoted to a job-order costing application to PSFs, no other references found
<u>Managerial Accounting</u> , 3rd ed., Davidson, Maher, Stickney and Weil	One and one-half pages devoted to a variable overhead application of PSFs; three pages to cost flows for PSFs
<u>Cost Accounting</u> , 2nd ed., Deakin and Maher	One and one-half pages devoted to budgeting applications; one page to cost flow applications; one and one-half job-order applications of PSFs
<u>Cost and Managerial Accounting</u> , 2nd ed., Hartley	Entire chapter on cost accounting applications to non-manufacturing costs, including four and one-half pages dealing with cost accounting systems for PSFs
<u>Introduction to Managerial Accounting</u> , 7th ed., Horngren and Sundem	One page on the characteristics of PSFs; one page on product costing application of PSFs
<u>Management Accounting</u> , Decoster, Schafer, and Ziebell	No references to PSFs found
<u>Managerial Accounting</u> , Engler	No references to PSFs found
<u>Managerial Cost Accounting</u> , Ferrara, Dougherty, and Keller	No references to PSFs found
<u>Cost Accounting/A Managerial Emphasis</u> , 6th ed., Horngren and Foster	The chapter on nonmanufacturing job costing, project costing, operation costing, and JIT costing has a major section devoted to professional services firms

Rationale For Studying PSFs

While many of our students will find employment with PSFs and many others will be in consultative positions serving PSFs, generally, they are not being exposed to this environment. Beyond the career interests of our students, our concern that these firms require academic study is based on their growing importance in the American economy, the increasingly competitive environment they face, and the growth in firm size which has created an organizational complexity which did not exist until recently. All of these changes necessitate improvement in the planning and control of PSFs and elevate the importance of treating them as a topic for academic study. The researcher will find the field virgin for adapting manufacturing concepts as well as developing new concepts.

Performance Measures

Management performance is measured by well articulated and readily accepted measures of performance. Such measures provide the means of providing comparisons over time and against external and internal standards for a business. These measures are well developed in manufacturing and many large publicly owned service companies largely because their records have been in the public domain for some time and they have been the subject of intensive research. PSFs, however, are still largely characterized by being privately owned and small; consequently, little has been done to develop techniques and standards for comparative measurement.

Computer and communications technology is changing the means used by businesses to plan and control and the geographical space in which they operate. These forces are at work on PSFs as well as other service and manufacturing firms. Local firms have become regional, national, and even multinational in accounting, advertising, consulting and other professional services industries. The products (services) these firms offer is also undergoing change: accounting firms, for example, do a great deal more than tax and auditing these days. And the organizational structure of PSFs has changed from one of partners and staff--a very flat organizational structure--to one of hierarchical layers, brought about by increased geographical and service diversity.

As a consequence of these changes, practitioners are concerned that the management styles of the past are no longer appropriate for the PSF of today. It is the new kind of management accounting which is emerging in the accounting literature that is most applicable to

professional services firms. For example, Johnson and Kaplan in *Relevance Lost, The Rise and Fall of Management Accounting* discuss those factors which are not necessarily financial that impact a company's long term profitability. Their work is relevant to PSFs although this book does not deal with them explicitly. Essentially, the nonfinancial indicators which accounting teachers should be incorporating into their classes include product innovation, product leadership, product quality, market share, market growth, employee skills, employee morale, employee productivity, delivery and customer service, and customer loyalty. [1987, pp. 256-260]

All of these factors are as applicable to PSFs as to manufacturing companies and in some cases are more applicable. Since the competitive advantage of any successful PSF must be in its personnel, performance measures must be designed to measure effectiveness in this area. The challenge to us as researchers and teachers is to develop appropriate performance measures and incorporate them into our classes for our students, who someday will be managing with these measures.

Our analysis suggests that manufacturing accounting concepts can be adapted and applied toward measurement of PSF performance in several areas. These areas include capital investment, product planning, cost control, quality measures, time, and other topics. These and other concepts and measures are presented in summary form in Table 2.

Capital Investment

For a PSF, capital investment is primarily people-oriented and the major capital investment is in employing, retaining, and providing for the continuing education of its staff. With today's accounting standards, these are not balance sheet items. Since the nature of "expertise" is constantly changing, the true asset base of many firms is changing even though the financial balance sheet may not be. We understand that a firm can lose its edge in productivity if the company does not constantly upgrade its manufacturing plant and equipment; surely, it is as important for a professional firm to realize that the same can happen with personnel. For the manufacturing firm, financial statement measures compared with those of the competition can be used in assessing asset productivity and aid in making investment decisions. For the PSF, with its major "asset" off the balance sheet, traditional measures would lull management and not alert them to the potential problem.

A major capital investment decision for a PSF consists of training and continuing education programs

TABLE 2
POSSIBLE AREAS FOR RESEARCH:
MANUFACTURING CONCEPTS WHICH MAY BE TRANSFERABLE
TO PROFESSIONAL SERVICES FIRMS

Manufacturing	Management Accounting Concepts	Professional Services
Manufacture product and components or use subcontractors	Make or buy decisions	In-house services such as training vs. outside consultants
Product output/Man-hour Sales per employee	Employee productivity	Ratio of billable hours to total hours
Sales/Total market	Market share	Revenues/Total market
Product segment information	Market mix	Ratio of unique service hours to commodity service hours; Ratio of institutional customer hours to new customer hours
EOQ, JIT	Inventory control	Scheduled hours/Total hours; Data on outside consultants
Plan capacity for peak demand or use outside contractors	Load planning	Employee staff specialists or provide referrals to specialists; Staff for peak loads or hire temporary staff
New hires/Labor force	Employee turnover	New professionals/Total professionals; New support staff/Total staff
Inventory, tooling, training	Cost of diversity	Training, library, memberships, continuing education requirements for maintaining certification

for its personnel. This area is ideal for presenting the classic make-or-buy decision and for studying relative productivities. Deciding whether to have a training program in-house or whether to use outside consultants can be presented as the make-or-buy decision. Studying the effectiveness of different pedagogues for updating a firm's professionals is similar to studying the productivity of different machines.

A PSF has additional nontraditional capital investments: art, for example. Aesthetics are as important for a professional environment as shelf placement is for marketing a product as clients are attracted to a firm which gives a quality appearance and professional talent is attached to a pleasing work environment. No PSF of substance today would open an office without expensive art work on its walls and this expenditure is a part of the capital investment of the firm. But aesthetics, and training discussed above, have not become a part of the accounting lexicon so the research has not been done to determine the ROI of such capital investment.

A third capital investment decision concerns the technology used in accessing and manipulating information. The firm (and its employees) that knows what and how to access the information it needs and that can quickly respond to client needs will have the competitive advantage. Capital equipment provides for this competitive advantage for PSFs, just as it does in manufacturing firms. The economic value of information is still an embryonic field, and research in this area will be of help to PSFs.

Product Planning

Product planning in the manufacturing environment refers to forecasting demand, planning product mix, capacity planning, line balancing, materials requirement planning, purchasing, and inventorying. Many quantitative techniques have been developed to implement manufacturing systems and to measure their performance. Research is needed to determine ways to apply these techniques to professional services.

Parallels between manufacturing and professional services exist for forecasting demand. In some cases, demand for professional services can be forecast with considerable precision, much like that for manufactured consumables, and in other cases, with great imprecision, such as for capital goods. An accounting firm, for example, knows its clients will have tax and auditing needs annually but merger and capital-raising services tend to come in waves which are less predictable.

Capacity planning in manufacturing is primarily a function of machine capacity whereas in professional services it is almost entirely a function of head count and how well that head count can be leveraged. Line balancing in manufacturing refers to optimizing the combination of machines so that their output is synchronized and bottlenecks and idle machines are minimized. Comparable planning in professional services would be the prioritizing of work so that those activities which have the highest payoff for the firm relative to time invested are done before those which are easy or interesting or otherwise personally rewarding. Hiring policies and training in PSFs are comparable to materials requirement planning, purchasing, and inventory control. Instead of buying components, the firm is buying expertise which is its inventory. Question: can these manufacturing control concepts be adapted to the PSF environment?

Cost Control

American manufacturers no longer think of product diversity and inventory as being ineluctably of value but rather as being causes of increased costs. This attention to cost cutting has been extended to simplifying product lines, decreasing the number of components, and reducing work-in-process. Professional services firms also have diversity cost. This cost includes such items as: investment and maintenance costs of a professional library, membership fees, and the cost of maintaining expertise by members of the firm. The resource demands of each of these needs become more complex as the diversity of the practice increases and costs will increase proportionately. Consequently, marginal

analysis is as appropriate in PSFs as in manufacturing firms when making the decision to expand the business and should be studied from that prospective.

Quality

American manufacturers have recently become aware of the importance of quality, a topic which has always been of importance to PSFs. Quality, as evidenced by the firm's reputation, has been the successful PSF's most important competitive advantage. Yet, since tolerances cannot be computed, voltages measured, nor rejects counted--since it is intangible impressions rather than physical defects--quality measurement has a different and difficult dimension with PSFs. It is the area, perhaps, which has the greatest potential payoff for research.

Professional services firms are facing environmental changes such as regional expansion, litigation, and competition from nontraditional competitors. These changes are challenging the maintenance of the firms' reputations. The expected impact that expansion will have on the practice of law has been outlined in the recent book by Mark Stevens, *Power of Attorney* [Glaberson, 1986, p.104-112]:

As veteran lawyers begin to retire, there is likely to be a decline in the service the law firms offer their corporate clients. The professional atmosphere that fostered high-quality work won't survive the corporatization of law practice. The bigger you get, the sloppier the work is going to get. For those who can't streamline or specialize, there's going to be a lot of suffering.

The equivalent of "production" and "inspection" have always been integrated in professional services; when services are performed poorly, the client usually knew immediately and specifically on whom to affix responsibility. A danger exists, however, if the two functions become separated. As firms grow and levels of responsibility evolve and as principals in these firms leverage their time by delegating functions to staff or outside service firms, the role of the principal will become one of inspecting the work of others. Many accounting firms do not prepare the forms for their tax clients today, for example, but rely on firms which specialize in this service.

This different and changing environment should enable the researcher to relate the concept of quality to the way industries are organized. In a closed market, as the environment was when PSFs were operating in a local setting, sellers can trade off price against quality.

A firm can develop a market niche based on low cost or high quality. In an open or broader market, sellers must compete on the basis of price and of quality. Quality not only offers a competitive advantage, as in manufacturing, it also has a role in cutting cost and provides a possible defense against litigation.

Quality, as can be seen, has many more facets when presented in the PSF context than when presented for manufacturing. It opens a world for the researcher to think in terms of: "What really is important for firm success and survival?"

Time

One studying manufacturing does not really appreciate the economic importance of time as the emphasis is much more on the concept of quantity. The popularity of "time management" courses parallel the emergence of professional services for a good reason. In professional services, revenues usually are billed directly on the basis of time so it can be studied more as a limiting resource. A key question in organizational growth for PSFs is how the time of the principals can be leveraged best to maximize firm revenues, a concept which receives little attention in the manufacturing environment.

Other Topics

Many aspects of services are interesting in their own right and should be studied. Services are neither homogeneous nor interchangeable. The level of cost in a reporting period for a PSF is not necessarily related to the number of clients served by a PSF during that period. In general, services can not be inventoried and demand for professional services can not be back-ordered. These facets of professional services are an interesting contrast to the manufacturing environment and should provide the managerial/cost researcher with ample areas for study.

Conclusion

Professional services firms face the same problems of economic scarcity and environmental change problems that manufacturing firms encounter. As a topic of study, professional services have not received attention that manufacturing firms have because they were relatively unimportant to our economy until recently and their success was based entirely on the reputation of the partners' local reputation. Today, professional services firms are gaining national and international stature and require professional management. Many of the techniques and systems for providing management of these firms with the information necessary for making deci-

sions has not been developed but the basics can be readily adapted from selected traditional management accounting concepts.

We are familiar with the story of the generals who studied the last war and were unprepared for the changed technology of the next war. The real culprit was the teachers of those generals, of course, as the teachers prepared the generals for an environment which no longer existed. As cost and managerial accounting teachers, we must ask ourselves: "Are we preparing the next generation of accountants and managers for an economy which no longer exists?" The question is rhetorical and will be answered from a different angle: We are not preparing students to work and manage in an economy which does exist--one based on professional services--because we have not done the research necessary to understand this new economy. This paper highlighted some of the important cost drivers in PSFs to show how managerial and cost teachers can address topics appropriate for PSFs. By studying these cost drivers in the professional services context, a beginning can be made in educating our students for this important component of today's economy and for providing techniques to improve management of these firms.

References

- 1 Cherrington, J. Owen, Hubbard, E. Dee, & Luthy, David H. (1988). *Cost Accounting: A Managerial Approach* (2nd ed.). St. Paul: West.
- 2 Davidson, Sydney, Maher, Michael W., Stickney, Clyde P., & Weil, Roman. (1988). *Managerial Accounting* (3rd ed.). New York: Dryden Press.
- 3 Deakin, Edward B. & Maher, Michael. (1987). *Cost Accounting* (2nd ed.). Homewood: Irwin.
- 4 Decoster, Don T., Schafer, Eldon L., & Ziebell, Mary T. (1988). *Management Accounting*. New York: John Wiley.
- 5 Engler, Calvin. (1987). *Managerial Accounting*. Homewood: Irwin.
- 6 Ferrara, William L., Dougherty, Frank P., & Keller, I. Wayne. (1987). *Managerial Cost Accounting*. Houston: Dame.
- 7 Glaberson, William B. (November 17, 1986). Megafirms Are Taking Over Corporate Law. *Business Week*, 104-112.
- 8 Hartley, Ronald V. (1986). *Cost and Managerial Accounting* (2nd ed.). Boston: Allyn and Bacon.
- 9 Horngren, Charles T. & Foster, George. (1987). *Cost Accounting/A Managerial Emphasis* (6th ed.). Englewood Cliffs: Prentice-Hall.
- 10 Horngren Charles T. & Sundem, Gary L. *Introduction to Managerial Accounting* (7th ed.). Englewood Cliffs: Prentice-Hall.
- 11 Johnson, H. Thomas & Kaplan, Robert S. (1987). *Relevance Lost/The Rise and Fall of Management Accounting*. Boston: Harvard Business School Press.
- 12 Madigan, Kathleen. (1988). The Hiring Machine Will Work Overtime This Year. *Business Week*, June 6, 22.