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# Some aspects of accounting and management accounting during economic downturns

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**Abstract:** Economic slowdown and downturn creates new situation for every organisation, no one can avoid facing to new situation created by the global financial-, and economic crisis. All of the organisational function should reconsider its own role within the company due to the new circumstances, Accounting and Mangement Accounting can not be exception, but they have more complex and emphasized role in these difficult times. In the following paper I can not avoid to mention some general statement about importance of accounting and accounting principles, while there are a number of critical accounting and financial reporting issues that accountants and auditors should consider. In the framework of the paper I can not face with all relevant issues of the topic, but after some general statement I would like to highlight some special area regarding to management accounting, which can be more important during these challenging time for decision makers and accountants. Regarding to balance sheet analysis its important to mention current debate about fair value comparing with historical cost from accounting point of view, on the other hand from the view of management reporting system I would like to highlight the importance of working-capital indicators. More practical topic is the crucial role of budgeting and forecasting during economic downturns, and at the end I would like to show why it is more important monitoring price variance and indirect cost allocation in these uncertain business circumstances.

***Key words:*** Economic downturn, management accounting, working capital, forecasting, tools

## Introduction

Economic slowdown and downturn creates new situation for every organisation, no one can avoid facing to new situation created by the global financial-, and economic crisis. All of the organisational function should reconsider its own role among the new circumstances, Accounting and Management Accounting can not be exception within the whole organisation, but these functions have more complex and emphatic role in these difficult times. As the following paper deals with global economic crisis, I can not avoid to mention some general statements about the importance of accounting and accounting principles, but in the main part of the paper I would like to focus on generally known Management Accounting tools which can have bigger importance nowadays, and which can help business management in proper decision making.

## Results and discussion

### *Audit and Accounting consideration*

In today's economic environment, which affects all types of businesses and industries, it is crucial to remain cautious to current events and to evaluate how they affect the audits the companies perform. There are several critical accounting and financial reporting issues that auditors should consider, such as: fair value, including fair value measurements in illiquid markets, impairment, liquidity restrictions, etc. Consequences of Enron's accounting failure are well known, we should not emphasize the importance of proper accounting, when credibility and transparency mean more and more value for investors.

Hungary is experiencing great economic instability; it is officially declared that the country and the region are entered into a recession. These ever-changing economic times make accounting for transactions and auditing entities more challenging. Few, if any, industries are immune to the affects of the crisis so it is more critical than ever for accountants and for auditors to understand the rapidly changing business and economic environment in which Hungarian companies are operating.

The recent economic conditions and circumstances may cause additional risk factors that had not existed or did not have a material effect on audit clients in prior years. Some risks may include: constraints on the availability of capital and credit, going concern and liquidity issues, marginally achieving explicitly stated strategic objectives, use of off-balance-sheet financings, special-purpose entities, and other complex financing arrangements, and volatile real estate markets and the credit crisis, which result in significant measurement uncertainty, including accounting estimates and fair value measurements. While many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. Additionally, given the constant changing status of economic conditions which could affect companies, accountants and auditors should consider modifying procedures to ensure risks are still addressed adequately.

## Balance sheet analysis – fair value

One of the most crucial accounting tasks in the uncertain period is to present and to understand what the company holds on its balance sheet. From investor point of view credibility means the transparency of assets and liabilities, and the proper evaluation of them, which should based on fair-value evaluation.

Fair value recognises changes in market prices of assets and liabilities immediately. Accounting standard-setters have defined fair value in different ways. All of them are essentially variations on current market value or an estimate, where a market value is unavailable or regarded as unreliable, of what the market value would be if there was a market. Fair value is also referred to as mark-to-market.

There are various alternatives to fair value as a basis of measurement in accounts. The principal one, and in the context of the current debate the only one seriously considered as an alternative, is 'historical cost'. There are two major differences between fair value accounting and historical cost accounting:

- Fair value recognises unrealised gains, whereas historical cost only recognises realised gains – i.e., gains that arise when assets are sold. That is to say, fair value accounting recognises gains where assets rise in value above their historical cost.
- When assets fall in value, this is recognised under both fair value and historical cost accounting. But whereas fair value means the assets are written down to their new fair value, historical cost means that an impairment provision is made against those assets.

After understanding the principles of fair value analysis I would mention two more general aspects of fair value analysis. It is also important for every accountant to gather updated market information to fair value analysis, which is not obvious during the ever changing period. Not strict related to the accounting itself, but it is also important to prepare the management and the investors to the Profit and loss statement (P&L) impact of any financial evaluation.

## Management reporting system – Focus on working capital

Working capital management means managerial accounting strategy focusing on maintaining efficient levels of both components of working capital, current assets and current liabilities, in respect to each other. Working capital management ensures that a company has sufficient cash flow in order to meet its short-term debt obligations and operating expenses. The well-known „Cash is a king" slogan was never so relevant than nowadays, when all businesses have to operate in freezing financial circumstances, and no one can expect significant improvement from increasing revenues.

As I wrote earlier, in the frame of this paper I just highlight some aspects of accounting in economic downturns, so I can give only some general statements about an effective management reporting system regarding to working capital management.

An effective management system means reporting and maintaining close contact with the company could alert directors to potential danger about working capital issues, which can reflect in providing and analysing the following indicators:

- Declining turnover
- Working capital deficiencies
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment
- Excessive reliance on short term borrowings to finance long-term assets
- Denial of usual credit terms by suppliers and other creditors
- Negative cash flows from operating activities, either historical or projected
- Adverse financial ratios
- Significant deterioration in the value of assets used to generate cash flows

If the management reporting system can provide these indicators in time, it also important to use the gathered information. It means not only to monitor accounts receivable, watch for new patterns of slow payments and follow up immediately, or just review largest and riskiest accounts to determine the potential impact of credit constraints and economic slowdown on their ability to pay you. In case of manufacturing companies it also includes to review inventory management practices and identify opportunities to reduce your on-hand inventory. Re-evaluate the potential risk related to reliance on critical supply chain partners.

## Planning and forecasting – difficulties of precise prediction and timing

Importance of planning and forecasting is an everyday activity for management accounting, and not just in case of bigger companies, but due to relatively cheaper information technology tools is a general practice in case of SMEs (small and medium enterprises).

Forecasting Methodologies can be divided into two categories: Qualitative forecasting techniques and Quantitative forecasting techniques.

***Table 1.*** Forecasting techniques

| Qualitative Techniques | Quantitative Techniques |
|---|---|
| Expert Opinions | Naive Methods (Linear Growth) |
| Consumer Surveys | Moving Averages (Simple, Exponential) |
| Sales Force Polling | Time Series Decomposition |
| Economic Indicators | Box-Jenkins Approach<br>Regression (Simple, Multiple) |

http://bizjournal.smbzen.com/small-business/an-overview-of-business-forecasting.html

Both techniques depends on reliable and available information, to gather data is more and more difficult in the hectic business environment, no one may safely neglect any available source of information. In the business world success depends on comprehending the situation than other does, and acting in accordingly. What is recognised „as fact" must first be evaluated correctly to make it useful and undertaking.

Other relevant aspect of forecasting is the timing and the question of what can we expect on short-term and long-term. Nowadays we can easily forget what we had in the operating plan or in any forecast which was put together few weeks ago, while key assumption are changing day to day. In spite of annual planning and forecasting quarterly estimates are much more useful and relevant, there is not any reason to plan on a longer term in an ever-changing world.

The previous concerns do not mean that the companies should forget forecasting model, even more these tools are much more important than earlier, but the reliability and quality of key assumption and basic information, and the time range for what we forecast should be considered very carefully during uncertain economic circumstances.

## Other practical subject of management accounting

Finally, I am just listing some more practical subjects, which should be in the focus of management accounting during economic crisis because of various reasons.

Budgeting – I should not emphasize how important is to control as much as the company can in difficult situation and reduce spending in any discretionary areas to lessen existing cash-flow needs. While every cents or filler counts, cost management includes not just big cuts, like layoffs or facility closing, but it is also important to pay attention on relatively smaller budget, like travelling restriction.

Proper management and allocation of indirect cost – Cost management is important in general, but it is extremely crucial how the companies handle indirect cost during falling production, while typically these kind of costs can not be reduced with the ratio of volume drop, and proper allocation of them in the unit-cost calculation can result proper decision making according to product portfolio-management.

Price difference, price variance – Continuous monitoring of price differences and variances are also very important, while the fluctuating market prices has significant impact on these numbers. In the pricing process if the company should not analyse actual variances versus the previously set up standards, it can easily result smaller or bigger issues in profitability in a very short period.

## Conclusions

I have highlighted some special area regarding to management accounting, which can be more important during these challenging time for decision makers and accountants. Fair value analysis, working capital management and forecasting are crucial tasks for every accountants. Credibility and transparecny never were so important, and accountant have crucial role to ensure them.

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