THE USE OF SIMULATION IN ACCOUNTING: A MANAGERIAL EMPHASIS

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This paper reviews some of the uses of simulation in accounting. The primary thrust of the paper is toward the area of managerial accounting. However, the paper also examines the use of simulation in auditing and in the public sector.

1. INTRODUCTION

1.1 Purpose

The purpose of this paper is to:

- review some of the major applications of simulation in accounting
- provide a focus and an organization of the use of simulation in accounting.

An examination of the accounting literature will find a diverse set of applications of simulation. The reader would find one application there and maybe two in another location, etc. Further, some classic sources in accounting do not reflect simulation in their indices, though terms of other analytic tools like linear programming and regression are common. Kottas and Law (1975) have noted that the accounting literature has a "negative" orientation toward simulation. This is certainly not a criticism, but merely a reflection of "what is" the state of the use of simulation in accounting.

This paper has as its motivation the desire to summarize in a single location, a set of references in accounting and simulation and a review of the corresponding simulation models in use in the accounting literature to aid in integrating, to a greater extent, simulation into accounting.

1.2 The Accounting Framework

In accounting, the major uses of simulation occur in management accounting, auditing, and public sector accounting. This paper follows those lines of analysis but the primary emphasis is on management accounting. In addition, the paper recognizes that there are two major users of accounting models:

- practitioners in accounting
- researchers in accounting.

The first group deals with accounting models in practice, while the second is concerned with research in and with accounting models.

1.3 Outline of Paper

The paper is outlined as follows. In Section 2, the findings of a recent study on the use of quantitative methods by controllers is reviewed to aid in the analysis of the use of simulation in accounting in practice. Section 3 surveys the management accounting literature to determine what kinds of uses of simulation have been made in management accounting. Section 4 surveys the uses of simulation in research in management accounting. Section 5 surveys some uses of simulation in auditing practice and Section 6 reviews the use of simulation in research in auditing. Section 7 reviews some uses of simulation in public sector accounting.

1.4 Limitations of Paper

This paper does not claim to be an all encompassing review of simulation in accounting. Neither time or space allow for a complete analysis. Instead this paper is a beginning of an analysis of the use of simulation in accounting.

This paper is seen as an evolving document. The author is interested in expanding the paper. As a result, the author would be interested in other applications, major references, etc. that the reader may be aware of. The author also welcomes comments about the contents, readability, etc.

2. USE OF SIMULATION IN MANAGERIAL ACCOUNTING PRACTICE

A recent paper by Kian-Aslani (1977-78) surveyed the controllers of the Fortune 500 to determine the use of quantitative models by the controllers. Of the 500 surveyed, 208 returned usable responses and those 208 responses, 176 reported use of
quantitative methods. The 176 used an average of about 2.6 simulation applications per respondent.

Table 1 provides a summary of the types of problems for which simulation is used and the number of respondents who used simulation for the various problems included in the survey findings. This list of problems to which simulation has been applied is substantial. Further, some may not consider many of these applications as accounting problems. This suggests that a number of "non-accounting" problems are in the decision making realm of controllers.

Table 2 summarizes the frequency of use of simulation. It is clear that most uses of simulation are not a routine phenomenon (less than 20% is on a routine basis). More than likely, most controllers use simulation to help them solve non routine problems of the type listed in Table 1.

Table 3 summarizes the satisfaction associated with the use of simulation. About 80% reported fair to very good as a level of satisfaction with simulation. When simulation is being used it is apparently meeting their needs.

Table 4 summarizes the frequency and satisfaction compared to other quantitative techniques used by controllers. Simulation is ranked second only to forecasting in terms of satisfaction and only third to forecasting and inventory models when compared to other non-traditional accounting tools. This would exclude the traditional accounting concepts of present value and flexible budgeting.

**TABLE 1**

<table>
<thead>
<tr>
<th>TYPES OF PROBLEMS</th>
<th>NUMBER OF CONTROLLERS REPORTING SIMULATION USE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production Planning and Control</td>
<td>58</td>
</tr>
<tr>
<td>Financial Forecasting and Budgeting</td>
<td>46</td>
</tr>
<tr>
<td>Facilities Planning</td>
<td>39</td>
</tr>
<tr>
<td>Distribution</td>
<td>37</td>
</tr>
<tr>
<td>Forecasting Demand, Supply, Price</td>
<td>35</td>
</tr>
<tr>
<td>Replacement and Maintenance of Machinery/Equipment</td>
<td>35</td>
</tr>
<tr>
<td>Inventory Analysis and Control</td>
<td>30</td>
</tr>
<tr>
<td>Production Mix</td>
<td>29</td>
</tr>
<tr>
<td>Plant and Warehouse Allocation</td>
<td>27</td>
</tr>
<tr>
<td>Capacity</td>
<td>27</td>
</tr>
<tr>
<td>Analyzing Capital Investment</td>
<td>23</td>
</tr>
<tr>
<td>Project Planning and Control</td>
<td>22</td>
</tr>
<tr>
<td>Make or Buy Decisions</td>
<td>17</td>
</tr>
<tr>
<td>Planning and Controlling the Budgetary Process</td>
<td>13</td>
</tr>
<tr>
<td>Planning and Implementing Revisions of Accounting Systems (e.g. Standard Costs)</td>
<td>12</td>
</tr>
</tbody>
</table>

(1) Source: Kiani-Aslan (1977-78)
(2) Total of Respondents who used quantitative tools was 176.

**TABLE 2**

<table>
<thead>
<tr>
<th>LEVEL OF FREQUENCY</th>
<th>(FREQUENCY)</th>
<th>(FREQUENCY PERCENTAGE)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Routinely</td>
<td>33</td>
<td>19</td>
</tr>
<tr>
<td>Periodically</td>
<td>49</td>
<td>28</td>
</tr>
<tr>
<td>Occasionally</td>
<td>53</td>
<td>30</td>
</tr>
<tr>
<td>Rarely</td>
<td>23</td>
<td>13</td>
</tr>
<tr>
<td>No Use Reported</td>
<td>18</td>
<td>10</td>
</tr>
<tr>
<td>176</td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

(1) Source: Kiani-Aslan (1977-78)
(2) Based on 176 responses that reported use of quantitative tools. Derived from 208 usable responses.

**TABLE 3**

<table>
<thead>
<tr>
<th>LEVEL OF SATISFACTION</th>
<th>(SATISFACTION) FREQUENCY</th>
<th>(SATISFACTION) FREQUENCY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Very Good</td>
<td>12</td>
<td>21</td>
</tr>
<tr>
<td>Good</td>
<td>36</td>
<td>64</td>
</tr>
<tr>
<td>Fair</td>
<td>31</td>
<td>54</td>
</tr>
<tr>
<td>Poor</td>
<td>9</td>
<td>16</td>
</tr>
<tr>
<td>No Satisfaction</td>
<td>12</td>
<td>21</td>
</tr>
<tr>
<td>Reported</td>
<td>100</td>
<td>176</td>
</tr>
</tbody>
</table>

(1) Source: Kiani-Aslan (1977-78)
(2) Based on 176 responses that reported use of quantitative tools. Derived from 208 usable responses.

**TABLE 4**

<table>
<thead>
<tr>
<th>FREQUENCY</th>
<th>SATISFACTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Present Value</td>
<td>1 Present Value Concepts</td>
</tr>
<tr>
<td>2 Flexible Budgeting</td>
<td>2 Flexible Budgeting</td>
</tr>
<tr>
<td>3 Forecasting Techniques</td>
<td>3 Forecasting Techniques</td>
</tr>
<tr>
<td>4 Inventory Models</td>
<td>4 Simulation Models</td>
</tr>
<tr>
<td>5 Simulation Models</td>
<td>5 Statistical Techniques</td>
</tr>
<tr>
<td>6 Sensitivity Analysis</td>
<td>6 Inventory Models</td>
</tr>
<tr>
<td>7 Statistical Techniques</td>
<td>7 Linear Programming</td>
</tr>
<tr>
<td>8 Linear Programming</td>
<td>8 Network Analysis</td>
</tr>
<tr>
<td>9 Network Analysis</td>
<td>9 Sensitivity Analysis</td>
</tr>
</tbody>
</table>

(1) Source: Kiani-Aslan (1977-78)
3. USES OF SIMULATION IN MANAGEMENT ACCOUNTING PRACTICE

While the previous section reported the results of a survey of controllers, this section concentrates on the models that appear in the management accounting literature. This section is oriented toward the models, as used by the practitioner. The applications discussed in this section include:

- Planning and Budgeting Models
- Forecasting Sales
- Capital Investment and Replacement Analysis
- Product Mix
- Planning and Controlling Budgeting and Other Projects.

For the interested reader there are a number of insightful reviews of management accounting in general, for example, Horngren (1982), Kaplan (1977-78, 1981, 1982) or Dopuch et. al. (1974). A useful bibliography of applications of simulation that have appeared in Operations Research and Management Science is Marshall and Richards (1978). A useful bibliography in management accounting appears in Klemstine and Maher (1982).

3.1 Planning and Budgeting Models

Probably the largest use of simulation in accounting is the area of budgeting and planning models. Simulation increases the effectiveness of budgeting and planning by allowing the user to evaluate a large number of alternatives by allowing the introduction of risk, examining more complex relationships, etc. As noted in Anthony and Dearden (1980), "Simulation is probably the most useful of the mathematical techniques advocated for the budgeting process."

A number of reviews of financial planning and budgeting models are available. These include Naylor and Schauland (1975), Gershefski (1969), Mattessich (1961) and Locasio. Dopuch et. al. (1974) devotes the most extensive discussion of simulation that was encountered in cost accounting textbooks to the topic of planning and budgeting models.

3.2 Forecasting Sales

An important use of simulation is the development of forecasts (See e.g. Moslove and Simkin (1981)). Forecasts are developed using causal models. The model is then analyzed using various assumptions or with the causal variables treated as random variables. Denski and Feltlham (1972).

3.3 Capital Investment and Replacement Analysis

A problem that has received substantial attention in the finance and accounting literature is the use of simulation in the analysis of capital investments. Hertz (1964) was the first to suggest simulation in this arena. Kennedy (1968) later replaced the capital investment problem in a decision support-like environment.

3.4 Product Mix

A important concern to the firm is determining the desirable sales mix of products. Simulation is an ideal tool for analysis of assumptions, introduction of risks, and determining key variables. (See, for example, Louderback and Dominiak (1975)).

3.5 Planning and Controlling Budgeting and Other Projects

Typically, PERT-like tools are used to help plan and control projects. Often simulation is added to account for interaction of variables, to introduce uncertainty, etc. In a similar manner simulation can be used to aid in planning and controlling the budgeting process. (See, for example, Morse (1977)).

4. THE USE OF SIMULATION IN MANAGEMENT ACCOUNTING RESEARCH

Simulation has been used by accounting researchers to analyze a broad range of problems. The use of simulation in accounting research has taken the following forms,

1. Evaluating the impact by the accounting system on behavior
2. Evaluating varying techniques on a common basis
3. Developing approximations to interacting random variables.

The applications that have utilized simulation include,

- Aggregation of Information
- Product Costing
- Cost Allocation
- Cost Volume Profit
- Capital Investment
- Performance Evaluation and Variance Analysis.

The structuring of these applications is borrowed, in part, from Kaplan (1977) and Klemstine and Maher (1982).

4.1 Aggregation of Information

Accounting systems by their very nature are systems that aggregate information. Feltham (1977) analyzes the consequences of aggregation of information by utilizing simulation to study payoff consequences.

4.2 Product Costing

One of the major controversies in accounting has been the analysis of direct costing versus absorption costing. The controversy is essentially a question of how should fixed costs be treated. Bailey (1973) used simulation to compare the effects of the costing method on management decisions.

4.3 Cost Allocation

Cost Allocation is the process of allocating those costs not directly attributable to a particular product, department, division, etc. There
are numerous techniques of cost allocation. Jensen (1973) has used simulation to analyze some of the methods under simulated conditions to obtain a statistical analysis of the allocation results.

4.4 Cost - Volume - Profit (CVP) Analysis

CVP analysis refers to the traditional breakeven analysis. The basic relationship used is:

\[ \text{Profits} = \text{Quantity Sold} \times (\text{Sales Price} - \text{Variable Costs}) - \text{Fixed Costs} \]

The accounting literature had a number of papers that developed closed form results in this area. Simulation has also been used. Ferrara et al. (1972) use simulation to investigate the case where sales price and amount sold are two independent normal random variables. Liao (1975) provided an analysis of sales and profits that would produce a closed form distribution for the random variable profit based on any distributions for the other random variables.

However, as noted in Kottas and Law (1978) these authors have "implied that simulation may be either too inaccurate, too expensive or both". In Kottas and Law (1978), the authors show that simulation is a useful, inexpensive and accurate approach to solving CVP problems.

4.5 Capital Investment

Sundem (1974) used simulation to compare capital budgeting decision models. In that paper he found that simple models can be used to improve the decision making capabilities of more sophisticated models.

4.6 Performance Evaluation and Variance Analysis

Performance evaluation is by its very nature an evaluation of the impact of accounting systems on human behavior. This has probably been the area experiencing the most extensive use of simulation in accounting research. Demeski (1969, 1970, 1971), Sweringa and Demeski (1972) and Lin have studied the impact on a manager of using different evaluation measures. The decision setting in Demeski (1970) is a single variable, while Demeski (1971) is a multivariate setting. Sweringa and Demeski (1972) extended Demeski (1971) to include additional incentives. Lin (1978) introduces a multiple objective setting to the previous studies. Finally, Magee (1976) utilizes simulation experimentation to compare different cost variance investigation models to determine how a rational manager should behave.

5. USE OF SIMULATION IN AUDITING PRACTICE

5.2 Parallel Simulation

Another use of simulation in auditing is parallel simulation. As noted in the Systems Audibility and Control Study (1977), "Parallel simulation programs accept and process the same input data as their corresponding application programs; they use the same master files and attempt to produce the same results. This simulation process allows verification of computer applications for correct input data validation, computations and processing logic, masterfile updating logic, controls and balancing procedures.

This method is described as parallel because all transactions for a particular processing cycle are processed by the normal application program as well as by the simulation program. Simulation results are compared with application program results to enable an independent and objective check by the auditor."

6. USE OF SIMULATION IN AUDITING RESEARCH

One of the primary uses of simulation in auditing research is that of comparing alternative methodologies. Characteristic of this research is Kinney (1979) and Kinney and Salamon (1982).

In order to validate a reported account balance the auditor will utilize tests of details and analytic review. The analytic review is oriented towards establishing a test of "reasonableness" of reported balances. One methodology that has been used to help with this problem is regression (Kinney (1979)). In Kinney (1982), two variations of using regression in analytic review were compared using a simulation of 200 audit years. The simulation was used to characterize the advantages and disadvantages of the respective models.

7. USE OF SIMULATION IN PUBLIC SECTOR ACCOUNTING

Decision makers in the public sector face many of the same problems as those in the private sector. Thus, many of the same applications of the private sector accountants can also be used by the public sector accountants. However, the public sector does face some unique accounting problems. A model to address some of these problems was discussed in Johnson et. al. (1977). In particular, the public sector is concerned with analyzing property tax collections and other fiscal policies. These were the focus of the RAFT model (Johnson et. al. 1977).

There has also been work in the area of simulation and public sector budgeting. Crevice (1967) presents a positive theory of the budgeting process in large municipalities. His model was subsequently tested on data from Cleveland, Detroit, and Pittsburgh.

8. CONCLUSION

The purpose of this paper has been to review some major applications of the use of simulation in
accounting and to provide an organization for the uses of simulation in accounting. The emphasis has been on managerial accounting.

As has been discussed, simulation is a useful tool to the practitioner. The uses in managerial accounting range from planning and budgeting to the process of controlling, planning and budgeting. Simulation is also actively used in auditing high risk areas and in the analysis of public sector fiscal policies.

Simulation is also of use to the accounting researcher. Simulation has been used in auditing to compare different audit methodologies. Simulation has also furnished management accounting researchers with insight into the behavior of costs and human behavior.

However, it appears that simulation in accounting has an identity problem. By bringing the uses of simulation and references of the uses of simulation in accounting together in this paper, perhaps accountants can focus on other potential uses of simulation to solve existing problems in accounting.

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