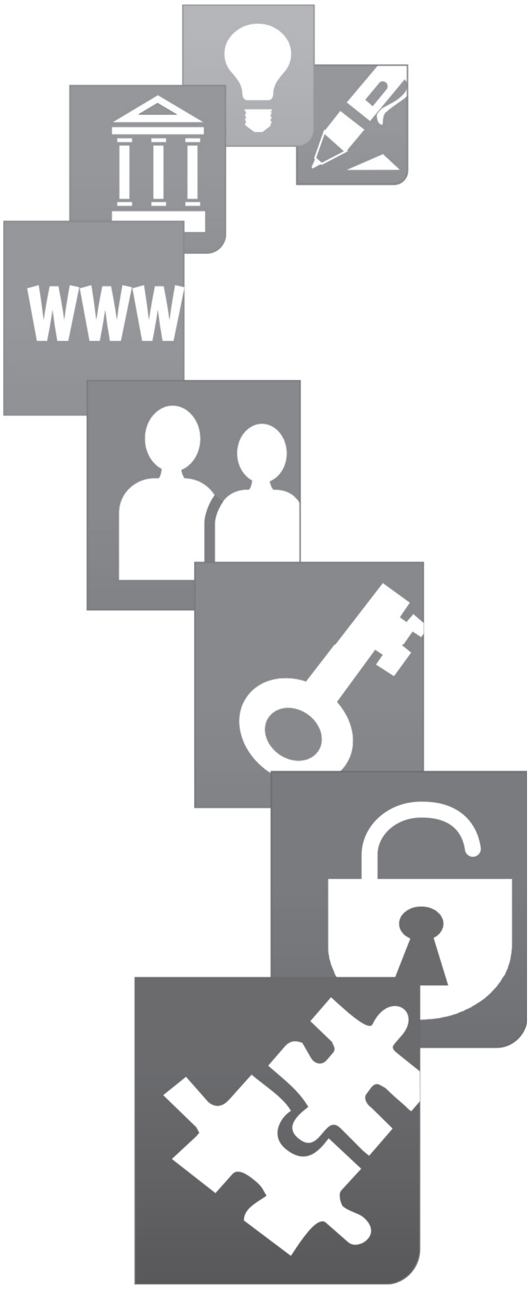
Module 1



While the traditional role of management accounting in supporting the decisions of operational managers is still extremely important and fundamental, since 1950 the discipline has increasingly embraced both a wider, strategic role and a more sophisticated range of techniques. In this module we shall look at the development and role of strategic management accounting and management accounting systems.

INTRODUCTION TO STRATEGIC MANAGEMENT ACCOUNTING

Contrasts with financial reporting to external groups.

Can be for both strategic and day-to-day decisions.

Aim of strategic management accounting (SMA)

Provide useful information for internal users

- Day-to-day decisions
- Strategic decisions

Decision areas:

Strategy
Products
Supply chain
Infrastructure
Financing
Resource allocation

Competition approach
Product mix
Organisation hierarchy
Obtaining finance

Pricing
Choosing suppliers
Allocate time

Form of SMA information:

- Budgets and forecasts
- KPIs
- Costings

Nature of SMA information:

- Financial
- Non-financial
- Specific
- Future-oriented
- Timely

Definition of strategic management accounting

Creating sustainable value by:

Supporting the formation, selection, implementation and evaluation of organisational strategy by management.

Providing information that captures financial and non-financial information from the internal and external environments, to assist management with effective resource allocation.

Note that this definition includes the concepts of creating value and business sustainability.

Contrasts with external reporting of financial, historical, delayed, aggregated information to external users.

Evolution of management accounting

1950 — 1965 — 1985 — 2000

Technical activity + Management activity + Strategic activity + **Strategic management accounting**

Technical activity
- Determine costs
- Financial control

+

Management activity
- Information for planning and control
- Responsibility accounting

+

- Efficiency of processes
- Reduced costs of technology
- Realtime information available

+

Strategic activity
- Use resources to create customer and shareholder value
- Active involvement in decision-making and resource allocation

+

Strategic management accounting
- External stakeholders
- Social, environmental, ethical issues
- Globalisation
- Create value responsibly and sustainably

Started out in manufacturing:

- stable, simple, predictable environment
- standard costing
- variance analysis
- detailed cost focus.

Modern SMA:

- dynamic, complex, competitive environment in tertiary and manufacturing
- value added
- external focus – relative performance
- commercially focussed
- process orientated
- quality.

Unsustainable practices:

- economic – bank lending practices
- social – sweatshops
- environmental – fisheries, agriculture.

- Life cycle costing
- Full cost accounting
- Benefits assessment
- Strategic planning for environmental management

Global economy

Economic turmoil

- Contagion.
- Political/economic instability.
- Levels of government debt.
- Focus on risky areas in business.

Globalisation

- Competition.
- Capabilities.
- Culture.
- Legal/political.

Structural change

- Effect of technology.
- Manufacturing → services.
- Wider participation in economy of Africa.

Sustainability

- Economic, social, environmental.
- Stakeholder focus – CSR.
- Environmental MA.
- Ethics.

Technology

- Capital equipment eg 3D printing.
- Speed of development/obsolescence.
- Information systems + technology.
  = better data + information.
- ICT: cloud computing, employee-owned devices & open systems, Big Data.

Internal structures

- Flatter hierarchies.
- Functional structures.
- Outsourcing and offshoring.
- Global teams/virtual offices.
- Joint ventures/strategic alliances.
- Management reporting.

- Growth rates
- Government spending
- Debt levels
- Consumer spending habits
- Regulations (e.g. Basel III)

- Cost centre
- Revenue centre
- Profit centre
- Investment centre

- Leading indicators that drive results
- Competitor activity
- Industry analysis
- Non-financial performance
- Projects

Challenges

Some of the key challenges facing management accountants include:

- using technology effectively while guiding others effectively use management accounting systems;
- managing resources; and
- promoting innovation.

Part A: The role of management accounting | Evolution of management accounting | Causes of change in the business environment | **Role of management accountant** | Value and value creation | Strategic management

Matrix of skills required in management accountants

Required skills

Intellectual skills

- Ability to research and organise information.
- Critical analysis, logical reasoning.
- Ability to solve unstructured problems.
- Ability to monitor internal financial performance.
- Designing performance management tools.

Personal and interpersonal skills

- Self-management; ability to use initiative.
- Ability to influence and assess priorities.
- Ability to meet deadlines.
- Ability to adapt to change.
- Ability to work in teams and interact with a diverse range of other people.
- Ability to negotiate effectively.
- Ability to listen.

Technical skills

- Numeracy.
- IT and software capability (spreadsheets, databases).
- Cost analysis.
- Cost control.
- Compliance requirements.

Communication skills

- Deliver and defend opinions.
- Use of both formal and informal approaches.
- Listen, read and speak effectively.
- Written communication skills.
- Cultural sensitivity.

Organisation/business management skills

- Organise and delegate tasks.
- Lead and motivate people.
- Project evaluation skills.
- Ability to provide information for planning and decision making.

This is the focus of strategic management accounting.

Creating value for shareholders must not be restricted to short-term financial matters.

Creating value
Combining resources in a way that produces desirable outcomes

Value and performance reporting
Performance reporting: analysing, reporting and evaluation in the pursuit of value

Value

Role of management
To create, manage and protect value

Maximising shareholder value
Not possible in the long term unless the company is **sustainable**

Traditional view of value creation
Companies should seek to maximise shareholder wealth

Other stakeholder perspectives of value
Other stakeholders interested in other aspects of value: customer satisfaction, job security, environmental protection, etc.

Not-for-profit organisations and **public sector organisations** also create value – but not measured in terms of shareholder/owner wealth

Organisational perspective of value
Measure performance as it matters to the organisation, e.g. maximisation of shareholder value

Society perspective of value creation
Measure performance as it matters to society more generally

These perspectives may be consistent with each other.

But the pursuit of value from an organisation perspective can be damaging to value from a society perspective – e.g. unemployment, environmental degradation, sale of harmful products

The choice of perspective affects the way in which performance is measured and reported.

Strategic management: avoid becoming so preoccupied with immediate issues that you lose sight of ultimate objectives.

Management involves

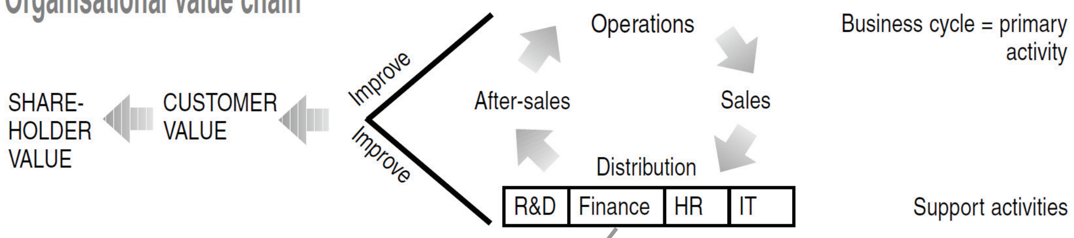
- Planning
- Controlling
- Leadership
- Creating value

is the basis for:

Managing business strategy

Strategy:	course of action to achieve a specific objective
Strategic plan:	statement of long term objectives, and those policies which will ensure their achievement
Strategic management:	management of the elements involved in planning and controlling a business strategy over the **long term**
Operations management:	the **short term** actions required to achieve entity's objectives

Organisational value chain



Operations etc: How can an organisation deploy its resources to achieve its strategies?

Does it have the resources it needs?

Distinguish between strategic planning vs operational planning.

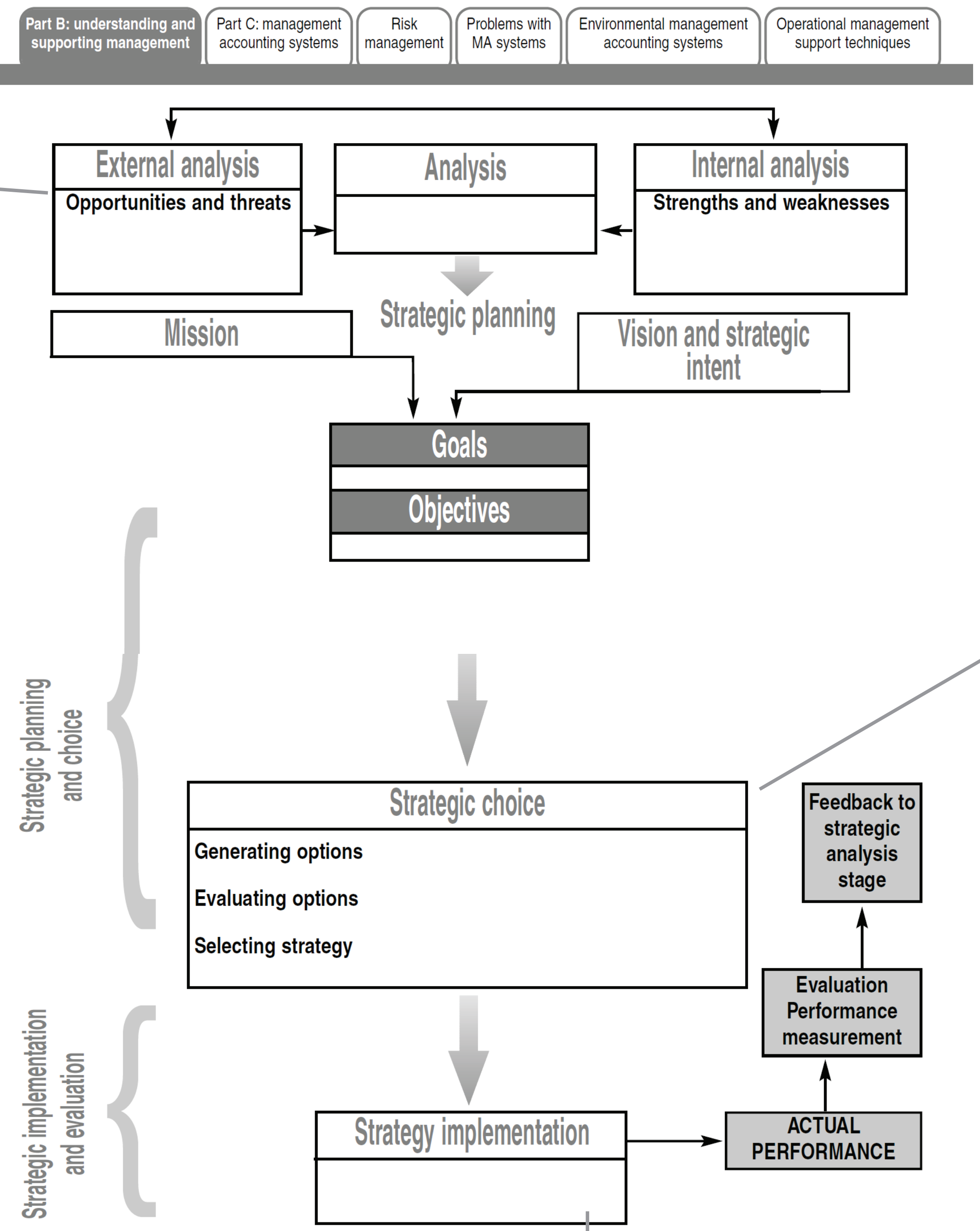
(Strategic has external focus rather than internal).

Four key stages of strategic management:

- analysis
- planning and choice
- implementation (action)
- evaluation.

Key issue in strategic choice:

Is strategy appropriate for an organisation and its context?



We shall look at this diagram again later in the course.

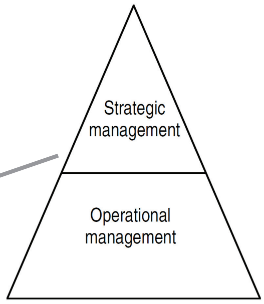
SMA supports operational planning through for instance:

- budgets
- costing systems
- variance analysis.

Importance of linking management of **daily** activities to achieving strategic and tactical plans.

Management includes ensuring that an organisation's objectives are achieved, that procedures are adhered to, and that an organisation responds appropriately to changes in its environment.

There are two primary types of organisational management:



Setting the long-term objectives of an organisation and ensuring planning and control, and implementation, are aimed at achieving them.

Strong links and feedback required

Management involves ensuring that tasks are being carried out effectively and efficiently. Used to control the day-to-day operations of each department or division or unit.

Operational management	Supported by information from SMA via:
Planning	Budgets, forecasts, costing systems
Evaluating	Benchmarking
Controlling	Variance analysis, performance indicators, reconciliations
Communicating	Budgets indicating priorities
Co-ordinating	Production process for budgets
Rewarding	Performance measures used in reward systems
Decision-making	Cost and other information

How do Information Systems (IS) and information requirements vary for the two levels?

Support for operational managers from SMAs:

- product costing
- cost-volume-profit (CVP) analysis
- budgeting
- variance analysis
- working capital management.

Difficult in service businesses as services are intangible.

Information on strategic variables that create value.

Also delays in feedback, short-termism and lack of focus on quality.

Elements of management information systems

Management information systems are useful for score-keeping, attention-directing and problem-solving. They should assist strategic planning, management control and operational control.

Key elements

- Accounting system.
- Sales/marketing system.
- Operations and logistics systems.
- Research/development system.
- Human resources system.
- Information from external environment.

Definition of management accounting system (MAS)

The organised process or system that identifies, collects, processes and communicates financial (and relevant non-financial) information.

Strategic information — MAS information — Operational control information

Areas of MAS support

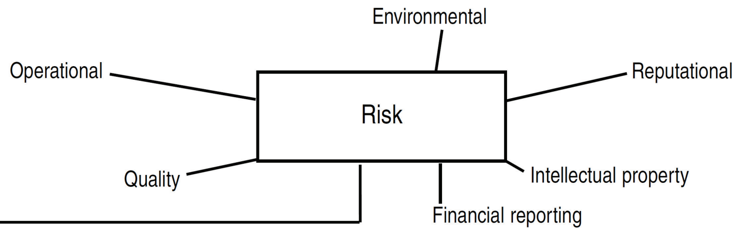
People management	Productivity and efficiency, employee rewards and turnover.
Marketing and sales	Profitability analysis, pricing and marketing campaign evaluation
Performance management	Benchmarking, developing KPIs, and measuring and managing shareholder and customer value creation.
Asset management	Working capital management, capital expenditure decisions and appraisal, product life cycle management and asset registers.
Business controls	Corporate governance and internal control frameworks.
Environmental/social management	Balanced scorecard and triple bottom line accounting, costings to support evaluation and implementation of environmental strategies.
Financial management	Activity-based costings and activity management, and measuring and managing risk.
Intellectual capital management	Measuring and managing customer and employee satisfaction and levels of information technology (IT) literacy, and maintaining strict controls on intellectual property such as patents and licences.
Information management	Ensuring data security and controls. Implementing and generating value from e-commerce and electronic data interchange (EDI), and using IT to support 'just in time'.
Quality management	Performance measures and costings to implement and manage total quality management (TQM).

Source: Adapted from Sharma, R. (1998), 'Management accounting: Where to next?', *Australian CPA*, December, pp. 24-5

Information for controlling processes.

We shall look at many of these areas in detail as we go on.

Overarching corporate governance systems in an organisation require **risk** to be addressed in a structured manner.



MAS:

- Captures information.
- Identifies issues.
- Implements internal controls.

Risk Management System

- Risk identification.
- Risk classification: severity/probability.
- Measuring and monitoring risk.
- Managing risk:
  - Avoidance.
  - Reduction.
  - Transfer.
  - Acceptance.

Risk classification matrix

When to start managing/mitigating a risk: classify probability of occurrence and severity of outcome if it does occur

PROBABILITY	Severity			
	Low	**Medium**	**High**	**Catastrophic**
Low	L	L	L	L
Medium	L	M	M	H
High	L	H	H	H
Certain	M	H	H	H

H = higher risk – act immediately to eliminate/mitigate
M = medium risk – act to reduce risk
L = lower risk – periodic reviews

Internal accounting controls help to reduce/eliminate risk:

- separation of duties
- independent verification
- physical security
- document design and handling
- cash control.

MAS produces information to identify particular risks across all areas.

Right process and right culture – both are required

Risk management should be done at both a strategic and an operational level.

Internal control is any action taken by management to enhance the likelihood that established objectives and goals will be achieved.

CONTROL FRAMEWORK

Control environment

Control procedures

- Process controls
- Accounting controls

Aims of internal controls

Internal controls are designed to achieve the following aims:

- Appropriate response to risks (safeguarding of assets, liability management).
- Ensure quality of reporting (maintenance of records, generation of relevant information).
- Ensure compliance with laws and regulations.

Control procedures

Aim of accounting controls

To minimise/prevent control failure:

- Fraud.
- Theft of assets.
- Unacceptable accounting method.
- Inaccurate data entry.
- Inaccurate records.
- Loss/destruction of assets, including information.
- Non-compliance with external regulations.

Key accounting control procedures

- Separation of duties.
- Physical security measures.
- Authorisation of transactions.
- Management review of information.
- Supervision.
- Reconciliations, esp. of cash.
- Effective document design and handling.
- Cash control procedures.

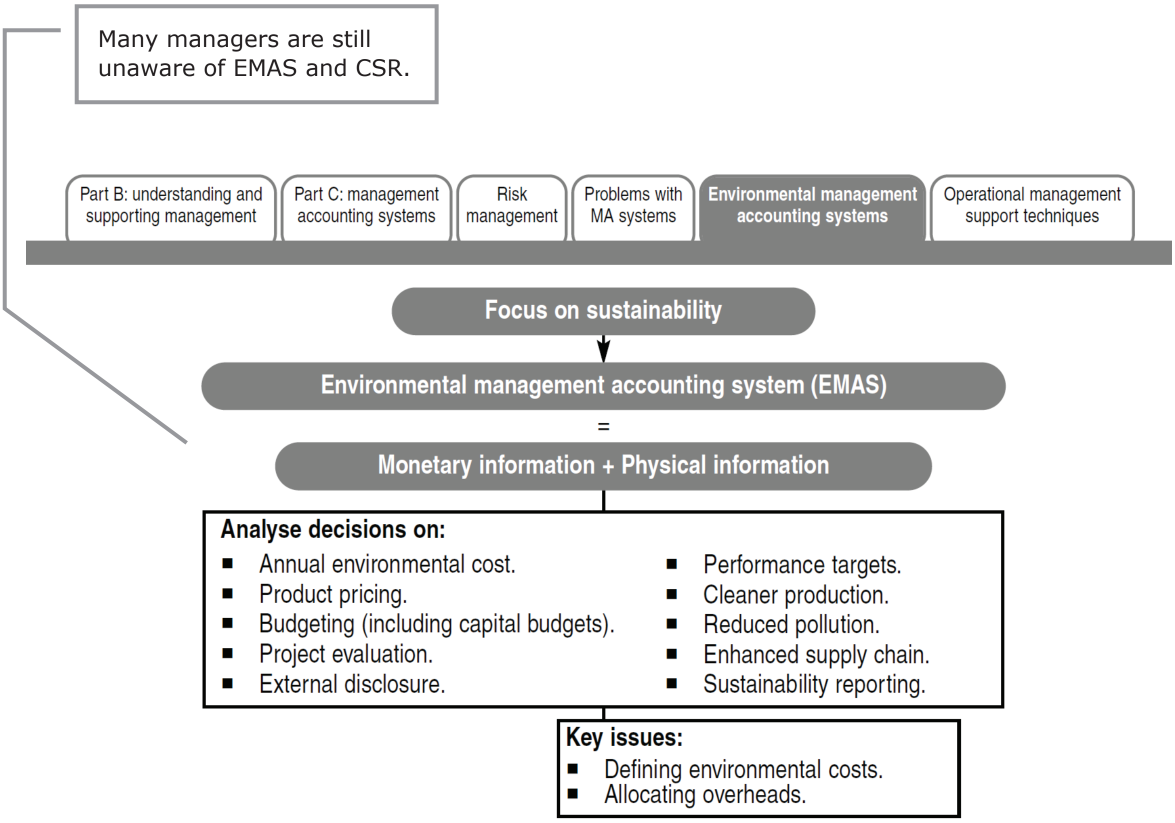
Watch out for over-simplistic methods of allocating overheads.

See Module 3.

Timing	Management accountants focus on the production stage, not the design stage when the key decisions are made.
Controllability	Focus is on direct costs, rather than overheads, when overheads are more difficult to control. MAS information does not address/solve problems.
Different assets	Systems have difficulty measuring non-tangible assets and how they affect resource allocation and strategic value.
Customers	Systems fail to analyse how customers drive costs.
Cost reporting	Reporting reflects functional structure rather than processes that drive costs and cut across functions.
Overhead cost allocation	Allocations based on labour hours are inappropriate for many modern non-labour intensive processes. Activity-based costing may be a better method. Cost of waste should not be allocated.
Standard costing	Inappropriate where flexibility/customisation/service are important.
Short-term financial measures	Take too long to produce/too narrow.
Cost accounting methods	Emphasis on quantifiable financial benefits at expense of non-quantifiable or non-financial benefits.
Variances	Can produce inappropriate responses (excess inventory).
Investment appraisal	Fail to consider financial constraints/strategic issues.
Transfer pricing	Problems resolving conflict between economic price and inappropriate behaviour.
Balanced scorecard	Range of measures, links with strategy, but difficult to understand/gain overall impression.
Environmental reporting	Full cost accounting including hidden costs, contingent liabilities, rectification costs, emissions cost, waste cost, consumption of raw materials, value-added analysis, and total cost of ownership.

ERP software can help with many of these problems.

Remember that techniques such as Discounted Cash Flows (DCF) calculations are not just about numbers, but aim to control performance, staff, returns and decision-making.


Many managers are still unaware of EMAS and CSR.
Part B: understanding and supporting management
Part C: management accounting systems
Risk management
Problems with MA systems
Environmental management accounting systems
Operational management support techniques
Focus on sustainability
Environmental management accounting system (EMAS)
=
Monetary information + Physical information
Analyse decisions on:
Annual environmental cost.
Product pricing.
Budgeting (including capital budgets).
Project evaluation.
External disclosure.
Performance targets.
Cleaner production.
Reduced pollution.
Enhanced supply chain.
Sustainability reporting.
Key issues:
Defining environmental costs.
Allocating overheads.

Cost classifications

Direct/indirect; variable/fixed

Direct costs (usually variable)		+	Indirect costs (often fixed)			
■ Materials	X		■ Materials	X		
■ Labour	X		■ Labour	X		
■ Expenses	X		■ Expenses	X		
			■ Admin overheads	X		
Prime cost	X	+	Indirect cost	X	= Total product cost	X

SMAs classify cost information to help operational managers control day-to-day processes (production, purchasing etc).

Methods of cost classification

- Outlay(actual) v opportunity (alternative forgone).
- Relevant/sunk.
- Value added/non-value added.
- Committed/discretionary.
- Controllable/uncontrollable.

CVP analysis

The interactions of two types of cost, volume and profit = CVP analysis.

Information on a product's/operation's:

Revenue – Variable cost of sales = Contribution (in total or per unit)

- Prime cost
- Variable selling costs

((Selling price – variable **cost**) × sales **volume**) – fixed costs = **profit**

CVP analysis used by operational managers for:

- Go-ahead decisions (breakeven point, target profit)
- Risk management (margin of safety calculations)

Both fixed and flexible budgets are used in planning.

Flexible budgets are used for control.

Product costing

- Job costing of clearly identifiable task or job.
- Process costing for large number of similar products/services.
- Overhead allocation for non-direct overheads.

Budgeting

A budget is an organisation's plan for a forthcoming period, expressed in monetary terms.

Uses of budgets

- Planning:
  - Force management to look ahead.
  - Establish formal system of communicating plans and ideas.
  - Co-ordinate activities.
  - Quantify organisation's objectives.
- Control:
  - Compare with actual results.
  - Provide a framework for responsibility accounting.
  - Motivate managers and employees to improve their performance.

Fixed budgets

- Prepared on the basis of an estimated volume of production and an estimated volume of sales.
- Not adjusted (in retrospect) to reflect actual activity levels.
- Used for planning and to define the broad objectives of the organisation.

Fixed budgets are the starting point for the on-going budgeting process, and provide a plan or target.

Flexible budgets

- Recognise different cost behaviour patterns and how they change as activity levels change.
- Can show the effect of the actual volumes of output and sales differing from budgeted volumes at the planning stage.
- Actual results are compared to a flexed budget *(what results should have been at actual output and sales volumes)* as a control procedure during/at the end of a period.
- Variances between what *did* happen and what *should have* happened at the activity level are analysed and provide guidelines for management control action.

Variance analysis

Material price

Favourable	Adverse
Unforeseen discounts	Price increase
Material std changed	Careless purchasing

Variable and fixed overhead

Favourable	Adverse
Cost savings	Excessive use

Fixed overhead variances are not calculated when marginal costing is used.

Idle time

Machine breakdown
Illness/injury

Material usage

Favourable	Adverse
Higher quality material	Defective material
Effective use of material	Excessive waste

Labour rate

Favourable	Adverse
Lower rate paid	Wage rate increase

Labour efficiency

Favourable	Adverse
Motivated staff	Lack of training
Quality materials	Sub-standard material

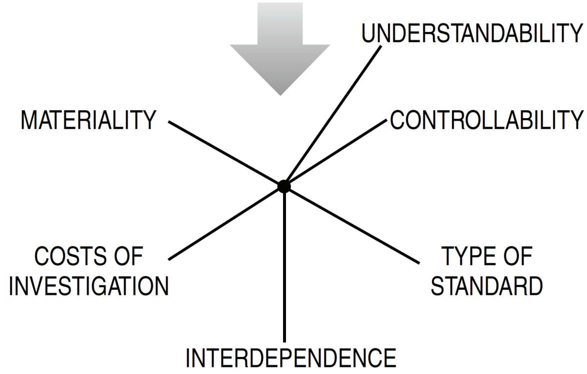
It can be very difficult to maintain relevant and usable standard costs for a product or unit.

Interdependence of variances

The cause of one adverse variance might be wholly or partly explained by the cause of another favourable variance.

- Material price and usage variances.
- Material price and labour efficiency variances.
- Labour rate and efficiency variances.

Significant variances should be investigated. Factors to take into account:



Working capital management

Cash management:
- Cash budgets.
- Internal controls (e.g. separation of duties, bank reconciliations).

Accounts receivable management:
- Credit policy.
- Accurate recording.
- Giving discounts.

Working capital measurement:
- Liquidity:
  - Working capital ratio.
  - Quick ratio.
- Efficiency:
  - Turnover ratios.
  - Receivables/payables/inventory days.

Accounts payable management:
- Taking discounts.

Inventory management:
- Controlling physical inventory.
- Managing costs:
  - EOQ.
  - Buffer stocks.

- Inventory too high = financial problem
- Inventory too low = operational problems

Balance funding for accounts payable with need to comply with agreed terms.