CHAPTER 1 - Management accounting and the strategic management framework

Contents

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1.1 Introduction

The business environment that organizations face today is increasingly complex, dynamic, and uncertain. There is no better time for management accountants to optimize their potential in supporting and contributing to the strategic activities within the organization. The premise behind the production of this learning resource is to provide an understanding of the standard strategy models and frameworks and to discuss the management accounting techniques that complement the strategic management process.

Perhaps the best way to begin an exploration of strategy and management accounting is to provide an overview of a strategic management framework and review the purpose and development of management accounting as the discipline adapts to meet the changing needs of businesses.

The purpose of management accounting is to provide managers with the information they need to manage the business. Traditional management accounting, however, has been criticized for not supporting managers in making strategic decisions. The term *strategic management accounting* emerged as academics promoted techniques that would provide more support within the strategic management process. This chapter discusses the criticisms of traditional management accounting and the emergence of strategic management accounting with reference to the academic literature.

The chapter then looks at what is meant by strategic management, outlines how the understanding of the term has changed, and presents a strategic management framework that forms the structure for the rest of this learning resource. The exploration goes on to discuss questions such as who sets the strategy, the different levels, planned versus emergent, and the inside-out or outside-in perspective. There then follows an overview of how management accounting can support the strategic management process. Chapters 2 – 11 deals with this in detail. The chapter concludes with a discussion of the concept of *strategy as practice* to illustrate the role that management accounting can play throughout all aspects of the strategic activity within organizations.

The strategic management framework presented here follows a rational approach to the analysis, formulation, implementation, evaluation, monitoring, and control of strategy. In practice, the process is much more flexible. Taking a rational approach facilitates a discussion of management accounting within a strategic context. The danger of taking this approach, however, is that it may give the impression that the position within the framework in which the strategy model or accounting technique appears is the only place it can be applied. Many of the models and practices are useful within several areas of the strategic management framework. It is crucial to appreciate that strategic management is essentially a continuous and iterative process. The business environment in which many organizations operate today is complex and dynamic, and the ability to respond and adapt appropriately to changes can mean the difference between success and failure. Management accounting in support of strategy is about providing support for all levels of management throughout the entire strategic management process.

1.2 Learning outcomes

After studying this chapter, you will be able to:

- Understand the purpose of management accounting
- Understand what is meant by strategic management
- Critically evaluate the development of management accounting in response to criticism of traditional techniques
- Critically evaluate management accounting from a *strategy as practice* perspective
- Understand how management accounting can support the strategic management process

1.3 What is management accounting?

Active reading. As you study this section, note the difference between financial and management accounting, the functions of management accounting, and the criticisms of traditional accounting. Also, note the changing definition of management accounting as it takes on a more strategic perspective. Think about why this change happened.

Management accounting has been distinguished from financial accounting by its focus on providing information for management activities such as planning, decision making, and control (Kaplan and Atkinson, 1989; Aver and Cadez, 2009). Financial accounting is required by law, as organizations must ensure that they can accurately record financial transactions, and report profits and losses to the providers of capital, and the tax authorities. Thus, the provision of financial information is predominantly to an external audience. Financial accounting must conform to reporting conventions such as those set out in the International Financial Reporting Standards (IFRS), the U.S. GAAP (Generally Accepted Accounting Principles), and the U.K. GAAP (Generally Accepted Accounting Practice). Management accounting, however, is not governed by any rules, and organizations are free to use whatever tools, techniques, and practices they think fit for their organization. The audience is internal; hence the format and the frequency of information are determined by need, not external standards. Essentially management accounting is there to help managers manage.

Traditionally, the management accounting information was typically internally generated, financial in nature, and focused on identifying the product cost (Bhimani and Bromwich, 2010; Drury, 2012; Ward, 2016). The cost formed the basis for pricing decisions, as well as the planning and control of operations. The method of valuing products, to some extent, was influenced by the need to include the value in the financial accounts within the cost of goods sold, shown in the income statement (also known as the profit and loss account), and the value of inventory, shown as a current asset, on the balance sheet. There is a requirement to record inventory within these statements at cost, including materials, labor, and factory overheads, and in relevant cases, freight, handling, and import duties.

The early definitions of management accounting focused on the cost and production aspects of a business. Indeed, one of the leading professional bodies in management accounting, the Chartered Institute of Management Accountants, was initially created in 1919 as the Institute of Cost and Works Accountants. The direct costs of producing products were predominately materials and labor, known as the prime costs of production. Towards the end of the nineteenth century, an element of indirect costs, also referred to as production overhead costs, such as utility, building, and administrative costs, were included in the product costs. Solomons (1952) noted that the typical method of applying production overheads to product costs was by adding a percentage of the labor cost, or by creating a company-wide overhead cost rate per labor hour. As the main costs were labor and materials, traditional forms of management accounting focused on measures of productivity such as cost per hour, or cost per kilogram produced, per process, or per worker. These measures of productivity were used as measures of performance and fed into budgeting, target setting, and the motivation of workers and managers (Johnson and Kaplan, 1987). Management accounting was, therefore, the provision of cost and productivity information to assist managers in the activities of operational planning (via budgeting), decision making, and control.

In the late 1980s, traditional definitions of management accounting received much criticism for being inappropriate for modern business (Johnson and Kaplan, 1987; Hiromoto, 1988; Bhimani and Bromwich, 1989) in that they focused on cost and operational control. More recent definitions include an explicit reference to nonfinancial information. For example, Groot and Selto (2013: 3), refer to management accounting as being, "… concerned with the generation, communication and use of financial and non-financial information for managerial decision making and control activities." Other authors alluded to providing support for broader strategic management activities (Dixon, 1998). Anthony's (1965) categories of management activity shown in Figure 1.1, operational, tactical, and strategic, demonstrate the change of focus required. Management accounting focused on the lower end of the hierarchy, which ignored the higher end of strategic activity within the organization. As we move up the levels, the focus of information required by managers changes from internal, quantitative, and short-term, to include information that is more external, qualitative, and future-oriented.

Towards the 1990s, academics began to suggest that management accounting should become more externally focused and should take a more proactive role in the strategic management process (Johnson and Kaplan, 1987; Bromwich, 1990, 1994). It was also becoming recognized that it is the strategy that drives the information needs. Therefore, the best approach is to tailor the management accounting systems to each organizations' specific requirements. Kaplan (1984: 414) notably commented, "… management accounting can no more exist as a separate discipline, developing its own set of procedures and measurement systems and applying these universally to all firms without regard to the underlying values, goals, and strategies of particular firms, but it must serve the strategic objectives of the firm."

A change of focus was needed which met the needs of the managers who were formulating strategies in a changing business environment.

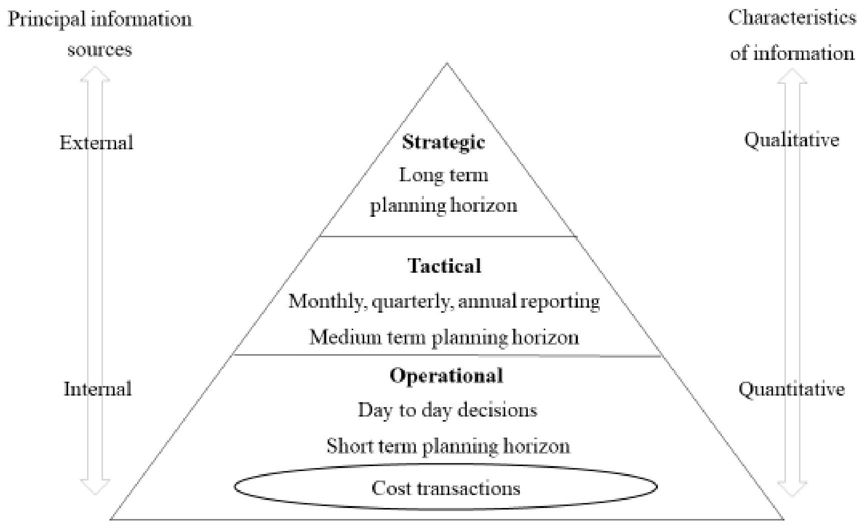

Figure 1. 1 Typical management information requirements at different levels of the management hierarchy.

Over the year's management accounting has developed in a variety of ways to meet the changing requirements of the business (Burns and Scapens, 2000; Weetman, 2006). As the business environment became more competitive, and the emphasis moved from strategic planning to strategic management (Whittington, 1996; Hoque et al., 2001; Nixon and Burns, 2012), the call from academics was not only for the need for management accounting practices to respond to the changing needs of the business but for accountants to become more involved in the strategic management process (Shank, 1989, 1996; Bhimani and Keshtvarz, 1999; Mia and Clarke, 1999; Tayles et al., 2002; Pitcher, 2015, 2018; Stein Smith, 2017).

The definitions of management accounting began to recognize this change of emphasis. For example, The Institute of Management Accountants' (U.S.) description (IMA, 2008) included the phrases "partnering in management decision making" and "to assist management in the formulation and implementation of an organization's strategy." The inclusion of these terms indicates that the accountant is no longer seen as just the person with the numbers but is an active member of the management team involved in the strategic management process. Brewer (2008: 29) suggests that the "ultimate responsibility of management accounting is adding stakeholder value … by providing leadership, by supporting a company's strategic management efforts, by creating operational alignment throughout an organization, and by facilitating continuous learning and improvement."

1.4 The development of strategic management accounting

Active reading. Note the differences between traditional and strategic management accounting shown in Table 1.1, and the definition of a strategic accounting system given by Brouthers and Roozen (1999), think about the key differences that distinguish strategic from traditional management accounting. Ideally, successful organizations would embrace both traditional and strategic accounting practices. Also, note that the early researchers disagree as to what constitutes a strategic management accounting technique (shown in Table 1.2).

Simmonds (1981) promoted the development of the concept of strategic management accounting. He focused his attention on the need for external information and specifically on data related to competitors and markets. The term strategic management accounting, however, has not found favor with practitioners (Guilding et al., 2000; Roslender and Hart, 2003; Jorgensen and Messner, 2010; Nixon et al., 2011; Pitcher, 2015), and an agreed definition has defied academics. Bromwich (1988), like Simmonds, emphasized gathering and analyzing information about competitors and benefits to customers over the long term. Govindarajan and Shank (1992), however, placed the emphasis more on the concept of strategic cost management, while Ma and Tayles (2009) defined it as being concerned with strategically orientated information for decision making and control. Hopwood (2007), however, recognized the continued benefit of traditional accounting practices and proposed they be used to aid the formulation of strategic plans.

In contrast, Roslender and Hart (2003) adopted a broader viewpoint and suggested merging management accounting and marketing principles within a strategic framework. Hoque (2001) also takes a more comprehensive view and argues that strategic management accounting is a process of identifying, gathering, choosing, and analyzing accounting data for helping the management team to make strategic decisions and to assess organizational effectiveness.

Brouthers and Roozen (1999: 311-312) talk in terms of a strategic accounting system and suggest that it should, "… provide information necessary to perform the following strategic functions: (1) environmental analysis, (2) strategic alternative generation, (3) strategic alternative selection, (4) planning the strategic implementation, (5) implementing the strategic plan, and (6) controlling the strategic management process. In order to fulfil these information functions, a strategic accounting system must contain information that is (1) mostly non-financial; (2) focused on the future; (3) both internal and external to the firm; and (4) based on realistic projections of the future, not simple extrapolations of the past." Whatever the definition, the need for management accountants to become actively involved within the strategic management process was compelling.

Table 1.1 summarizes some of the differences between traditional management accounting and strategic management accounting.

Table 1.1 The difference in orientation of traditional and strategic management accounting

Traditional management accounting	**Strategic management accounting**
Historical	Future-oriented
Internal focus	External focus – outward-looking
Predominantly financial	Places equal importance on nonfinancial information
Quantitative – transaction-based	Makes use of qualitative measures
Short term in nature – planning, and control	Long term outlook and use of scenario planning
Uses variance analysis to determine corrective action	Seeks to understand the reason behind the variance to inform future decisions
Supports operational decision making	Supports strategic decision making
Programmed decision making	Un-programmed, uncertain, and ad hoc decisions
Reactive	Proactive
Developed to support manufacturing	Developed to support the competitive position
Focuses on reporting performance of existing activities and explaining the past performance	Also reports on consequences and potential impact on future performance, as well as alternative strategies
Reporting of actual versus plan – comparison	Reviews performance against external benchmarks

Early research into the development of strategic management accounting (SMA) focused on the extent to which organizations use SMA techniques. These surveys typically use questionnaires to collect data. A problem, however, is the fact that it is the academics that predefine the set of techniques ascribed to SMA. There are, however, variations in the number of techniques defined. For example, Guilding et al. (2000) identified twelve techniques; Cadez (2006) identified seventeen techniques; Cinquini and Tenucci (2007) fourteen techniques; and Cadez and Guilding (2008) sixteen techniques. McLellan (2014), however, took a slightly different approach and tested the use of forty-two management accounting techniques, some of which were deemed to be strategic. Table 1.2 provides a brief explanation of the techniques included within these studies. Some of the techniques have fallen by the wayside in recent years, often due to the difficulties of implementation. Therefore, this learning resource only deals with the accounting techniques deemed to provide the most benefit in the strategic management process.

Table 1.2 Strategic management accounting techniques

1. Guilding et al. (2000)
2. Cadez (2006)
3. Cinquini and Tenucci (2007)
4. Cadez and Guilding (2008)

Strategic management accounting (SMA) technique		**Authors**			
	Brief description	**1**	**2**	**3**	**4**
Activity-based costing	An approach to the costing and monitoring of activities, which involves tracing resources consumption and costing final outputs. Resources are assigned to activities and activities to cost objects based on consumption estimates. The latter uses cost drivers to attach activity costs to outputs.			✓	
Attribute costing	An extension of activity-based costing using cost-benefit analysis (based on increased customer utility) to choose the product attribute enhancements that the company wants to integrate into a product. This technique has fallen by the wayside.	✓	✓	✓	✓
Benchmarking	The establishment, through data gathering, of targets and comparators, that permits relative levels of performance (and particularly areas of underperformance) to be identified. The adoption of recognized best practices should improve performance.		✓	✓	✓
Brand value budgeting and monitoring	Brand valuation assigns a financial value to the equity created by the name or image of a brand. It can be represented as the net present value of the estimated future cash flows attributable to the brand.	✓	✓		✓
Capital budgeting	The process of selecting long-term capital investments.		✓		

Competitor cost assessment	A technique in which the competitor cost per unit is ascertained from available information. It is often, at best, an estimate.	✓	✓	✓	✓
Competitive position monitoring	Monitoring the market position and competitive strategy (market positioning) of the key competitors.	✓	✓	✓	✓
Competitor financial appraisal	Looking for strengths and weaknesses in the competitors' financial position.	✓	✓	✓	✓
Customer profitability analysis	Customer profitability analysis (CPA) is the analysis of the revenue streams and service costs associated with specific customers or customer groups to ascertain their relative profitability.		✓	✓	✓
Integrated performance measurement	The use of a range of performance measurements other than financial. The balanced scorecard is a typical example, which includes nonfinancial as well as financial, internal, and external measures, quantitative and qualitative. The balanced scorecard reviews performance from several different perspectives, for example, customer, internal business, and learning and growth as well as financial.		✓	✓	✓
Life cycle costing	Life cycle costing is the profiling of costs over the life of a product, including the preproduction stage and recycling.	✓	✓	✓	✓
Lifetime customer profitability analysis	Estimating the profitability of a customer over its lifetime, considering future revenues and costs, including the cost of acquisition and retention.		✓		✓
Quality costing	The concept of quality costs is a means to quantify the total cost of quality-related efforts and deficiencies. It can be broken down into appraisal costs, prevention costs, and internal and external failure costs.	✓	✓	✓	✓

Strategic cost management	Strategic cost management is the overall recognition of the cost relationships among the activities in the value chain, and the process of managing those cost relationships to a firm's advantage.	✓	✓	✓	✓
Strategic pricing	Strategic pricing considers market segments, ability to pay, market conditions, competitor actions, trade margins, and input costs, as well as other potential factors affecting market position and demand for the product.	✓	✓	✓	✓
Strategic planning and budgeting	A system of developing strategic objectives and ensuring that budgets developed by individual units contribute to their achievement – essentially ensuring alignment of departmental budgets to strategic objectives.				
Target costing	Target costing is an activity that is aimed at reducing the life cycle costs of new products, by examining all possibilities for cost reduction at the research, development, and production stage. It is not a costing system, but a profit-planning system—the selling price and profit requirement are set during the research stage, thus creating a target cost.	✓	✓	✓	✓
Value chain costing	Based on Porter's value chain analysis, a firm may create a cost advantage either by reducing the cost of individual value chain activities or by reconfiguring the value chain.	✓	✓	✓	✓
Valuation of customers as assets	A technique like lifetime customer profitability that attempts to ascertain the net present value of a customer.	✓	✓		✓

1.5 The uptake of strategic management accounting

Active reading. Note the range of countries covered by recent studies on the use of SMA techniques and the finding on why the uptake in developing economies might be better than in developed nations. Think about other functional specialists, apart from management accountants, that provide information for strategic management in the organization.

Since the late 1990s, there has been a surge of studies undertaken to explore the uptake of strategic management accounting in practice. Many of the research surveys conducted have focused on uptake in specific sectors or countries. Examples include: Fowzia (2011) investigated SMA practices in Bangladesh; Cadez (2006) undertook a cross-industry analysis of SMA techniques in Slovenia; AlMaryani and Sadik (2012) reported on Romanian companies; Said et al. (2010) on Malaysian Local Government Authorities; Noordin et al. (2009) Malaysian electrical and electronic sector; Bahaa et al. (2019) hospitals in Malaysia; Agasisti et al. (2008) on Italian universities; Shah et al. (2011) conducted a study in Australia; Oboh and Ajibolade (2017) on Nigerian banks; Glushchenko and Yarkova (2016) on the Russian chemical industry; Alamri (2018) on the Saudi industrial sector; and Jbarah (2017) on Jordanian industrial companies.

Most studies use questionnaires asking about the usage of techniques determined by the researchers as being classified as strategic management accounting. Early surveys reported limited use of the defined SMA techniques. Still, more recent studies indicate that usage of some techniques, such as strategic planning and budgeting, customer accounting, target costing, and integrated performance management, is increasing. Nevertheless, Al-Abdel and McLellan (2013) argue that the specific strategy of an organization needs to be supported by particular accounting practices, echoing the calls of previous writers that accounting should support the strategic management process. The need to support a specific strategy means that different organizations will use different techniques, and the adoption of some techniques may not be universal.

Some surveys note that respondent organizations perceived that a higher benefit accrued from more traditional management accounting techniques, for example, Sulaiman et al. (2002) in Malaysia, Cadez (2006) in Slovenia, and McLellan (2014) in the U.S. The perceived benefit may be due to the comfort factor of the conventional techniques and the uncertainty surrounding the value of the more sophisticated advanced techniques. Conversely, more recent studies suggest that organizations are gaining performance benefits from using strategic management accounting and can use it to support competitive advantage. For example, the studies by Noordin et al. (2015) and Bahaa et al. (2019) in Malaysia, Oboh and Ajibolade (2017) in Nigeria, Alamri (2018) in Saudi, and Jbarah (2017) in Jordan all suggest performance benefits. Interestingly, Guilding et al. (2000), in an international comparison of SMA practices, felt that organizations established in the more developed countries were less inclined to move away from the tried and tested techniques of the conventional accounting systems, whereas, organizations in developing economies were perhaps more inclined to seek advantage from newer techniques.

There are also published papers that look at specific uses of SMA concerning particular activities or take a theoretical perspective. For example, Jorgensen and Messner (2010) and Nixon et al. (2011) investigated the role of SMA in new product design and development. Tillmann and Goddard (2008) reviewed SMA as sense-making in a multinational company. Ma and Tayles (2009) and later, Sunaryanto et al. (2017), explored the development and use of SMA from the perspective of institutional theory.

An interesting finding from several studies is that the practitioners of management accounting do not use the term strategic management accounting (Guilding et al., 2000; Roslender and Hart, 2003; Nixon and Burns, 2012; Pitcher, 2015). Although increasing in usage, it is also evident that the uptake of the techniques is not as widespread as early proposers of SMA had hoped. Despite this, evidence suggests that management accountants are becoming more directly involved in the strategic management process (Cuganesan et al., 2012; Pitcher, 2015; Glushchenko and Yarkova, 2016; Jbarah, 2017; Oboh and Ajibolade, 2017).

It is worth noting, however, that not all the accounting information is necessarily the preserve of the management accountants (Dixon and Smith, 1993; Lord, 1996; Anderson, 2006). This observation alludes to the fact that functional managers now have access to a range of information through integrated management information systems and decision support systems that include accounting information (Dixon, 1998; Laudon and Laudon, 2006). Couple this development with the increased importance of nonfinancial information involved in strategy formulation, implementation, and evaluation (McNair and Mosconi, 1989; Lynch and Cross, 1992; Kaplan and Norton, 2005) and it is clear that management accountants are part of a management team involved in the strategic management of an organization. The focus of this learning resource is the role that the management accountant can play in that process.

1.6 The need for a strategic management process

Active reading. Note how the need for strategic management developed to cope with changes in the business environment and the all-encompassing definition of the strategic management process.

In the 1950s and 1960s, management writers were discussing long-range planning. In many cases, organizations were taking their annual budgets as a start point and extending them for a period of five to ten years by adding in a growth factor, thus creating a long-range plan. In the 1970s, and particularly in the 1980s, the focus shifted toward strategic planning as markets became more competitive, and a definitive strategy was needed to develop the business. Toward the end of the 1980s and into the 1990s, the focus changed again, this time more broadly encompassing the activity of strategic management, as organizations needed to become more responsive to changes in what was becoming a more dynamic and complex business environment. Rather than just producing a strategic plan that would be implemented by the business units, it was becoming necessary to adopt a proactive approach, not only to strategy development but to managing the environment. Hence, strategy as a management process.

Despite SMA not becoming the messiah that some had hoped, the sentiment that management accounting should support the strategic management process is still overwhelming (Smith, 1997; Brewer, 2008; Blocher, 2009; Pitcher, 2018). Here, however, arises another difficulty – how to define the strategic management process. Barney et al. (2010) describe it as formulation, implementation, and evaluation of the strategy. A more encompassing and generally accepted definition is offered by Nixon and Burns (2012: 229) as containing the following key activities: "(1) development of a grand strategy, purpose or sense of direction, (2) formulation of strategic goals and plans to achieve them, (3) implementation of plans, and (4) monitoring, evaluation, and corrective action." This description aligns with the definition of the strategic accounting system outlined by Brouthers and Roozen (1999) described in section 1.4 - The development of strategic management accounting. However, both the Brouthers and Roozen definition of strategic accounting and the Nixon and Burns definition of the strategic management process, implies that strategic management is a routinized and formal process.

Although many firms adopt a rational planning process (Chenhall and Langfield-Smith, 1998; Rigby, 2001), there is a recognition that strategic decisions are often complicated, non-linear and fragmented (Hendry et al., 2010). Therefore, as a necessity, the strategic management process is iterative, rather than a formalized step by step process undertaken by senior managers in the organization (McNulty and Pettigrew, 1999). Indeed, many would describe strategy formulation as being a social and political process (Eden, 1992) in that strategy involves consensus, and may not always appear rational. The influence of particular power groups within an organization can also impact on the strategy development. For simplicity, this learning resource adopts a normative and logical approach to strategy as the structure for the work. Still, the author recognizes that there is considerable debate in academia about *how* and *who* determines the approach to strategic management in an organization.