Chapter 1:

Managerial Accounting: Tools for Decision Making

Agenda

- Strategy → Accounting
- Financial vs. Managerial Accounting
- Maximization of Shareholder Value
- Planning and Evaluating a Strategy
- Organizations, Missions, and Goals
- The Value Chain
- Planning, Organizing and Controlling

Does Accounting Matter?

- How do you know where you're going?
- How do you know if you've gotten there?
- What should you do to get there?

The old adage …

- "If you don't know where you're going, any road will take you there."
- In other words, accounting wouldn't matter.
- But you maximize profits by planning a course of action.
- In business, we have a name for charting our course …

STRATEGY

Strategy Blunders

- IBM's failure to maintain its leadership in the personal-computer market, arguably one of the past decade's biggest strategic blunders, cost Big Blue as much as $ 90 billion in lost market capitalization.
- The decision by former Apple Chairman John Sculley not to license the Macintosh operating system in the mid-1980s cost Apple Computer Corp. $ 20 billion to $ 40 billion in value.

Strategy Wins

- Procter & Gamble Co.'s decision to compete on the basis of low prices flew in the face of conventional strategic thinking, which argued that companies with premium brands never have to worry about being the low-cost producer in an industry.
- By challenging that widely held belief, P&G reinvented itself and its industry.
  - Result: Profit margins are at a record 11.6%, up from 6.4% when the about-face in strategy occurred.

Retail Industry

- From 1985 to 1994, about $ 163 billion of stock market value was created in the retail industry.
  - Some 25 companies were responsible for creating 85% of that wealth, and many of them did it with "business designs" that featured stores outside shopping malls, with low prices, quality merchandise, and broad selection.
- While Wal-Mart Stores Inc. generated $ 42 billion and Home Depot Inc. added $ 20 billion in value, Sears' retail operations captured less than $ 1 billion in that 10-year period. "HUGE HOLE." How did it happen?
  - Like so many American business icons, Sears lost sight of its customers. "We didn't know who we wanted to serve," concedes CEO Arthur C. Martinez. "That was a huge hole in our strategy. It was also not clear on what basis we thought we could win against the competition."

Accounting …

- Evaluates the success of a company's chosen strategy

Financial vs. Managerial

- Financial versus managerial accounting
  - Different audiences (external vs. internal)
  - Access to different data (public vs. private)

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Does this mean financial statements are not *useful* to *managers*?

- Financial statements are extremely useful to managers
  - Financial statements are the only way to compare your performance to that of your competitors
    - Financial statements are available for ***all*** publicly traded firms

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What is the goal of management?

- To maximize value for their shareholders
  - Since shareholders only have access to publicly-available F/S, managers care deeply about how the results of their operations flow into the financial statements.

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Is Maximization of Shareholder Value Myopic?

- Instead, managers should focus on executing the strategy of the business
- Are financial statements useful for this?
  - Too aggregated
  - Not timely – decisions are "prospective"
    - Data is stale (e.g., prices, costs, etc.)
    - Historical cost perspective
- Financial statements can only evaluate the success of a past strategy at the ***surface***.

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Cash is King ….

- Are all accounting reports denominated in dollars?
  - Units of time
  - Customers served
  - Units produced

Get Creative ….

It's allowed in managerial accounting!

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Goal: Planning and Evaluating Strategy

- Cost Driver Analysis
  - What are the firm's costs?
  - What drives them?
- Strategic Position Analysis
  - What is the firm's strategy?
    - e.g., product differentiation, low-cost/volume, market penetration, expansion, focused operations, etc.
- Value Chain Analysis
  - Focus on what adds value

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Organizations, Missions, Goals

A strategy is defined by its organizational structure, its mission, and its goals.

First step is to ***define*** … then we can measure and evaluate the success.

Your "mission" … Should you choose to accept it

- Mission: A basic purpose to which a business's activities are directed; missions are not precisely measurable.
  - What are the opportunities or needs that we aim to address? (Purpose of the organization)
  - How will we address those needs? (Business statement)
  - What principles or beliefs guide our work? (Values of the organization)

Big Brothers/Big Sisters

The mission of Big Brothers/Big Sisters of America is to make a positive difference in the lives of children and youth, primarily through a professionally-supported, one-to-one relationship with a caring adult, and to assist them in achieving their highest potential as they growth to become confident, competent, and caring individuals, by providing committed volunteers, national leadership and standards of excellence.

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Big Brothers/Big Sisters

- Purpose: to make a positive difference in the lives of children and youth so that they'll achieve their highest potential
- Business: providing and supporting committed volunteers who have one-to-one relationships with children and youth
- Values: individuals who are confident, competent, and caring; leadership and standards of excellence

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Other mission statements …

- Google - "To organize the world's information and make it universally accessible and useful."
- 3M – "To solve unsolved problems innovatively."
- Mary Kay Cosmetics – "To give unlimited opportunity to women."
- Merck – "To preserve and improve human life."
- Wal-Mart - " To give ordinary folk the chance to buy the same thing as rich people. "
- Walt Disney - " To make people happy. "

Goals

- Goal – Definable, measurable objective
  - Goals are often stated in terms of revenues, profit margins, accounting returns, market shares, dividend payments, minimum number of defects or unemployment, etc.
  - Goals should be congruent with the mission

BHAGs

- BHAG – Big, hairy, audacious goal – coined by Jim Collins and Jerry Porras (authors of *Built to Last*)
- Anatomy of a BHAG:
  - It has a long time frame – 10 to 30 years (or more)
  - It is clear, compelling, and easy to grasp
  - It connects to the core values and purpose of the organization

BHAG – Long Time Frame

- Citigroup set a BHAG in 1915
- To become the most powerful, the most serviceable, the most far-reaching world financial institution ever
- Took more than 50 years to achieve
- Short time frames cause managers to sacrifice long-term results for the sake of achieving a short-term goal (managerial myopia)

BHAG – Easy to Grasp

- Philip Morris in the 1950s
- To knock off R.J. Reynolds as the number one tobacco company in the world
- Doesn't leave much room for confusion

BHAG – Connected to Mission

- Nike's BHAG in 1960s
  - To crush Adidas
  - Fit perfectly with Nike's core purpose "to experience the emotion of competition, winning, and crushing competitors."
- Sony's BHAG in 1950s
  - To become the company most known for changing the worldwide poor-quality image of Japanese products
  - Flowed from stated core value of elevating the Japanese culture and national status

Strategy

- Strategy – an action plan to achieve stated goals
  - A firm can choose among many strategies but they should pursue the strategies that are in line with their stated values and provide the greatest cost/benefit advantage.

Strategic Position Analysis

(Michael Porter, 1980; Sharon Oster, 1990):

- An individual firm's strategy cannot be analyzed without considering the mission/goals/strategies of the firms' competitors.
  - Cost Leadership – still constrained by quality
  - Product Differentiation – still constrained by price
  - Focused (market niche) – serves a small segment of the market (limited products or customer list)

Stuck in the middle …

- All firms should be classifiable into one of these three strategies.
- Firms that do not fall into one of these categories are referred to as "stuck in the middle".
- How would you classify:
  - Apple Computer
  - Black and Decker
  - Starbuck's
  - Whirlpool
  - Home Depot
  - General Electric

Threats to a Chosen Strategy:

- Commoditization – access to numerous suppliers (domestic and global) puts downward pressure on input prices (and more importantly, finished goods)
- Unsuccessful cost containment – Given point 1, cutting costs are the only way to preserve profits
- Inability to innovate – innovation prevents point 1 and the inability to do so accelerates it.

What is the only asset that is safe?

Human capital !!

(creativity)

The Value Chain

- Devote time and resources to only activities that add value
- What is value?
  - Something the customer is willing to ***pay*** for!

Look high and low ….

- Suppliers
  - Must deliver quality goods, on-time, at a low cost
- Customers
  - Ask them what they want, when they want it, and how much they will pay for it?

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… and look within …

- Must hunt for and eliminate internal inefficiencies
- Use technology wherever its benefit outweighs its cost
  - Has ***barcode technology*** affected the value chain?

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Get techie …

- Enterprise Resource Planning Systems (ERP)
  - Improved upon old material requirements planning (MRP) systems through use of better integration, relational databases, and incorporation of accounting, finance, human resource, functions into operations
- Supply Chain Management Systems (SCM)
  - Streamlines order fulfillment and inventory management between supplier and customer.
- Customer Relationship Management Systems (CRM)
  - Automates customer orders, service and support. Makes sales suggestions and offers special discounts and buying opportunities.

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Collaborate or die ….

- Slogan from J.D. Edwards – produces ERP software
- Focus on managing ***cross-company*** processes
  - Reduce costs, increase speed, and improve quality
- Think of your case company from financial accounting
  - Take a moment and think about how cross-company collaboration would benefit the company.

Key point – managerial accounting is necessary for all the strategy goals we've been discussing.

High quality accounting → High quality decision-making

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Planning, Organizing, and Controlling:

- Planning – selection of goals and strategies in which to achieve those goals
- Organizing – assignment of responsibility to implement strategy
- Control – evaluation of feedback and fine-tuning of strategy (or goals); cycles back to planning

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Progress Makes Planning, Controlling, and Evaluating Difficult

- Technology
- Business culture
- Pay for performance
- Global economy
- Ethical environment

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Oh, the technology ….

- Technology has shortened product life cycles (and hence firm life cycles).
- Production has moved from labor-based to technology-based.
- Products have become more diversified (leading to increased complexity in production).

How has technology changed the operations of your case company?

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Times … they are a changing …

- Compare and contrast the business culture in the 1960s with that of today:
  - Decision-making has been pushed down the line.
  - Flattened the hierarchical structure of organizations (leaner, decision-making is closer to the customer, employees are invested in success of company/empowered, quality is improved/need for inspection is reduced)
- This leads to more visible management accounting.
  - What trust issues are present when "opening the books" to employees?

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Pick a number …. Any number …

- Imagine you're all sales people and that the VP of sales asks you to forecast what you expect to sell next period. How do you come up with a number?
- Subjective (at best)
- May have incentives to underreport (risk aversion)
- May have incentives to overreport (overly-optimistic or ego-driven)
- How does this affect the ability of the budget to be used for planning?
- How does this affect the ability of the budget to be used for control?

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You're the boss …

at Boeing Corporation. Suppose you're charged with coming up with a reward structure for the sales force based on sales.

What measure of sales should you use for performance evaluation?

- When orders are placed?
- When goods are delivered?
- A pro-rated method?

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Let's go global …

- Transition to Global Economy
  - Accelerated by
    - Telecommunications
    - Information systems
    - Transportation networks
    - Legislation

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Free Trade

- North American Free Trade Association (NAFTA) (1994) – phases out duties on goods shipped between U.S., Mexico and Canada over 14 years. The treaty was initiated due to concerns that companies would relocate to Mexico and called for unanimous environmental regulations between the three countries.
- General Agreement on Tariffs and Trade (GATT) (1948) – This treaty was created to accelerate recovery after WWII by removing trade barriers between 23 countries. In 1994, it was updated to create the World Trade Organization and has expanded over time to include over 125 countries.
- Economic expansion throughout Asia

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Global Economy = ↑ Competition + ↑ Opportunity

- World is potential supplier
- Platforms of global competition
  - Price
  - Cost
  - Service
  - Quality