Business value created by management accounting

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Abstract

Porter stated in his value chain concept that business support activities are contributing to the value creation process of a business organization. Management accounting is a classical business support activity that contributes to the business organization value chain. Can this value contribution be somehow determined or quantified? The present paper is highlighting one possible alternative to determine the value contribution by using value driven performance indicators.

1 Introduction

An individual or other organization, when acting in their role as shareholder, is the trigger of a business idea being operationalized through the set up and establishment of a legal business entity. From the moment when a business idea is operationalized, and a legal business organization is established it is expected to create value for its shareholders, shareholders being the source of equity. Besides the primary activities of a business organization can the support activities be considered a value contributor? If yes, how can this value be measured?

According to Porter's value chain concept support activities have a clear contribution to the margin achievement of any business organization. The value contribution of support activities is spread over several support activities of the business organization traditional business support services. According to the value chain model (see Figure 1) primary activities are supported by support activities, like firm infrastructure, human resources management, technology development and procurement.

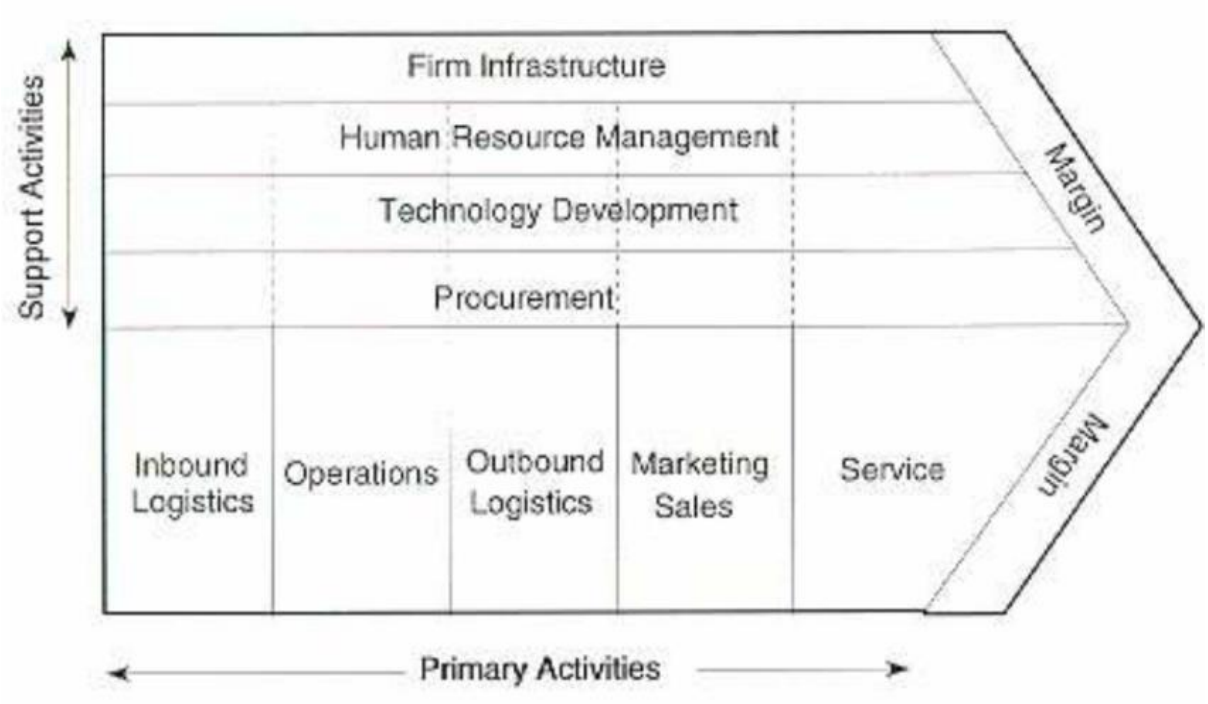

Figure 1 - Porter value chain / Source: Porter (1985)

Most intangible assets, the business organizations knowledge pools, are grouped under the generic term of "firm infrastructure" (in Porter's value chain concept) like financial accounting, management accounting, general management, strategic planning, control systems, etc.

Management accounting is part of "firm infrastructure" and is a contributor to the margin achievement of the business organization.

The purpose of this paper is to illustrate the created value of management accounting and to measure is by using value based performance evaluation.

2 Management accounting scope, importance, and value contributor

2.1 Scope of management accounting

Management accounting, a still young business activity has transformed from reactive cost determination focus to proactive value creating and considerate resource business driver. Management accounting is on the way to asserting itself as a proactive business value driver for the modern 21st century business organizations. (Daraban M. C., 2017, p. 1)

The Institute of Certified Management Accountants defines the management accountant as follows: A management accountant applies his or her professional knowledge and skill in the preparation and presentation of financial and other decision oriented information in such a way as to assist management in the formulation of policies and in the planning and control of the operation of the undertaking. Management Accountants therefore are seen as the "value-creators" amongst the accountants. They are much more interested in forward looking and taking decisions that will affect the future of the organization, than in the historical recording and compliance (scorekeeping) aspects of the profession. Management accounting knowledge and experience can therefore be obtained from varied fields and functions within an organization, such as information management, treasury, efficiency auditing, marketing, valuation, pricing, logistics, etc (Institute of Certified Management Accountants, 2017)

Management accounting is providing the management data and information that can be used in the management decision process. The sole scope of management accounting is to analyse the facts, data and information and to make recommendations for future management decisions that enable the alignment with the strategic defined goals and targets.

A more simplistic definition of management accounting can be made in comparison with financial accounting. Financial accounting is giving and answer to "how and what has happened". Management accounting is providing answers to "why has happened and what if" being more concerned to look towards the future whereas financial accounting is more concerned about the clear recording and documentation of past events.

2.2 Importance of management accounting

One of the most important goals of business management is to assure for the own organization the best sustainable competitive advantage as a prerequisite for the positive and successful return on investment for shareholders. Management accounting is one of the most important data and information provider for the management decision process. The management decision process relies on data and information inputs provided by 3rd parties or by the own organization to make the most beneficial and efficient decision towards the attainment of the needed sustainable competitive advantage.

Management accounting is using the historical data analysis as a foundation for the predictive higher value business data generation and dissemination that is needed for the business planning and decision support. The management accounting system is leveraged and driven forward by the knowledge worker, the management accountant that is the enabling factor for the learning ability of the knowledge based organization. (Daraban M. C., 2017, p. 4)

Moreover, by sustaining the management decision process, management accounting is establishing itself as a facts and data based insurance for the shareholder value creation process of the business organization.

2.3 Management accounting as a value contributor

Business value creation is the goal of any business organization and can also be defined as being the sum of the value created by all business activities and processes from the specific organization. The todays business organizations must compete in the globalized, dynamic and information driven markets. The competitive advantage that assures the future of the business organization can be gained by coping with the 21st century market requirements, understanding and managing the available data and information that are business relevant. (Daraban M. C., 2017, p. 5)

The created value of management accounting comes from its purpose and scope in any business organization, to analyse and provide data for the management decision process that thrives to assure the best sustainable competitive advantage.

As an internal suborganization, the management accounting organization is the typical knowledge based organization, that acquires, processes and shares knowledge derived from the past and current available business data and information. Through the function of knowledge based organization, management accounting, management accounting creates value that sustains and contributes to the business organization value creation process.

Management accounting is the sourcing, analysis, communication and use of decision-relevant financial and non-financial information to generate and preserve value for organisations. (Association of International Certified Professional Accountants, 2017)

The Association of International Certified Professional Accountants recognizes in their definition of management accounting its value creation and preserving role for the business organization.

3 Value based performance measurement of management accounting

Management accounting has recently broadened its scope to encompass contributing to the so-called value creation process. Value creation is usually presented as a simple, strategically relevant and all-embracing concept. Drawing from the Marxist concept of reification, this article shows that value creation is commonly reified through its objectification, which prevents any dispute and further maintains social domination (Bourguignon, 2005)

The objectification of value can be done by using measurement concepts that highlight the created value, therefore value based performance measurement is most feasible.

Any business organization has at least two value chain drivers, primary activities and support activities. Both drivers converge and sustain the organizational value chain by specific activities. The efficiency of the value drivers is measured in the case of primary activities by means of performance indicators that are well established and documented. Traditionally, support activities have been deemed as value and resource consuming rather than as value creators.

3.1 Value based performance indicators

Classical performance indicators are not applicable for the determination and calculation of the created value through operational business. The classic view on performance has its roots in the industrial revolution where the attainment of the quantitative aspects have been the main interest. Performance measurement concepts like Economic Profit and EVA are compensating for the shortcomings of classical performance indicators by including the value aspect into their quantification.

What is known today as the Economic Value-Added concept was developed by the management consulting company Stern Value Management that owns the trademark of EVA™ as a way of evaluating the business organizations performance expressed as value generation for shareholders. (Daraban M. , 2017, p. 2)

Stern Value Management develops 1983 the EVA concept based on the works of Merton H. Miller and Franco Modigliani as a model for maximizing the value created that can also be used to provide incentives at all levels of the firm. (Stern Value Management, 2016).

EVA is defined as follows:

$$EVA = NOPAT - (IC*WACC)$$

Economic Profit is a variation of the Residual Income “classical” economic concept that adds to the accounting profit the need for coverage of implicit costs besides the explicit already covered costs. Economic Profit can be defined as follows:

$$Economic\ Profit = Accounting\ Profit - Implicit\ costs$$

3.2 Value quantification of management accounting

The mentioned value based performance indicators can be used to objectify, to quantify the value contribution of management accounting using a calculation model.

The calculation model is based on the following assumptions:

Company ABC Ltd has simplified P&L as follows:

	ABC Ltd
Sales / Revenue	800.000
COGS	500.000
Gross Profit	300.000
SG&A	80.000
EBIT	220.000

Figure 2 - Simplified P&L of ABC Ltd / Source : Marius Daraban

Based on the same simplified perspective management accounting (MA) can be mapped as follows on the simplified P&L structure:

	ABC Ltd	MA
Sales / Revenue	800.000	10.000
COGS	500.000	
Gross Profit	300.000	10.000
SG&A	80.000	
EBIT	220.000	10.000

Figure 3- Simplified P&L ABC Ltd and MA / Source: Marius Daraban

MA has no COGS, SG&A when considered as an independent activity, it's revenue is determined and equal with the costs of MA at ABC Ltd level.

EVA = NOPAT – IC * WACC = (EBIT*(1-tax rate))- IC *WACC

EP = Accounting Profit – implicit costs = EBIT – IC * WACC

For the current calculation model, we have additional following assumptions

Tax rate = 16% (current income tax rate in Romania)

WACC = 10% (a precise industry specific WACC can be calculated and used)

IC = invested capital = long term debt + equity = 300.000 + 100.000 = 400.000

	ABC Ltd	MA
Sales / Revenue	800.000	10.000
COGS	500.000	
Gross Profit	300.000	10.000
SG&A	80.000	
EBIT	220.000	10.000
tax rate	16%	
NOPAT	184.800	8.400
IC	400.000	
WACC	10%	
EVA	**144.800**	**8.400**

Figure 4 - EVA calculation for ABC Ltd and MA / Source: Marius Daraban

Based on the above assumptions EVA can be determined for MA (management accounting) that represents ~6% of the total EVA of ABC Ltd.

Starting from the calculation presented in Figure 3 and based on the same assumptions Economic Profit can also be determined. The implicit costs are represented by the WACC that is the minimal amount (being the cost of the invested capital) that must be covered additional by the accounting profit.

	ABC Ltd	MA
EBIT	220.000	10.000
implict costs	22.000	1.000
EP	**198.000**	**9.000**

Figure 5 - EP for ABC Ltd and MA / Source: Marius Daraban

Where

Implicit costs = WACC = minimal costs that must be covered by the accounting profit.

EP = economic profit

ABC Ltd has still some leeway of implicit costs until it gets zero or even negative economic profit.

4 Conclusions

The value contribution of intangible assets like data, information and knowledge is highlighted by using value based performance indicators. Even though the presented model is based on assumptions that simplify the concept of the value objectivation and quantification, the business organization value chain contribution of business support activities is clearly highlighted through the usage of demonstrated economical concepts. The value based evaluation of business performance puts "classical" indirect productive business activities into the spotlight. Management accounting is the typical knowledge driven, value creating business activity that is handling the intangible side of business organizations in the information age by acquisition, processing and sharing of insights of business performance and evolution.

The presented value based performance evaluation model is making the subjective aspect of the value consideration obsolete by specific and objective calculations. The value based performance evaluation approach is taking into consideration that the objective of a business organization is to cover at least all investment related costs including the cost of invested capital.

Due to the shift in paradigm generated by the information age, where data, information and knowledge is the prime commodity, management accounting is playing a pivotal role in the support of management decision by providing the needed, specific and accurate data and facts. The value created by management accounting for modern business of the 21st century information age is important and constitutes a critical component of the management decision process.

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