ACCT3012: Management Accounting B

[Week 1]

Introduction to Management Accounting and Analysing the External Environment

Introduction to Management Accounting

- Unlike financial accounting and tax accounting, there are no prescriptive rules as to how information is to be presented. Financial accounting has GAAP and tax accounting has tax codes.
- The users of management accounting unlike financial accounting (a variety of external users) and tax accounting (the tax department).
- There is a motivation to look good for financial accounting purposes and bad for tax accounting purposes, however with management accounting most will aim to look accurate.
- Management accounting plays a vital role in managing business and can provide key information for informing strategic decisions.
    - It is capable of recognising, generating and analysing financial and non-financial information the is useful for managerial decision making and control.
    - It utilises the knowledge of both the organisation and its environment.
- To emphasis on the strategic role of management accounting necessitates more than just knowledge of cost accounting but also applying that to an environmental (outward-looking) and longer-term (forward-looking) perspective.
- To better aid management in decision-making, the management accountant needs to understanding of both the internal workings of an organisation and the external environment.
- Organisational analysis can be broken down into:
    - The macro (or 'general') environment.
        - PEST analysis can be used here.
    - The industry (or 'competitive') environment.
        - Porter's Five Forces can be used here.
    - The organisation.
        - Looking at the organisation's resources and capabilities.
- Management accounting tools can be grouped into the following categories denoted by the acronym 'PACE'.
    - Planning.
    - Analysis.
    - Control.
    - Evaluation.

Analysing the External Environment

- The business environment encompasses many different influences and contributes significantly to strategic decision making.
- There is a considerable amount of uncertainty inherent in the external business environment.
- Mangers must overcome risks of oversimplification and inherent bias in decision making when addressing the external business environment.
- There are a number of frameworks that can be used to understand the external business environment. These tools can be used to form a comprehensive understanding of a firm's strategic position:
    - Preliminary analysis may be conducted to gain an initial view of the organisation's environment in terms of how uncertain it is. The complexity and the extent of how static or dynamic the industry is should be consider. This will help gauge the significance of other stages of the analysis process.
        - Environmental uncertainty increases as environmental conditions become more dynamic or are more complex.

        - In simplistic (or 'static') environments, the conditions influencing business are simple or low in numbers. This makes forecasting predictable and using a historic basis may be appropriate.
        - In dynamic environment, management will need to give greater consideration to how the future will deviate from the past. This may be done intuitively or through structured ways like 'scenario planning'.
        - In complex environments (which may include dynamic conditions) there is difficulty in analysis. These challenges may be partially mitigated through effective organisational structure which gives resources and authority to separate components of the organisation allow them how to handle how a subset of the organisation's activity will be specifically effected by the environment.
    - The next step may be to engage in auditing of the environmental factors. The aim of this stage is to gauge how the different macroeconomic factors are likely to effect the organisation. This is looking at general factors. This will include analysis of the political, economic, social and technological (PEST) factors.
        - Environmental forces which have a significant impact on one organisation, may have little impact on another. A useful starting point is to look at the factors which have had considerable impact on operations in the past.
        - The factors that are included in PEST analysis are:
            - Political (and legal or regulatory) factors which include competition regulation, environmental policy, trade agreement's and employment law.
            - Economic factors which includes business cycles, interest rates, inflation and unemployment.
            - Sociocultural factors which include demographics, income distributions, consumer trends and levels of education.
            - Technological factors which include government spending on research, rates of obsolescence and new discoveries.
        - Another tool to evaluate the environment influences on an organisation which is particularly useful in the context of competition is Porter's diamond. This framework suggests that the home base of an organisation plays a key role in shaping the extent to which it is likely to achieve advantage on a global scale.
            - Specific factor conditions are one force that help explain the advantage on a national level. This may include employment law or the skillset of a nation's workforce.
            - Home demand conditions of an organisation's products will have a considerable impact on how the advantages of organisations are shaped.
            - Another factor is the presence of presence of related and supporting industries within the country.
            - The characteristics of firm strategy, structure and rivalry in one country may be more suited to certain industries more than others.
        - Once an understanding has been built of the major influences and drivers of the external environment, management can construct scenarios to consider how to approach these influences. This is known as 'scenario planning'.
    - After this is consider, one may look at the immediate environment of the organisation. This refers to analysis of the industry environment. Tools like Porter's Five Forces can be used to analyse this. This is used to understand the immediate or competitive environment which the organisation operates in.
        - The five forces considered in Porter's framework are:
            - Threat of entry: The threat of entry will depend on the extent to which there are barriers to entry. These will generally come in the form of:
                - Economies of scale which would make a new firm trying to enter the market unable to compete.

    - The capital requirements of entry.
    - Access to distribution channels.
    - Cost advantages that come independent of size and may be a product of the experience gained from being an early entrant.
    - The expected retaliation of existing firms. This may drastically increase the cost of entry.
    - Legislation or government action that prevents new players from entering into a market. This includes patents or other kinds of IP protection.
    - Differentiation strategies employed by existing players (like a reputation for high quality) that new players would have difficulty competing with.
- Power of buyers: The bargaining power of buyers is likely to be high when there is concentration of buyers. This will be further increased when:
    - The supply industry consists of a large number of small operators.
    - There are alternate sources of supply. This may be the result of a product being undifferentiated.
    - The product is costly as this will incentivise buyers to 'shop around'.
    - The cost of switching between suppliers is low.
    - There is a significant threat of the buyer purchasing the supplier (backwards integration) if quality or price ideals are not met.
- Power of sellers: The bargaining power of suppliers is likely to be high when there is a concentration of suppliers rather than a fragmented source of supply. Other factors that will increase the bargaining power of suppliers are:
    - The switching costs of moving from one buyer to another are high.
    - The brand power of a supplier is powerful.
    - There is a possibility of a supplier integrating forward if they do not achieve the margins they desire.
    - The customers are highly fragmented.
- Threat of substitutes: The threat of substitute products can some in different forms. These include:
    - Product-for-product substitution: Whereby one product achieves the exact same purpose for a consumer as another product.
    - Substitution of need: Whereby a new product reduces the need of a related product (it does not replace the old product).
    - Generic substation: Where products of the same nature compete for need.
    - Doing without: This can also be viewed as a substitute.
- Competitive rivalry: This refers to the extent of direct rivalry between an organisation and its competitors. Some considerations (in addition to the above) which influence the degree of rivalry are:
    - The extent to which the competitors are 'in balance', meaning that they are roughly of equal size. This will often increase rivalry as one attempts to gain dominance.
    - Market growth rates are another consideration. In maturity industries, there will often be greater rivalry as competitors must take business away from each other to grow.