BUSINESS VALUE CREATED BY MANAGEMENT ACCOUNTING

Marius Costin Daraban[1]

Abstract: Porter stated in his value chain concept that business support activities are contributing to the value creation process of a business organization. In the "classical view" business support activities are considered as indirect productive and not having a clear and direct contribution to the business organization value chain. The information age has enabled and leveraged business support activities to become decisive contributors to the value creation process of any business. Can this value contribution be somehow determined or quantified? Management accounting is a classical business support activity that contributes to the business organization value chain. Through usage of value management and value driven performance indicators, the value contribution can be determined and quantified. The present paper is highlighting one possible alternative to determine the value contribution by using indicators like economic value added and economic profit. The value-based approach is putting indirect productive business activities into a new position, the one of a clear and important business value creator that cannot be ignored in the 21st century, a century driven by data, a nd information and knowledge that can sustain a decisive sustainable competitive advantage.

JEL Classification Numbers: M21, D46, L21; **DOI:** http://dx.doi.org/10.12955/cbup.v6.1136

Keywords: Value, management accounting, economic value, EVA, economic profit

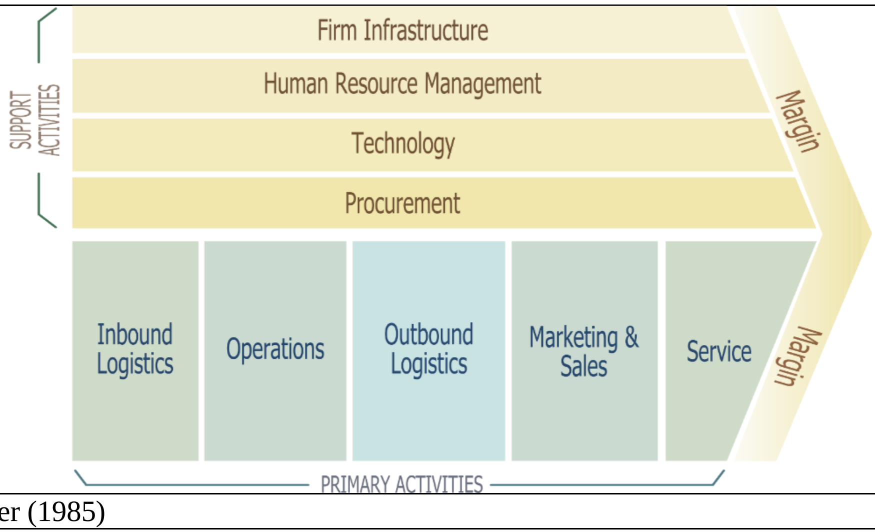
Introduction

An individual or an 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, the 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 contribution 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 Model



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

[1] Lucian Blaga University of Sibiu, marius.daraban@ulbsibiu.ro

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

Management accounting scope, importance, and value contributor

Scope of management accounting

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

The Institute of Certified Management Accountants defines a 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 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 an answer to "how and what has happened". Management accounting is providing answers to "why has it happened and what if" and being more concerned with looking towards the future whereas financial accounting is more concerned about the clear recording and documentation of past events.

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 providers 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 business planning and decision support. The management accounting system is leveraged and driven forward by the knowledge of the 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 fact and data-based insurance for the shareholder value creation process of the business organization.

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 a specific organization. Today's 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 a knowledge-based organization, 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).

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 through 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.

Value based performance indicators

Classical performance indicators are not applicable for the determination and calculation of the created value through the operational business. The classic view on performance has its roots in the industrial revolution where the attainment of the quantitative aspects has 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 business organizations performance expressed as value generation for shareholders (Daraban M. , 2017, p. 2).

Stern Value Management developed in 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 by Stern Value Management as follows:

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

Where:

EVA = Economic Value Added

NOPAT = net operation profit after tax

IC = invested capital

WACC = weighted average cost of capital

Bending accounting rules has become so ingrained in our corporate culture that even ethical business leaders succumb to the temptation to “manage” their earnings in order to meet analysts' demands for smoothly rising results. This has led to the fact that accounting itself has become “unhinged from value.” (Stewart, 2003)

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:

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

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:

An example company which we have termed ABC Ltd has a simplified P&L as follows:

Figure 2 - Simplified P&L of ABC Ltd

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

Source: Author

Where:

COGS = cost of goods and services sold

SG&A = sales, general and administrative expenses

EBIT = earnings before interest and taxes

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

Figure 3- Simplified P&L ABC Ltd and MA

	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

Source: Author

MA has no COGS, SG&A when considered as an independent activity, its 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

Figure 4 - EVA calculation for ABC Ltd and MA

	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**

Source: Author

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

Figure 5 - EP for ABC Ltd and MA

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

Source: Author

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.

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 value objectivation and quantification, the business organization value chain contribution of business support activities is clearly highlighted through the usage of the 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 takes into consideration that the objective of a business organization is to cover at least all investment related costs including the cost of the 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 decisions by providing the needed, specific and accurate data and facts. The value created by management accounting for modern business of the 21stcentury information age is important and constitutes a critical component of the management decision process.

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