Tailoring and Customising Financial Performance Reporting to suit the needs of different Management Teams and Business Units

John Beechey
Senior Lecturer of Management Accounting
School of Accountancy Law and Finance
UNITEC

"Traditional (Historical)" accounting is dead?

There is a school of thought that advances the proposition that "traditional" financial accounting measures are insufficient to track how a business is moving towards its strategic objectives.

Traditional accounting does not link physical measures and profit. Nor does it identify the relationships between the business drivers, nor does it differentiate between leading and lagged indicators. New techniques, such as the balanced scorecard, active learning and benchmarking, are more powerful and forward looking. We cannot subscribe totally to the view that "traditional" accounting is dead, if only because legislation and stewardship require accounts to be produced. The newer techniques should supplement "management" accounts, not replace them.

Before we can develop management accounts (accounting) further, current standards of "traditional" accounting presentation need to be addressed in order to get the basics right as a sound foundation

Measuring up

Does your business’s performance measurement system aid (senior) executives and board members track how effectively corporate strategy is being implemented? Do (senior) executives know when important elements of the strategic plan are on track, and when corrective actions are necessary? Are financial performance measures adequate for answering such questions?

Businesses face increasing legal and regulatory pressures to improve their governance practices. Boards of directors are expected to supervise management and affairs of the business. They must ensure that a strategic planning process is in place. They must monitor management’s success in implementing the strategy. They are expected to understand the principal risks of the business and ensure the successful implementation of systems to monitor and management those risks.
Boards are also responsible for taking into account the impact of the business's activities on stakeholders other than shareholders, such as employees, customers, suppliers and communities.

Nonfinancial information is necessary for many board and management responsibilities, particularly those that involve strategic planning and monitoring the effective implementation of those strategic plans. Today, intangible assets - such as employee knowledge, innovative activity or practices and customer goodwill - are strategically more critical to the creation of wealth than they have been in the past. Financial performance measures, however, fail to capture in a timely fashion the effect of intangibles on wealth creation. They also do not provide sufficient information to allow management to direct and control intangibles.

In 1995, the Conference Board of Canada reported that traditional accounting based performance measures:

- Are excessively historical,
- Lack predictive power,
- Reward the wrong behaviour,
- Do not capture key business changes (until it is too late), and
- Give inadequate consideration to such resources such as intellectual capital.

Each of these considerations suggests that strategically orientated performance measurement systems should measure nonfinancial as well as financial outcomes.

The competitive reinvention of existing and new products and services, delivery channels, and management styles has brought with it an instrument panel of fresh dials and gauges to guide business decisions. These new dials and gauges are non-traditional, developed at the segment level, are created by line managers and maintained by information officers. Derived from management information systems (MIS), this crucial data is divorced from the general ledger, the financial source supporting Generally Accepted Accounting Principles (GAAP). Consequently, GAAP based accounting and reporting functions are losing relevance as tools for the governance of strategically active businesses. To modern managers, GAAP is an encumbrance, the glacially evolving creature of rule making bodies such as ICANZ. In their pursuit of the drivers of value creation, progressive managers look instead to the new models.
Any management that restricts itself to GAAP financial reporting is out of touch with the indicators needed in adapting a business to a changing strategic environment. The same GAAP induced blind spots that cloud the vision of managers also undermine analyst and investor perceptions of value. These are audiences whose clear sightedness on questions of value we should want to encourage. Clearly, management must go far beyond GAAP in building cost effective measurement systems to support business planning.

Standards of management accounts

Look at your own management accounts.

Often we see excessive pages of poorly presented data – the majority dealing with overhead spent. Some compare actuals with budgets. Some use last year as the yardstick, some last month’s forecast. Others use no yardstick at all.

There are no set standards for drawing up internal accounts, very few examples, no theory and, frankly, bad practice – the exception of course, being your own business’s accounts. The task of drawing up a set of accounts is often done on the basis of "These are the answers, now what is the question?".

If you ask, "What factors contribute most to profit?" and then measure the area of paper given to reporting these key factors, you would conclude that the majority of the paper used for reporting is wasted as it deals with factors governing only a very small percentage of the profits.

We cannot blame the advent of personal computers for the state of our art, but we could site weakness in the guidance and training of (management) accountants as the art of presenting management accounts is not part of degree syllabi

There are well-defined standards for external reporting, following a statutory framework. You may not agree with the standards or the layout of a set of statutory accounts, but at least you know what to expect and they satisfy the needs of stewardship for external stakeholders. But what are the needs of internal stakeholders? Are they really any different?
Management accounts have three objectives;

<table>
<thead>
<tr>
<th>Objective</th>
<th>Need</th>
</tr>
</thead>
<tbody>
<tr>
<td>Monitoring</td>
<td>Progress to target</td>
</tr>
<tr>
<td>Understanding</td>
<td>For action</td>
</tr>
<tr>
<td>Information</td>
<td>Forward planning</td>
</tr>
</tbody>
</table>

Some fundamentals need to be reinforced.

Management reporting is about communicating. Successful communication depends on giving, receiving and understanding the message.

The message must be;
- CLEAR,
- **FOCUSED**, on what is important, and
- Comprehensive message – REPORTING

Presentation is nine tenths of the art. It is not only what should be reported, but how. Management accounts can impress – but should not confuse. Less is more. Data is not information, if you cannot get it onto one sheet of A4, it’s not worth doing. One clearly understood fact is far more valuable than one thousand pieces of misunderstood data. It is too easy to drown a clear signal with irrelevant noise.

In this we are reminded of Lord Nelson writing to Lady Hamilton “Please forgive me, but I have no time to be brief”.

At the corporate (board) level, management is concerned with strategy. Here, only summary accounts are needed to highlight the main direction of the business.

At the functional level, management is concerned with control – comparisons of actual performance with targets.

At line management level, individual or unit activity reports need to highlight specific indicators leading to actions and improvements.
Not all these levels should all of these statements in an account "pack". These should be selectivity in reporting at all levels. In response to specific queries, the pyramid of data can be selectively drilled down for targeted reports.

Adopting a clear focused reporting approach is a culture shock for management. Leaving behind the comfort of detail and simplifying reports to the key elements requires a fresh brave approach. Why? Because they are constructed on the "need to know" basis.

*If you can’t measure what you want, don’t measure what you don’t want.*

**Challenge your balanced scorecard**

Balanced scorecards can be embraced superficially and ineffectually. Ineffective scorecards contain measurements that are too numerous to collect and track. They collapse under their own weight. They become bulky and impressive documents that sit on top of executive furniture unimplemented and unused. Creating a good balanced scorecard requires hard work, revising and re-visiting the list of measurements that comprise the balanced scorecard. Yet repeating the same exercise again and again is unlikely to be productive, especially given the temptation to add more measures at each repetition. Instead, executive teams need an effective way to sort measures into the *vital few* rather than the *trivial many*.

**Challenge – balancing leading and lagging indicators**

The concept of leading and lagging indicators is borrowed from economics. Financial measures are lagging indicators because even quarterly information must accumulate over a quarter or two before it conclusively shows whether there are major problems. In contrast, well-chosen leading indicators foreshadow success or failure well before the financials can reflect them. In general, leading indicators are nonfinancial measures. A ratio of six nonfinancial measures for every financial measure on the scorecard will aid business to achieve a balance of power between the traditionally persuasive financial measures and the less familiar nonfinancial measures.
Challenge – finding the important drivers

A good balanced scorecard contains all the information needed to keep score of winning or losing and nothing else. This challenges managers to prove that the business process that is selected to be measured is a key driver of either past or future performance. Learning from the past is straightforward – look at the financials for the past few years, for example, and identify and rank the reasons why performance varied. Add to this short list of drivers any issues with which management had major struggles but managed to avoid a performance hit. Learning about the present and the future is straightforward. Any executive group can articulate the characteristics of customer services and internal operations that matter. Little investigation is required to determine which industry trends will affect services that are important to customers or critical to effective internal operations.

Challenge – measuring strategic change

As a driver of future performance, strategic change deserves its own explicit challenge. Strategic change that is managed effectively is also measured effectively. A simple, but ruthless test for adequate inclusion of measurements to manage strategic change is the two-finger test. Take whatever articulation of strategy exists - such as the reasons for change, the general nature of the change needed and specific actions initiated to start change. Put one finger on each particular statement within the strategy – for example, “We increasingly will offer our products and services to customers over the Web”. Put another finger on a corresponding balanced scorecard measure – such as the number of customer interactions with the business via the Web. If there is no such measure, add one. The statement of strategy may not describe the full chain of cause and effect from the immediate action to the end results of strategic change – but the measurements and plans should.

Challenge – moving measurements off the scorecard by delegating

Skillful managers avoid micromanaging, because major long-term issues get lost in the clutter. For the same reason, well-designed balanced scorecards avoid large numbers of measurements. The mechanics of challenging delegation are simple – if there are too many measurements, some must be taken off the executive scorecard and offered as candidates for the scorecards of middle and lower management. The key question is “Is this measurement so important, so difficult to achieve and so vital to the future success of the business that top management must monitor and act upon it?”
Challenge – avoiding unbalanced, game-able measurements

The perils of focusing on a single measure are well known. Focusing on profitability alone, especially over the short term, motivates skimping on customer service and future development of people and products. Opportunities abound for perverse incentives.

A scorecard should be balanced in the breadth of measures and the avoidance of suboptimisation – optimising a part at the expense of the whole – as well as balanced in leading and lagging indicators. To test whether the choice of measures is balanced, ask the following two questions:

1. What actions could I take that would improve performance yet be bad for the business, and
2. For each of those actions, is there another measurement that would prevent me from taking it? If there isn’t, add one.

Challenge – getting input and buy-in

The business landscape is littered with “strategies” consisting of only fine words and lofty financial targets created by top management. These reflect little focused investigation of whether the means exist to meet the goals or how managers will measure progress towards the goals. Such information typically must come out of middle or lower management.

The broader challenge

An effective balanced scorecard system also will reveal whether management is improving over time. To achieve this, the scorecard continually must convey two themes. Firstly, the scorecard must reflect fact-based understanding and prioritisation of business issues. Secondly, it must be regarded as the most tangible manifestation of an integrated management system.

The measurements used on scorecards will continue to evolve as the business is better analysed and understood. Factors that will contribute to this evolution include changes in the competitive environment, the success of strategic initiatives, and the creation of new initiatives. Ultimately the real test of the balanced scorecard is its ability to create positive change.

Small business and the balanced scorecard

A business will not survive unless it knows how to achieve a competitive advantage in the marketplace. Managers of small businesses might think that only large blue-chip companies need strategic measurement systems and balanced scorecards.
To date, reported applications of the balanced scorecard mostly have been confined to these large international businesses. They tend to face more turbulent and competitive environments, have more dispersed and varied products and processes that need coordination and monitoring and also have more resources for undertaking change initiatives. The reality is, however, that every business has to know how to equal and to surpass its competitors. Small business owners have a number of tools to measure key processes. Using a simple balanced scorecard and finding three or four critical processes to measure from each of the dimensions chosen can do this. Measuring critical processes presupposes that the proprietors want continuous improvement. There is no value in measuring performance if the information is not used to make operational improvements. Tracking the drivers of performance is a tool enabling business to focus on the future. De-emphasising the cashflow and Statement of Financial Performance is an efficient way to change current mindsets. To bring about a shift in behaviour, greater links to customer's needs are required. There is sufficient anecdotal evidence that measures of quality and customer satisfaction are finally beginning to affect small business across the board. Although multinational businesses, such as Motorola, Toyota, Ericsson, and IBM have already incorporated continuous improvement principles and methods into their business, small business operators are just now beginning to explore the tremendous possibilities. The objective for the managers of small businesses is to ultimately improve the bottom line. The key point to remember is that what gets measured, gets managed.

A scorecard for the 21st century
Maybe it is time to try something new. The balanced scorecard is an exciting new idea that may help businesses restructure and refocus in order to survive in the difficult and dynamic business environment. It is a concept that helps management direct its attention to those goals and objectives and the measures that drive the business toward achieving those goals and objectives that will allow the business to reengineer and or restructure to meet the needs of the 21st Century.

The balance scorecard is not so structured that it can serve all organisations uniformly. But, instead, its strength lies in providing management with the ability to design a unique scorecard that specifically fits the need of that company, business, organisation, subunit, division or individual employee. While it is a relatively recently developed performance management tool, its perceived advantages at this point in time indicates its longevity.