Improving strategic decision making

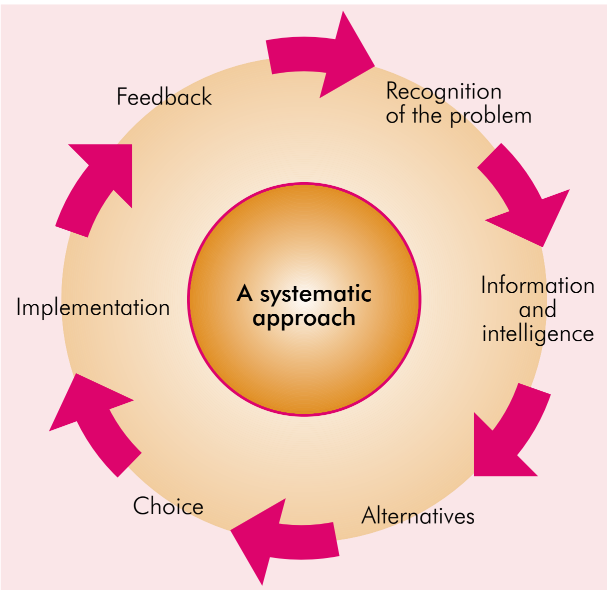
Introduction

Financial accountants keep records of business transactions such as sales invoices. They use these records to prepare a firm's accounting statements. Management accountants evaluate and interpret this financial data to advise the senior managers in the business. They play important roles in managing business performance and improving decision making.

CIMA is the leading and largest professional body for management accountants with over 171,000 members and students operating at the heart of business in 165 countries. Its members work in financial and non-financial roles throughout organisations and carry out all their training and experience requirements in business itself. This provides them with a unique insight into how their organisations operate. CIMA's mission is to be the first choice for employers in the qualification and development of management accountants. Young people obtain the CIMA qualification and then membership for many reasons. Some want a career in accountancy but do not just want to work with numbers. They look for management and leadership roles where they can contribute to business performance. Others are already managers in business but want to improve their skills in financially-based decision making. CIMA people are financially qualified business leaders and are not limited to working in accountancy practices and finance departments. They are active across a range of management roles in retailing, manufacturing, property, energy and government services.

The decision making process

Effective strategic business decisions bring together the right resources for the right markets at the right time. Timing is crucial. For example, Tesco developed its online ordering and delivery service as internet shopping expanded. Virgin sold off its music stores as downloading music became more popular. The quality of a company's decision making helps it gain an advantage over competitors. Business decisions must reflect an organisation's **aims** (its purpose), such as to maximise returns for its shareholders. They should also relate to its **objectives** (its goals), such as to be the market leader in its field. To achieve its aims and objectives, a business puts in place **strategies**. This approach applies regardless of the size of the business.



Consider a local bakery that operates a small café business. The café is open from 9am to 4pm, Monday to Friday. Competition from a nearby supermarket and fast food outlets is preventing the café business from growing. What action could the café take to increase sales?

The key issue to identify is why customers are choosing other outlets. Is it because of location, price or product quality? Analysing a problem of this kind needs a systematic approach.

CURRICULUM TOPICS
- Decision making process
- Levels of decision making
- Analysing accounts
- Performance indicators

GLOSSARY

Aims: the general end purposes towards which an organisation focuses its activities.

Objectives: the end purposes that an organisation or individual seeks to achieve.

Strategies: long-term business plan of an organisation.

Talking to customers about what they like, visiting other outlets to see the competition and examining in-house data on costs, pricing and service could provide valuable information. Based on this research, alternative courses of action might include cutting costs in order to reduce prices or promoting the café in different ways. The business chooses actions based on evidence in support of its objectives. The decision may be a hard one. As a last resort, the bakery may need to exit the café market altogether if it cannot combat the competition and increase sales. Monitoring the feedback from, or outcomes of, a decision allows the business to know what is working and what is not, which leads to a new decision making cycle.

A rational decision making approach can help to reduce uncertainty. However, the **external environment** of a business adds variable factors which can increase risk. For example, suppose an engineering business needs new cost-saving technology to improve production and make it competitive. Justifying this expenditure becomes more difficult in a **recession**. However, what is the risk of not taking action? Will the business survive without the technology? It is also important to balance risk against the likely return on investment. The extent to which this happens may depend on the organisational culture. Some businesses encourage risk taking; some are more risk-averse. Virgin reflects its owner, Richard Branson, an entrepreneur who thrives on risk taking (both in business and in his personal life). The Nationwide Building Society, which has a duty to safeguard its members' money, adopts a more cautious approach. High-performing organisations use the skills of their people to ensure they make more effective decisions than poor ones.

Levels of decision making

Decisions are made at different levels in an organisation's hierarchy:

- **Strategic decisions** are long-term in their impact. They affect and shape the direction of the whole business. They are generally made by senior managers. The managers of the bakery need to take a strategic decision about whether to remain in the café business. Long-term forecasts of business turnover set against likely market conditions will help to determine if it should close the café business.
- **Tactical decisions** help to implement the strategy. They are usually made by middle management. For the café, a tactical decision would be whether to open earlier in the morning or on Saturday to attract new customers. Managers would want research data on likely customer numbers to help them decide if opening hours should be extended.
- **Operational decisions** relate to the day-to-day running of the business. They are mainly routine and may be taken by middle or junior managers. For example, a simple operational decision for the café would be whether to order more coffee for next week. Stock and sales data will show when it needs to order more supplies.

As these examples show, decisions at all levels need data. A business creates a trail of data. This includes data on sales, employee costs and payments. In a large company, such as Tesco, millions of data items are created every day against thousands of cost and sales headings. This data can provide a picture of trends, which the business can use in its forward planning.

Financial accountants use recorded data to prepare the accounting statements for a business. Every company (large and small) has a duty to keep accounting records and must prepare annual accounts that report on the performance and activities of the company during the year. Financial accountants must ensure these accounts are accurate and prepared in accordance with accounting rules and conventions.

Management accountants need to understand these formal accounting documents. However, because their role involves the analysis and application of data, they must also be familiar with business strategy and risk management. Management accountants use internal data (like a balance sheet) and external data (such as market information) to assess effects on the business and drive better informed decision making.

Analysing accounts

In practice the work of a management accountant is rather like that of a detective. The task is to sift through evidence and to extract meaningful messages that will help managers make effective business decisions. The starting point is often the basic accounting documents that record the progress of any business.

GLOSSARY

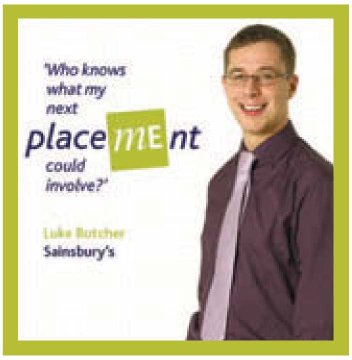
External environment: factors outside the business over which it has little control.

Recession: a time near the bottom of the business cycle when demand is falling and businesses sell less than they had planned to.

Strategic decisions: decisions made to provide advantages for an organisation and affecting it long-term.

Tactical decisions: decisions based upon strategic policy decisions, affecting shorter-term issues within the organisation.

Operational decisions: affecting the day-to-day running of the business.



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There are two key documents:

- the **income statement** is an aggregated record of all sales and all corresponding expenses over a given past period – typically a year
- the **balance sheet** explains how the business is currently using its resources and how those uses have been financed. It 'balances' the assets employed (all long-term resources in the business) against the **capital employed** (the long-term finance in the business).

These documents are closely related and need reading together. The balance sheet is a snapshot of a business at one point in time. The income statement is dynamic and describes the flow of money through the business over a period of time.

This example focuses on JJB Sports, one of the UK's largest sports retailers. It shows how management accountants were able to use information from the company's accounting documents to identify potential problem areas. JJB Sports was formed in 1971. The business started out with just one shop. The company expanded rapidly and it was floated on the London Stock Exchange in 1994. However, the business began to falter during 2007.

JJB Sports income statements 2007 and 2008

	2007 £m	2008 £m
Sales revenue	810.3	811.7
Cost of goods sold	425.3	405.6
Gross profit	385.0	406.1
Overheads	346.0	394.8
Operating profit	39.0	11.3
Other income	(0.5)	(0.5)
Pre-tax profit	38.5	10.8
Tax	12.7	1.2
Profit after tax	25.8	9.6

Financial data in isolation is not meaningful. To say that JJB Sports made a pre-tax profit of almost £39 million in 2007 reveals little. By comparing data over time and by calculating financial ratios a management accountant would identify a different picture. The data shows that the company's financial position weakened in some respects in 2008. Although sales remained fairly constant, the income statements show that pre-tax profits fell from £38.5 million to £10.8 million. JJB Sports' **return on capital employed** also fell significantly. This is an important financial ratio, as it is a measure of how well the company is exploiting the assets at its disposal. It is calculated by expressing a company's net (pre-tax) profit as a percentage of the capital employed.

JJB Sports balance sheets at years end 2007 and 2008

	2007		2008	
	£m	£m	£m	£m
Non-current assets		414.8		417.2
Current assets	358.0		372.3	
Current liabilities	(300.0)		(301.6)	
Net current assets		57.9		70.7
Assets employed		472.7		487.9
Loan capital		95.7		122.8
Share capital	181.2		183.1	
Reserves	195.8	377.0	182.0	365.1
Capital employed		472.7		487.9

This analysis suggested that, although JJB Sports was making sales, it was not getting value from those sales. Management accountants can compare the financial performance with other businesses in the retail and sports goods sectors for context.

GLOSSARY

Income statement: a statement setting out sources of income for a business e.g. sales revenue, interest earned etc as well as deductions for costs, interest paid etc. The term income statement has replaced profit and loss account under IFRS.

Balance sheet: this is a financial document that shows what a business owns (assets) and what it owes (liabilities) at a particular moment in time.

Capital employed: the total amount of capital (expressed in money terms) used by the business from all sources.

Return on capital employed (ROCE): the return on all the funds invested in the business expressed as a % of that capital.

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They would analyse the data further to highlight those areas where JJB Sports managers should take action. They would be concerned that:

- the reduced cost of goods sold in 2008 was not generating increased profits
- increased overheads were eating into potential profit.

Performance indicators

Key performance indicators (KPIs) are an important management tool and help to monitor the achievement and progress towards targets. A well-made set of KPIs or **metrics** enables a business to know if it is on the right track. Data used in this way can improve efficiency ('doing things right') and effectiveness ('doing the right things'). As management accountants are familiar with the strategy for the whole business, they can work with department managers to identify the appropriate measures for recording progress in each area. For example, Tesco uses the 'Tesco Steering Wheel' as a tool to drive performance. This states key performance indicators for people, finance, customers, operations and the community. Every store has its own steering wheel and its own target KPIs. Quarterly results are reported to head office. The table shows the company's performance against two KPIs.

Key performance indicator		Performance	
			Blue = above target Red = below target
Carrier bags	Reduce carrier bags given out by 25% over 2 years to 2008		Saved around 1.3 billion bags – over 25%
Landfill avoidance	To divert 75% of waste from landfill		70% of our waste was diverted

Adapted from Tesco plc Annual Report 2008

The carrier bag target has been easily achieved. The missed target on landfill avoidance will trigger a new round of action for 2009 or a modified KPI if the target is found to be unachievable. Using the feedback from the KPIs allows Tesco managers to make informed decisions and adjust strategy if necessary.

Conclusion

CIMA is the employers' choice when recruiting financially qualified business leaders. As CIMA members are management accountants they have broad-ranging business and management skills to complement their financial training. They are able to offer strategic and practical advice, manage risk and make and support key decisions at all stages of the decision making process. For example, at the problem recognition stage, they may be the first to detect an opportunity or approaching threat. At the ideas stage, they can help to provide creative solutions.

Management accountants also consider qualitative performance indicators such as brand reputation and customer satisfaction. They analyse external information, for example, about competitors and they may benchmark performance against similar organisations to help improve business efficiency. Management accountants have a far from 'back room' role. They are much more likely to be key partners in shaping strategy and contributing to competitive advantage in a business.

Questions

1. How is management accounting different from financial accounting?
2. What skills does a management accountant need?
3. Suggest ways in which a management accountant might contribute to a formal decision making process.
4. How far do you think that financial analysis can enable business managers to make the right decisions?

GLOSSARY

Key performance indicators: Financial and non-financial measures to monitor performance across a range of activities within a function, department or role.

Metrics: measurements.